MOD Private Finance Unit
Guidance Note
Assessing Value for Money

Version 3

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This document can be found on the MoD PFU website at :

http://www.mod.uk/DefenceInternet/AboutDefence/WhatWeDo/FinanceandProcurement/PFU/PrivateFinanceUnit.htm

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Issue No	Details Of Amendments Made	Amended By	Date
1	First issue	R Haria	January 2007
2	Second Issue	R Haria	August 2008
3	Third Issue – Updating links to external guidance	R Haria	August 2009

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Constraints

1. This guide is designed for those responsible for assessing Value for Money (VFM) appraisals of projects being considered for procurement through the Private Finance Initiative (PFI). This guidance supplements HMT Value for Money Assessment Guidance[1] published November 2006 and adapts it to meet MOD business practices. This guide should also be read in conjunction with the PFI Procurement Process Guidance Note[2], JSP 507 (MOD Guide to Investment Appraisal and Evaluation)[3] and Smart Approvals[4].

2. This guide is applicable to those MOD projects that are considering procurement through the Private Finance Initiative. The VFM assessment does not apply to all procurement routes; it is applied only to programmes and projects where the Procurement Authority believes that the evidence of the benefits which PFI can offer indicate that there is a prima facie case for considering PFI.

3. In accordance with HMT rules, Information Technology-based projects and projects involving a capital investment of less than £20m should not be procured through PFI. Projects procured through routes other than PFI will continue to follow extant departmental guidance in JSP 507 to establish VFM.

Authoritative Guidance Summary

4. HM Treasury instituted a revised process for assessing the value for money of PFI projects at Spending Review 2004. This process gives an indication at an early stage as to whether PFI is likely to represent value for money based on real evidence of PFI in practice, and employs an ongoing assessment of the project to ensure value for money is maintained during procurement. The value for money assessment process contains three stages:

[1] http://www.hm-treasury.gov.uk/ppp_vfm_index.htm
[2] The PFI Procurement Process Guidance Note is currently being updated and re-titled as The PFI Handbook. Copies of PFI Procurement Process Guidance Note will be provided on request
[3] http://defenceintranetds.diiweb.r.mil.uk/sites/polestar/cs/DocumentLibrary/11/2072_JSP507_Investment_Appraisal_and_Evaluation.pdf
[4] http://defenceintranet.diiweb.r.mil.uk/DefenceIntranet/Library/CivilianAndJointService/BrowseDocumentCategories/Procurement/AcquisitionProcess/InvestmentApprovals/SmartApprovalsGuidanceV10DatedJanuary2009.htm

1. Stage 1: is an initial assessment undertaken by departments during the Spending Review of whether PFI is likely to provide value for money for a whole programme of investment projects;

2. Stage 2: is a later assessment undertaken by the Authority working on a project within the PFI programme to assess whether PFI is likely to provide value for money given the individual circumstances of a particular project; and

3. Stage 3: is an ongoing assessment of the continued competitiveness of the market to ensure that value for money is not compromised once the assessment that PFI is the best route has been made and the procurement commenced.

Authoritative Guidance

Introduction

Role of MOD PFU and DASA-DESA

5. Within the MOD, lead responsibility for PFI lies with the MOD Private Finance Unit (MOD PFU). The MOD PFU plays an important role in both supporting the procuring organisation when undertaking the VFM assessment and when reviewing the outcomes of the assessment. A dedicated Project Support Officer (PSO) from the MOD PFU will assist and provide guidance to the Project Teams in undertaking the VFM assessment. DASA-DESA will provide support and assistance to the Project Teams with quantitative aspects of the VFM assessment at Stages 1 and 2 and with the development of the reference model and risk assessment at Stage 3. Both MOD PFU and DASA-DESA will review the outcomes of the VFM assessments.

Value for Money

6. The central proposition should always be that PFI should only be pursued where it delivers VFM, where VFM is the optimum combination of whole life cost and quality (or fitness for purpose) to meet the user's requirement, and this does not necessarily mean choosing the lowest cost bid.

Background

7. The PFI approach involves the public sector in contracting to purchase quality services, with defined outputs, from the private sector on a long term basis, and includes maintaining or constructing the necessary infrastructure so as to take advantage of private sector management skills, incentivised by having private finance at risk.

8. Because PFI is characterised by a long term, whole-of-life commitment by the private sector to deliver and maintain new public infrastructure, it will only be suitable for certain types of investment;

- PFI is one of a number of procurement options open to the public sector for modernising infrastructure and involving the private sector in improving public services with its own characteristics, costs and benefits;

- PFI should only be used where it is appropriate, in line with Government's commitment to efficiency, equity and accountability;

- there should be no inherent bias in favour of one procurement route over another and this principle must be followed throughout the procurement process.

9. In keeping with these aims, procurement decisions need to consider which procurement option is most appropriate, given the nature of the capital investment and the public service with which it is associated. The decision must involve an unbiased and rigorous assessment of all available options to determine the option, which is most likely to represent the best value for money.

10. HM Treasury instituted a revised process for assessing the value for money of PFI projects at Spending Review 2004. This process gives an indication at an early stage as to whether PFI is likely to represent value for money based on real evidence of PFI in practice, and employs an ongoing assessment of the project to ensure value for money is maintained during procurement. The value for money assessment process contains three stages:

- Stage 1: is an initial assessment undertaken by departments during the Spending Review of whether PFI is likely to provide value for money for a whole programme of investment projects;

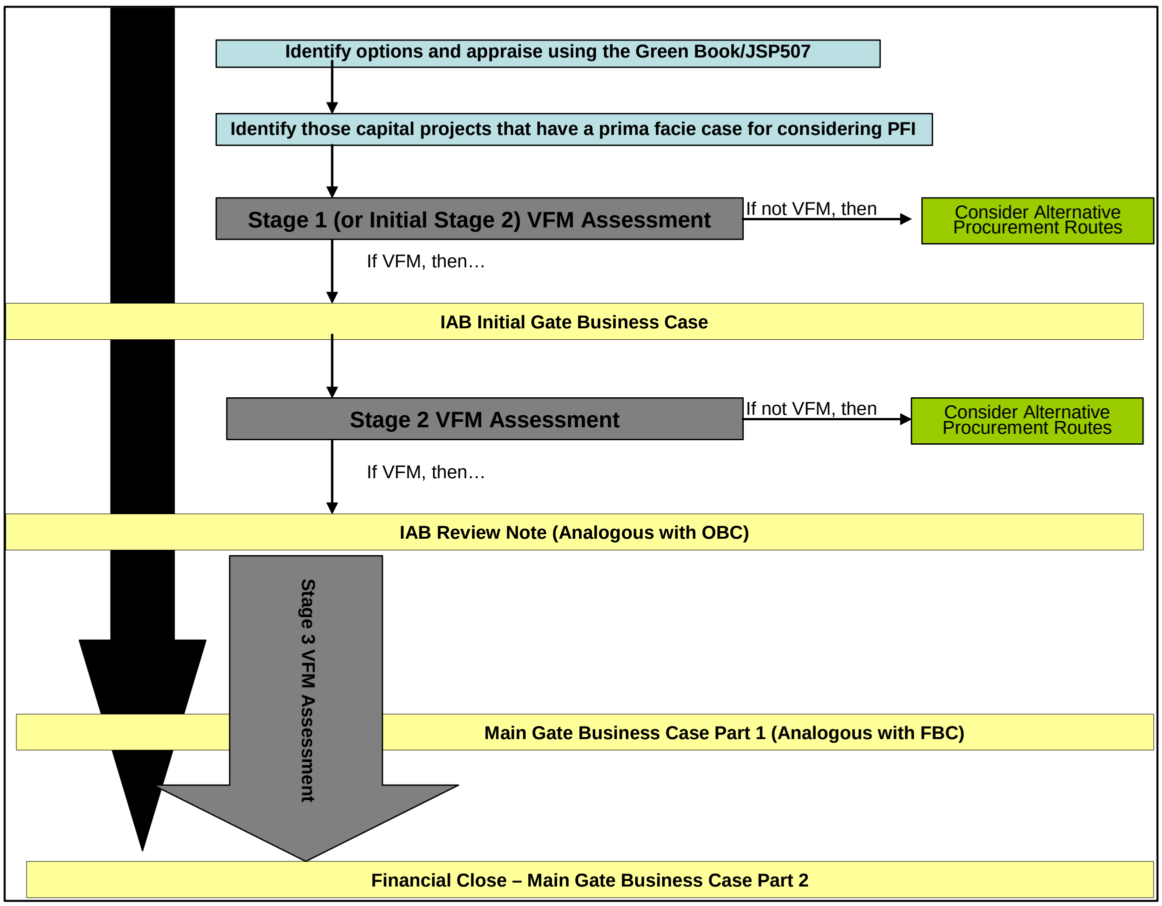
- Stage 2: is a later assessment undertaken by the Authority working on a project within the PFI programme to assess whether PFI is likely to provide value for money given the individual circumstances of a particular project; and

- Stage 3: is an ongoing assessment of the continued competitiveness of the market to ensure that value for money is not compromised once the assessment that PFI is the best route has been made and the procurement commenced.

11. Given the unique nature of MOD projects, HMT accepted that it was likely that Stage 1 and Stage 2 for some MOD projects would overlap

and that a conventional Stage 1 assessment detailed in the HMT VFM guidance could be omitted. However, for these projects, an initial Stage 2 assessment has to be applied at the inception of the projects and again once the IAB Review Note (Outline Business Case) stage is reached. Projects should then proceed as per the guidance, taking account of any extenuating circumstances. The Road Map for undertaking a VFM assessment of potential PFI investment proposal is listed below:

The PFI Value for Money Road Map



12. The Road Map highlights the steps that the project team must undertake in order to assess the VFM of a potential PFI investment proposal. The project team must as a first step of the Road Map establish whether the Department needs to undertake the investment to meet a particular need in satisfying Departmental policy as detailed in paragraph 16. If an investment need is identified the project team will need to take a second step to establish whether there is a prima facie case for considering PFI as the preferred procurement strategy. This is accomplished by assessing whether the investment required meets the PFI criteria as set out on paragraph 20. If the project team concludes it has a prima facie case for considering PFI, the project must commence the HMT VFM assessment as detailed in paragraph 21.

If a prima facie case for PFI cannot be established, VFM will be assessed in accordance with guidance published in JSP507.

IAB Approvals

13. As a consequence of aligning the HM Treasury VFM assessment for PFI with the IAB approvals process, special arrangements apply to PFI projects seeking approval. Projects should follow the specific guidance for PFI contained in SMART Approvals and they **must** engage with IAB Sec at the earliest opportunity.

Single Bidder Projects

14. There may be certain rare occasions when 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. Where this is the case and the authority is able to demonstrate this to the satisfaction of its own Accounting Officer and the MOD PFU, the authority may wish to pursue a single source procurement.

a) 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.

b) If the assessment suggests that PFI is VFM then the procuring authority should consider what other protections it can 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;

- Gathering data on comparable procurements so the prices, terms and conditions can be compared and benchmarked. Government has a clear preference for market testing ahead of bench-marking;

- Ensuring that specialist technical advice relevant to the particular service is available either in-house or through appointing external advisors; and

- Ensuring 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 re-tender the contract should new suppliers enter the market.

c) Although the decision as to whether to proceed or not rests with the Accounting Officer of the Project Team, there is a requirement to inform HM Treasury through MOD PFU where a project is proceeding as a single source PFI procurement. The procuring authority should also refer to departmental and OGC guidance on dealing with single supplier procurements.

Soft Services Facilities Management Test

15. Soft facilities management (also known as soft services) generally relate to the day-to-day supporting services such catering, cleaning, security etc. that support the operation of an asset. There is no a priori reason why a PFI scheme should or should not include soft services. The Treasury have introduced a strengthened soft FM test with the aim to challenge further the assumptions the public and private sector utilise for VFM assessments regarding the inclusion of soft FM in PFI. The emphasis for both procuring authorities and the private sector is, at all stages, to provide robust evidence in support of all elements of the VFM assessment. 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. The detailed methodology for the soft services test is set out in paragraph 4.8.

The Investment Decision

16. As with all projects, the first step before assessing the VFM in procurement is to determine whether there is a strategic need for the Department to undertake the investment to meet a particular requirement. The project team will need to follow specific guidance in Chapter 2.2 of JSP507 on how to analyse the strategic need for a potential requirement and whether the Department needs to make an investment to realise that need. As far as it is practicable, the policy decision to invest funds should be separated from the decision to undertake a particular procurement route.

17. The specific steps that the project team needs to undertake are:

- Justify the Requirement: The requirement must be linked to delivering final Defence outputs, and the implicit benefits of committing expenditure to the project must exceed the costs.

- Set Objectives: The objectives of a proposal must be clearly set out in order to identify the full range of options which may be available to deliver the proposal. The objectives should be developed from the requirement, and should clearly identify the outputs expected as a result of implementation.

- Develop Options: A range of options meeting the established objectives needs to be identified. Options need to establish whether all elements are justified; what benefits do individual elements bring; and could better overall VFM be achieved if some elements were removed, or benefits achieved by other means. The list of options should include:

  a) Do nothing;
  b) Do minimum;
  c) Investment Option/s;

- Reviewing and Evaluating Options: The costs and benefits of the options need to be appraised to determine whether an investment decision needs to be made.

18. DASA-DESA will assist the project team to evaluate and appraise options in order to determine whether investment is required to meet a strategic need for the Department. If a decision to undertake an investment is made then the next step is to establish where there exists a prima facie case for PFI procurement.

Identification of Potential PFI Projects

19. Once the project team has established that there is an investment need to meet Departmental policy through the options analysis process, the project team must then establish whether there is a prima facie case for a PFI procurement given the nature of the proposed capital investment and services required. PFI should only be considered where the evidence of the benefits which PFI can offer indicates there is a prima facie case for it. These include:

   - it is a major capital investment programme, requiring effective management of risks associated with construction and delivery;

   - the private sector has the expertise to deliver and there is good reason to think it will offer VFM;

   - 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 sharing between public and private sectors can be clearly made and enforced;

   - the nature of the assets and services involved 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 rapid change;

   - planning horizons are long-term, with assets intended to be used over long periods into the future; and

   - there are robust incentives on the private sector to perform.

20. The project team must prepare a report for endorsement by MOD PFU setting out the relevant evidence. For those projects where MOD PFU accepts that there is no prima facie case for PFI procurement, the project team must discard PFI as a procurement strategy and pursue other procurement strategies. The project team will need to follow guidance in JSP507 to establish VFM for these other procurement strategies. Otherwise, where a prima facie case for PFI procurement

strategy exists, the project team must evaluate whether a PFI procurement strategy will deliver a VFM outcome by undertaking the Stage 1 VFM assessments.

Stage 1 - Investment Programme Level Assessment

21. The Investment Programme Level Assessment should be carried out as part of the development of an individual project's Initial Gate Business Case (IGBC). HMT requires that the Investment Programme Level Assessment tests the potential value for money of procurement options when overall investment decisions are made, to ensure PFI is used only in those sectors where it is appropriate and where there is a good value for money case. It also requires that departments provide sufficient budget flexibility to accommodate subsequent decisions not to use PFI.

Scope

22. The Stage 1 assessment is predominately designed to assess VFM for a programme which is defined as 'a portfolio of projects that have certain common characteristics and which are selected or commissioned, planned and managed in a coordinated way and which together achieve a set of defined business objectives'. However, HMT recognise that most projects in MOD are large and unique and that they can be described as programmes in their own right.

23. HMT guidance allows Stage 1 assessment to be omitted where a department has a large unique project but Stage 2 should be applied both at the project's inception as part of the spending round and again once the IAB Review Note (Outline Business Case) stage is reached. This means that Stage 2 assessment would have to be completed twice - once at project initiation and at IAB Review Note (OBC) stage.

Approach

24. The Stage 1 assessment comprises two parts, qualitative and quantitative. The project team will firstly need to undertake the qualitative part of assessment. If this indicates that PFI has the potential to deliver a VFM outcome then the project team must proceed to undertake the quantitative part of the assessment. If the qualitative part of the assessment does not suggest PFI would deliver VFM then the project team, with the agreement of the MOD PFU, need not complete the quantitative assessment and PFI will be ruled out as the procurement strategy.

Qualitative Assessment

25. The Stage 1 assessment comprises qualitative questions considering Viability, Desirability and Achievability placing emphasis on assessing the likely value for money of PFI based on evidence from past projects. The qualitative questions, with guidance as to evidence required, are listed below. MOD PFU PSOs can assist project teams in answering the questions.

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	Stage 1 Assessment Requirement
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?	The project team will need to provide evidence or demonstrate that operable contracts exist, or can be constructed, with reference to similar or analogous services being provided in the Department or elsewhere. The project team will need to also confirm that the KURs can be framed into contractual outputs and be objectively measured.
	Is the requirement deliverable as a service and as a long-term contractual arrangement?	The project team will need to provide evidence or demonstrate that: • that the requirement lends itself to be delivered both as a service and as a long-term arrangement; • whether there are any inhibitors preventing it from being delivered; and • whether the service lends itself to providing the private sector with end to end control of delivery of the service.
	Could the contracts describe service requirements in clear, objective, output-based terms?	The project team will need to demonstrate that the KURs can be used to construct clear, objective, output-based terms. The project team will also need to consider whether the required service has clear boundaries and that interfaces have been identified.
	Can the quality of the service	The project team will need to

	be objectively and independently assessed?	provide evidence from contracts providing similar or analogous services as to whether it can conceive meaningful, high-level key performance indicators that can be used as the basis for measuring and remunerating the successful delivery of the required services.
	Is there a good fit between needs and contractible outcomes?	The project team will need to assess whether the fit between need and outcome is well understood.
	Can the contracts be drafted to avoid perverse incentives and deliver quality services?	The project team will need to confirm that performance mechanisms can deliver the right behaviours to provide quality services. If not, the project team will need to explain why not.
	Will there be significant levels of investment in new capital assets?	The project team will need to confirm the level of investment required and whether the capital assets are to be built or refurbished.
	Are there fundamental issues relating to staff transfer or other workforce issues?	The project team will have to determine the likely number, if any, of civilian staff to transfer under TUPE plus the effects on Military manpower. The team should attempt to satisfy itself that the likely VFM to be delivered by the private sector will not be at the expense of existing & future staff's terms & conditions of employment.
	If there are interfaces with other projects, are they clear and manageable?	The project team will need to identify all interfaces and the strategy it will employ to manage them.
Soft services	Are there good strategic reasons to retain soft service provision in-house e.g. longer-term implications of skill transfer?	The project team in conjunction with the HR Business Partner will need to provide evidence as to whether there are, or are not, strategic reasons to include the soft service provision within the PFI.
	What are the relative advantages and disadvantages? Is optimal risk	The project team will need to consider the following issues in their response:

	allocation achieved by transfer or not?	• Whole life costs; • Interface/Single point of contact; • Design integration; • Economies of scale; • Flexibility; • Interim Services; • Incentivisation.
	Is there a commitment that the assumed benefits can be delivered without eroding the overall terms and conditions for staff?	The project team will need to confirm if soft services are included that will not be at the expense of existing & future staff's terms & conditions of employment.
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?	The project team will need to identify the potential long tradeoffs between operational flexibility and cost that may or may not be acceptable to the Department in the delivery of the service over the long term.
	What is the likelihood of large contract variations being necessary during the life of the contract?	The project team will need to provide evidence of the stability of the requirement from a Departmental perspective and the potential likelihood of change whether it is small or large through the life of the contract. Project teams will need to consider technological advances, the impact of organisational changes and future demand for the service in their response.
	Can the service be implemented without constraining unacceptably the flexibility of the department to deliver future operational objectives?	If change is anticipated or likely to happen, the project team must demonstrate it has sufficient funding to allow for operational flexibility under a PFI contract without putting pressure on Departmental resources.
Equity, efficiency and accountability	Are there public equity, efficiency or accountability reasons for providing the service directly, rather than through a PFI contract?	The project team will need to provide evidence as to whether there are any public equity, efficiency or accountability reasons for providing the service directly either by MOD civilian or Military personnel, rather than through a PFI contract. The project team may need to consult with local Human Resource Business Partners on whether

		there are any overriding HR strategic issues that need to be taken into account. Project teams will need to consider whether skills, competencies and capabilities need to be maintained within the Department as core requirements. Project teams may need to also consider the potential use and role of sponsored reserves.
	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?	The project team will need to provide evidence as to whether the required services have clear boundaries and interfaces enabling the contractor to have 'end-to-end' control. As part of the assessment the project must identify all interfaces and relevant stakeholders.
	Are there regulatory or legal restrictions that require services to be provided directly?	The project team will need to identify any regulatory or legal restrictions that would prevent MOD from allowing the private sector to provide the services. The project teams will also need to consider the ownership of the IPR associated with performance/design/development of the assets for the required service may impact on the project.
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?	The project team will need to provide a brief narrative summarising whether the overall investment objectives and desired outcomes can be translatable into outputs that can be contracted for, measured and agreed as well as ensuring 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 disbenefits.

Issue	Question	Stage 1 Assessment Requirement
Risk management	Is the private sector likely to be able to manage the generic risks associated with the programme more	Using evidence from existing programmes and projects, the project team will need to assess and establish whether the

	effectively than the procuring authority?	Department has sufficient expertise to manage the risks in whole or in part or whether the private sector is better placed to manage these risks. Generic risks that need to be considered include the potential likelihood of cost/time over-runs with reference to both conventional and PFI procurement.
	Bearing in mind the relevant risks that need to be managed for the programme, what is the ability of the private sector to price and manage these risks?	The project team will need to provide evidence from existing contracts delivering similar or analogous services whether the private sector has or has not been able to price and manage the relevant risks satisfactorily to. ensure that best value is achieved and retained in terms of price, service level quality and the delivery mechanism.
	Can the payment mechanism and contract terms incentivise good risk management?	The project team will need to provide evidence from existing contracts delivering similar or analogous services whether the payment mechanism and contract terms can or cannot genuinely incentivise good risk management to ensure that best value is achieved in terms of price, service level quality and performance.
Innovation	Is there scope for innovation in either the design of the solution or in the provision of the services?	The project team will need to provide evidence as to the potential scope for innovation by reference to contracts for similar or analogous services. Lack of innovation does not prevent the delivery of the service via PFI.
	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?	The project team will need to establish and identify to what extant is the projects's scope, specification and operation pre-set or open to negotiation with the private sector. The project team will also need identify the degree of flexibility that will be given and whether the design of the solution is free from any imposed standards. The project team must identify any potential restrictions that may inhibit innovation.

	Does a preliminary assessment indicate that there is likely to be scope for innovation in the programme?	Project teams need to identify where innovation may occur and the likelihood of it happening in the project.
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?	The project team will need to provide evidence to underpin their assumptions as to future service demand by commenting on: • Possible changes in future service due to demographics, technological advances or policy changes; • Certainty of requirement and potential changes in End-user requirements; • Whole life costs including design and economic life of assets; • The number of major asset upgrades or refurbishments; and • Risk management and incentivisation. The project team will need to provide an estimate underpinned by evidence as to the expected life of the assets. The project team will need to consider the following factors in their response for advantages or disadvantages of a long term contract: • Certainty of requirement; • Asset lives (including major maintenance and renewals) • Continuity of service • Incentivisation and risk management • Ability to re-compete the contract regularly • Certainty of cost base
Incentives and monitoring	Can the outcomes or outputs of the investment programme be described in contractual terms, which would be objective, specific and measurable?	The project team will need to provide evidence from contracts providing similar or analogous services as to whether it can conceive meaningful contract, which is unambiguous and

	Can the service be assessed independently against an agreed standard?	measurable. The project team will need to provide evidence from contracts providing similar or analogous services as to whether it can be assessed against agreed standards.
	Would incentives for delivery of service levels be enhanced through a PFI payment mechanism?	The project team will need to consider whether the service lends itself to establishing a genuinely incentivised payment regime to ensure that best value is achieved and retained in terms of price and quality of service.
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?	Integrating design, build and operation should lead to facilities that are designed to focus on the whole costs. The project team will need to assess whether this possible and the potential benefits that may accrue. If this is mot possible, will need to explain the reasons as to why not.
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?	The project team will need to provide a brief narrative summarising the main benefit and dis-benefits of using PFI procurement over conventional procurement.
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	Questions	Stage 1 Assessment Requirement
Market Interest	Is there evidence that the private sector is capable of delivering the required outcome?	The project team will need to show by reference to contracts for similar or analogous services that the private sector is capable of delivering the services

		required.
	Does a significant market with sufficient capacity for these services exist in the private sector?	The project team will need to provide evidence that capacity for these services exists in the market the private sector can provide the similar or analogous services.
	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?	The project team will need to liaise with MOD PFU to determine how market appetite for this project can be assessed and whether there is 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?	The project team will identify whether similar projects have come to market and whether they have been successfully delivered. The project team will need to state whether there are any inherent factors that affect the procuring authority's commitment to a PFI solution.
Other issues	Is the procurement feasible within the required timescale? Is there sufficient time for resolution of key procuring authority issues?	The project team will need to show that it has sufficient expertise and appreciation of the PFI procurement process to deliver within the required timescale. If it does not, the project team will need to identify: • the actions it will undertake to manage the procurement process • the process to build up relevant expertise and skills The project team will need provide outline plans for how it intends to undertake the procurement.
	Is the overall value of the contract significant (sufficient for the public and private sector to justify their transaction costs?)	The project team will need to demonstrate that capital value of the project is more than £20M and that total contract costs are sufficiently significant so that transaction costs do not erode VfM.
	Does the nature of the deal and/or the strategic importance of the work	The project team will need to liaise with the MOD PFU to answer the question.

	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?	 The project team will need to demonstrate that it has appropriately skilled staff to define, deliver and support the service throughout the procurement and the subsequent delivery period. If it does not, then the project team will need to provide a plan has to how it will recruit skilled staff or train staff to obtain the relevant skills and competencies
OEVERALL 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?	The project team will need to provide a brief narrative summarising whether there is sufficient client side capability to deliver an achievable procurement that is both attractive to and deliverable by the market.

Quantitative Assessment

26. The quantitative assessment at Stage 1 requires the VFM financial model[5] developed by Treasury and Partnerships UK to be populated. Further guidance on the model and populating the model is provided in 'HMT Quantitative Assessment User Guide[6]. DASA-DESA and the MOD PFU can assist project teams in undertaking the quantitative assessment.

27. The VFM financial model provides a comparison between the risk-adjusted net present value (NPV) of the best value for money conventionally procured option that uses public funding and a PFI option. The model involves a number of simplifications, reflecting the inherent uncertainty surrounding some of the input values and therefore does not include some elements that one would normally expect to see in a conventional procurement or PFI cost estimate. The model is intended to provide a good estimate rather than an exact comparison of the value for money of the conventional procurement and PFI options.

28. The project team will need to undertake an investment appraisal to determine the best public sector conventionally procured option for use

[5] The VFM Financial Model will provided to project teams by MOD PFU
[6] http://www.hm-treasury.gov.uk/d/vfm_qaguide0307.pdf

in the VFM financial model. DASA-DESA will be able to offer project teams assistance with this.

29. The project team is required to input to the VFM financial model estimates of:

- The whole life costs of the conventional procurement, including capital, lifecycle and operating costs;
- The whole life costs that would be borne by a PFI provider, including capital, lifecycle and operating costs;
- The PFI company's debt service costs (interest rates etc);
- Optimism bias;
- Risk transfer;
- Transaction costs.

30. The project team should note that the VFM financial model cannot be used to assess affordability or generate a shadow unitary payment due to differences in methodology and coverage. Affordability is assessed through use of a reference model – see paragraph 69.

Limitations and Constraints

31. In undertaking the Stage 1 assessment, the project team will need to be aware of the following constraints for both the qualitative and quantitative assessments:

- Innovation will be difficult to model – until the market has proposed innovative solutions, their costs and benefits will be unknown. For large unique projects, potential for innovation should be considered as part of the sensitivity check process.

- The MOD evidence base is currently limited and may be of questionable quality. Unique projects may have difficulties in establishing the depth and level of evidence required. However, absence of evidence will not, in itself prevent these projects being taken forward.

Outcomes

32. Once the qualitative and quantitative assessments have been completed, an overall assessment should be made taking into account the results of both. This should recognise any limitations in the component parts of the assessment, but should provide the overall justification both for the preferred procurement route for the programme as a whole, and for its constituent parts. The outputs from the quantitative assessment should not be considered in isolation, specifically as a stand-alone case for, or against, PFI.

Stage 1 Documentation Check List

33. The project team will need to provide the following documentation as part of the Stage 1 assessment:

- Viability, Desirability and Achievability questions answered and the overall position signed off by the project team for each heading.

- A table listing the assumptions behind each of the spreadsheet inputs. Where there is a lack of supporting evidence this should be stated and the method used to approximate the input detailed.

- A plan and timetable to address any gaps in the information collected.

- A table setting out the key scenarios run for the programme spreadsheet and the reasoning behind these.

- The final programme documentation should include:

    - an assurance that there is sufficient flexibility within the overall capital programme to allow the project to switch to a conventional procurement route if it is not VFM as a PFI (no project should proceed as a PFI if it is not VFM);

    - an assurance that the project team has/will have the skills and resources to deliver the programme; and

    - an affordability calculation and the commitment that the specification falls within this envelope.

- A table setting out the programme with timetables.

Stage 2 - Project Level Assessment

34. The Project Level Assessment should be carried out as part of the development of an individual project's Review Note (analogous to an Outline Business Case (OBC)) and **before** there is any formal bidding process with industry. Stage 2 tests the Stage 1 programme level assumption that PFI is the most appropriate procurement route in light of the project's specific characteristics and requires the quantitative and qualitative assessments to be revisited. Where a Stage 1 assessment has not been undertaken, for example because the project is unique and not part of a wider programme, Stage 2 should be applied at project inception as part of the spending round and then again for the Review Note;

Approach

35. As with the Stage 1 assessment, the Stage 2 assessment comprises two parts, qualitative and quantitative. The project team will firstly need to undertake the qualitative part of assessment. If this indicates that PFI has the potential to deliver a VFM outcome then the project team must proceed to undertake the quantitative part of the assessment. If the qualitative part of the assessment does not suggest PFI would deliver VFM then the project team, with the agreement of the MOD PFU, need not complete the quantitative assessment and PFI will be ruled out as a procurement strategy.

Qualitative Assessment

36. This revisits the Viability, Desirability and Achievability of PFI from a project specific perspective. The project team should review its findings from the Stage 1 assessment and consider whether these initial assumptions still hold, allowing for the particular circumstances of the project. If the specific characteristics of a project suggest a different procurement route to the one recommended at Stage 1, then this deviation should be explained and documented.

37. The project team should look forward to 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 IAB Review Note.

38. The qualitative questions are listed below. MOD PFU can assist the project team in answering the questions.

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	Stage 2 Assessment Requirement
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?	The project team will need to update the Stage 1 assessment. Evidence will need to be provided as to: • how operable contracts would be constructed; • what contractual outputs/requirements (KURs) will be measured; and • how the contractual outputs/requirements will be 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?	The project team will need to update the Stage 1 assessment. The project will need to provide such as the Output Based Specification (OBS) as evidence.
	Can the quality of the service be objectively and independently assessed?	The project team will need to update the Stage 1 assessment. The project team will need to provide the high-level performance indicators that will be used as the basis for measuring the successful delivery of the services required.
	Is there a good fit between needs and contractible outcomes?	The project team will need to update the Stage 1 assessment.
	Can the contract be drafted to avoid perverse incentives and to deliver quality services?	The project team will need to update the Stage 1 assessment.

	Does the project require significant levels of investment in new capital assets?	The project team will need to update the Stage 1 assessment and confirm the: • level of investment required; and • new capital assets to be built or refurbished.
	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?	The project team will need to update the Stage 1 assessment highlighting the potential number, if any, of civilian staff likely to transfer under TUPE plus the effect on Military manpower. The local Human Resources Business Partner will need to provide an input as to whether there are any overriding HR strategic issues that need to be taken into account.
	Is service certification likely to be straightforward in terms of agreeing measurable criteria and satisfying the interests of stakeholders?	The project team will need to highlight any specific issues and how they intend to resolve them.
	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?	The project team will need to update the Stage 1 assessment by identifying any specific interfaces or dependencies with other projects. The project team will need to state how they intend to manage these interfaces.
	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?	The project team will need to confirm whether there is an essential need for the Authority to be involved in the delivery of the service. If there is a need, the

		project team will need to identify any specific dependencies such as manpower, data etc that the contractor will have to rely upon from the Authority. The project team will need to assess what the potential impact of failure of the Authority to provide the services and resulting impact upon 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?	The project team will also need to make an assessment as to whether is a strategic need for the Authority to retain control of IPR and what the likely consequences are to Department if it doesn't.
	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?	The project team will need to provide an assessment as to whether service will commence prior to the completion of the asset and what impact it might have to user. The project team will need to assess the how the transition phase will be managed before full service commencement.
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?	The project team will need to update the Stage 1 assessment by stating the specific long-term tradeoffs between operational flexibility and cost that the Department and project are willing to accept for this project.
	What is the likelihood of large contract variations being necessary during the life of the contract?	The project team will need to update the Stage 1 assessment taking into account any technological advances; impact of organisational changes and future demand for the services.

		The project team will also need to state what measures that intend to take to manage change over the life of the contract.
	Can the service be implemented without constraining the delivery of future operational objectives?	The project team will need to update the Stage 1 assessment identifying any constraints that may impede the delivery of future objectives.
	Is there confidence that operational flexibility is likely to be maintained over the lifetime of the contract, at an acceptable cost?	The project team will need to provide evidence of the stability of the requirement from a Departmental perspective and the potential likelihood of change whether it is small or large. If change is anticipated or likely to happen, the project must demonstrate it has sufficient funding to allow for operational flexibility under a PFI contract.
Equity, efficiency and accountability	Are there public equity, efficiency or accountability reasons for providing the service directly, rather than through a PFI contract?	The project team will need to update the Stage 1 assessment.
	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?	The project team will need to update the Stage 1 assessment.
	Are there regulatory or legal restrictions that require services to be provided directly?	The project team will need to update the Stage 1 assessment.
	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)?	The project team will need to assess the likelihood of whether economies of scale can be exploited and, if it can, what is the potential upside to the project.

	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?	The project team will need to provide a brief narrative summarising whether the overall investment objectives and desired outcomes can be translatable into outputs that can be contracted for, measured and agreed as well as ensuring 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	Stage 2 Assessment Requirement
Risk management	Bearing in mind the relevant risks that need to be managed for the programme 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?	The project team will need to update the Stage 1 assessment by identifying how risks are to be allocated between the Authority and the private sector. This includes those risks that are to be retained and managed by the Authority. The project team will need to update the Stage 1 assessment. The project team will need to state whether they intend to seek any specific derogations from the MOD Project Agreement.
Innovation	Is there scope for innovation in	The project team will

	either the design of the solution or in the provision of the services?	need to update the Stage 1 assessment.
	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?	The project team will need to update the Stage 1 assessment by providing evidence, where appropriate, of any constraints that reduce flexibility or the nature of the technical solution being proposed.
	Does a preliminary assessment indicate that there is likely to be scope for innovation in the programme?	The project team will need to update the Stage 1 assessment by identifying areas where innovation in the delivery of services is likely to happen.
	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)?	The project team will need to provide evidence as the potential third-party revenues opportunities and what the likelihood of generating sufficient revenues.
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?	The project team will need to provide evidence to underpin their assumptions as to future service demand and contract length. The project team need to consider: • Possible changes in future service either due to technological advances or policy changes; • Changes in End-user requirements; • Whole life costs including design and economic life of assets; • The number of major asset upgrades or refurbishments; and • Risk management and incentivisation.

	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?	Project team to update the Stage 1 assessment. The project team will need to provide evidence as to how they intend to maintain long term VFM over the duration of the contract. If the project team is not going to use either benchmark or market testing, they need to identify what other mechanisms they intend to use.
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?	The project team will need to update the Stage 1 assessment by providing evidence they have produced a meaningful draft contract which is unambiguous and requirements are measurable. The project team will need to update the Stage 1 assessment by providing evidence of the draft set of standards that they intend to use to measure performance The project team will need to update the Stage 1 assessment and provide evidence to underpin their assumptions.
Lifecycle costs	Is it possible to integrate the design, build and operation elements of the project? Are there significant ongoing	The project team will need to update the Stage 1 assessment highlighting the elements of the project that will be integrating design, build and operation. Where integration does not happen, the project will need to explain the reasons why not. The project will need to

	operating costs and maintenance requirement? Are these likely to be sensitive to the type of construction?	update the Stage 1 assessment.
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?	The project team will need to provide a brief narrative summarising whether the additional cost (risk premium) of PFI outweigh the benefits that it has over conventional procurement
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	Stage 2 Assessment Requirement
Market interest	Is there evidence that the private sector is capable of delivering the required outcome?	The project team will need to update their Stage 1 assessment by providing tangible examples of private sector delivering the services required.
	Does a significant market with sufficient capacity for these services exist in the private sector?	The project team will need update their Stage 1 assessment highlighting any specific supplier capacity issues.
	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?	The project team will need to update their Stage 1 assessment.
	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?	The project team will need to update their Stage 1 assessment highlighting whether any inherent factors have subsequently emerged to affect the procuring authority's commitment to a PFI solution.

	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?	The project team will need to liaise with MOD PFU to answer this question. The project team will need to demonstrate that it has a good understanding of the risks through an appropriate risk management strategy
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?	The project team will need to update the Stage 1 assessment by providing a detailed timetable for the procurement process highlighting any issues that may impact upon timescales. The project team will need to update the Stage 1 assessment, highlighting any issues that may impact upon transaction costs. The project team will need to update their Stage 1 assessment but they may need to liaise with the MOD PFU to answer the question. The project team will need to update their Stage 1 assessment highlighting whether it has sufficient client-side capability to manage the procurement process and subsequent operational delivery phase.
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?	The project team will need to provide a brief narrative summarising whether there is sufficient client side capability to deliver an achievable procurement that is both attractive to

		and deliverable by the market.

Quantitative Assessment

39. This assessment revisits the quantitative assumptions made at Stage 1. The project team should update the spreadsheet in light of the project's specific characteristics and on the basis of past experience. However, an input should only be changed where there is justifiably better information, e.g. capital expenditure. Teams should not alter the figures estimated; especially for risk factors such as Optimism Bias, without substantial evidence supporting the change. Further guidance and help on the Stage 2 Quantitative Assessment will be provided by DASA-DESA and MOD PFU.

Outcomes

40. Once the qualitative and quantitative assessments have been completed, an overall assessment should be made taking into account the results of both. This should recognise any limitations in the component parts of the assessment, but should provide the overall justification both for the preferred procurement route for the programme as a whole, and for its constituent parts. The outputs from the quantitative assessment should not be considered in isolation, specifically as a stand-alone case for, or against, PFI.

Soft Services Assessment

41. Project teams will need to undertake a detailed assessment of the merits of transferring soft services to the contractor as part of the project assessment at Stage 2. If the Stage 1 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 the Stage 1 qualitative assessment has indicated that the project 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. The project team will need to answer the questions below as part of the assessment:

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 these 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 budgets 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 establish 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?	

Stage 2 Documentation Check list (for inclusion in the IAB Review Note (OBC))

42. The project team will need to provide the following documentation as part of the Stage 2 assessment:

- Viability, Desirability and Achievability questions answered and the overall position signed off by the project team for each heading.

- Questions to Soft Services assessment answered highlighting whether or not the overall benefits of including soft services in PFI outweigh any additional costs and constraints.

- A table listing the assumptions behind each of the spreadsheet inputs. Where there is a lack of supporting evidence this should be stated and the method used to approximate the input detailed.

- A table setting out the key scenarios run for the project spreadsheet and the reasoning behind these.

- Analysis of the quantitative spreadsheet outputs and conclusions.

- A table setting out the reasoning behind changes made from the Stage 1 analysis.

- An updated affordability calculation and an assurance that the project specification falls within this.

Stage 3 – Procurement Level Assessment

43. This stage follows on immediately from Stage 2 and is more iterative in nature. The emphasis is on identifying market problems early in the process This stage will apply throughout the procurement period, from the issuance of the Official Journal of the European Union (OJEU) notice through to financial close. VFM is judged by:

- the quality of the competition;
- the success achieved in transferring to the private sector an appropriate level of risk;
- the reasonableness and stability of costs emerging from the competition following an efficient procurement process.

Quality of Competition

44. Table 1 below sets out points which should be considered by the project team and should reflect the nature of the sector. At any stage, if the project team identifies market failure, e.g. lack of competition as a result of a single bidder or perhaps two bidders where only one is credible, then it is unlikely that the project will deliver value for money. In such cases, the MOD PFU should be consulted on whether there are exceptional circumstances in which it is sensible to proceed as a PFI. The reason for the market failure should be examined closely as it is possible that it may, in some circumstances, equally affect a conventional procurement.

45. It should be noted that it is not only the number of bidders which is of concern in this regard; the quality of bidders will be a vital factor. It is possible to have an extremely effective competition with just two players if both are very credible and want to close the contract. In other circumstances three may be insufficient, if only one constitutes a serious contender.

<u>Table 1: Key Stages, Indicators, and Actions (Note, from January 2006 new MOD PFI procurements will be required to utilise the EU Competitive Dialogue procurement process, unless exempt from EU procedures for security reasons)</u>

The key stages and indicators, which should be considered, are:

KEY STAGE	INDICATOR	ACTION
Response to OJEU notice	A strong competition ideally requires a number of well qualified bidders. If the	The project team should reconsider the planned procurement at this time. There

	response indicates that this is not the case then, prima facie, optimal competitive conditions may be absent.	may be a case for revisiting the first stage of stage 3. If the problem is simply one of timing, a delay and re-launch may be appropriate. If the problem is more fundamental, the approach may need to be reconsidered, see outcomes above. A very low response, or only one credible bidder, should be regarded as a warning sign.
Pre-qualification	The project team would ideally want to see a number of strong bidders pre-qualifying and will want to be satisfied that a sufficient number of these will submit bids.	If not, the project team will need to reconsider the planned procurement. As above, there may be a case for revisiting the first part of stage 3. If timing is an issue, the project team should consider the case for delay and re-launch. If the issue is more fundamental, the approach should be reconsidered, see outcomes section above. The project team should only proceed with the minimum number of bidders that they are comfortable with, except in exceptional circumstances, and after consultation with MOD PFU (if applicable). If there is only one bidder, there will be a need to reconsider the approach.
Invitation to Dialogue	As above.	With a low number of bids or a proportion which are not credible, the project team will need to reconsider and, where applicable, consult with MOD PFU.
During Dialogue	Any loss of a bidder, which is not a decision of the project team, is a warning signal. If the competition is reduced to a single bidder through loss of bidder(s) (and not from decisions of the Authority) the procurement will need to be reconsidered.	Need to reconsider approach.

Risk sharing

46. Appropriate sharing of risks is key to ensuring value for money benefits in PFI projects are realised. The 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 in line with Standardisation of PFI Contracts Version 3 (SoPC3) and the MOD Project Agreement. The MOD'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 a better outcome.

MOD Project Agreement

47. All procurements should follow the approach set out in the MOD Project Agreement which incorporates SoPC4 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 MOD Project Agreement in order to frame a risk profile for the PFI procurement which provides proper incentives for the private sector to perform efficiently. Value for money judgements should be made on the basis that the risk allocation is a given in this context. It is not appropriate to use value for money arguments to alter the risk sharing arrangements set out in the MOD Project Agreement.

Market abuse

48. Once a preferred bidder has been selected it will be important to ensure that value for money is maintained in the absence of competition tension. Market abuse can be defined as a situation where the bid offered is out of the market, that is to say above the PFI market price for similar projects or where the risk profile has been substantially eroded relative to other similar recent PFI projects at this price. The project team can carry out a high level check of underlying costs against an appropriate range of benchmarks, but this must not involve any reference or return to the quantitative assessment conducted as part of Stage 2.

49. If there is market failure or abuse, this is likely to lead to a poor value for money transaction and the process should therefore be halted and either procured conventionally or cancelled. Bidders should be aware that in the absence of a valid competition this is a real possibility. Bidders should also be aware that projects may be withdrawn for reasons other than value for money.

Funding competitions

50. Where there is doubt over the ability of the bidders to achieve a

competitive rate for funding the PFI project, the project may wish to consider running a funding competition. If it is likely that this option will be exercised, the provision should be stated in the OJEU notice. This will only be appropriate in some cases and thought must be given to the trade off between the transaction costs associated with this versus the potential gains.

51. Changes in the scope or requirement of the project or the project team's requirements following the selection of the preferred bidder should be avoided wherever possible as at this stage competition is absent. Similarly, project teams should be clear about their own responsibilities under the contract and document the internal resource used for the procurement process.

Efficient Timetables

52. A realistic timetable for the procurement should be set out in the IGBC, and the project team should monitor progress against key milestone dates. Significant slippage in the procurement timetable might indicate potential problems in achieving value for money. In particular, the project team 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 value for money must be explicitly considered, as should the drivers behind this slippage. If the period extends significantly a further report should be required based on the checklists above. Consideration of appropriate steps that might be taken to ensure value for money 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 remains suitable.

Detailed Methodology

53. The table below provides a list of issues to consider as part of the continuous assessment of VFM during the procurement phase.

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	Was there a good response to the PIN/OJEU notice?

issues	How many potential bidders passed the PQQ criteria? Is 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? 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?

Evaluation of bids

54. When the bids have been received they should be evaluated to assess whether different proposals are based on different degrees of transfer of a certain risk. If they are, this will need to be taken account of to compare bids on a valid basis. This process is highly relevant to the question of affordability. It is tempting simply to look at the expected payments to the private sector in each year and compare those with the expected budget for the service but thought should also be given to possible financial consequences of risks which are retained by the public sector.

55. If there is a significant chance of such risks materialising and the financial consequences would be unaffordable, then the proposal as a whole should be treated as unaffordable. However, common sense must be applied in this area. The public sector is always bound to retain some risks which could render the project unaffordable if they materialised: these might include events which are classed as force majeure, discriminatory legislation etc. A proposal should not be ruled out on affordability grounds, simply because the public sector "should not" take on the risk of high impact events like these, the probability of which is very low.

Risk Assessment

56. Table 2 provides a stylised example of PFI bids received for a procurement project. It also illustrates how a project team might approach the standardisation, for comparative purposes, of the costings of these private sector bids. There are three bidders (A, B and C) who have each made a standard bid, with two bidders (B and C) making variant bids. For example, the standard bid by bidder A is for £429m. This price covers the basic procurement costs and also two transferred risks.

57. In this example, all of the three standard bids accept the transfer of the same risks (Design, Build, Finance and Operate (DBFO) and maintenance). The PFI bid prices for the procurement specification therefore include costs associated with these transferred risks. The project team has estimated the value of the transferred risks for each bid (£35m, being the sum of DBFO's £25m and maintenance's £10m).

58. The values of the other four risks (health and safety legislation, technology, client changes and discriminatory legislation) in the

example have also been estimated by the project team. These contribute to the overall real present cost of the procurement to the client. For instance, the standard bid by bidder A will cost the public sector client £499m, being the sum of the bid price (£429m) and the retained risks (£70m).

59. The two variant bids have different risk allocations which calls for careful risk accounting to determine which bid represents best value. This is not obvious from examination of the top line in the table, containing the prices of the bids. It might appear that the standard bid of bidder A is the cheapest but it is not in fact the best value for money.

60. Consider the risk adjusted NPV figures in Table 2. The variant bid by bidder B, which, unlike the standard bids, does not accept the transfer of maintenance risk, but does accept the transfer of the health and safety legislation and client changes risks, can be clearly seen to represent the best value for money at £480m, i.e. after the fact that an additional risk (client changes risk, valued at £25m) is to be transferred in this variant bid.

Table 2: Risk Allocation Accounting Amongst PFI Bids

	Standard PFI Bids			**Variant PFI Bids**		
	A	**B**	**C**	**A**	**B**	**C**
Basic NPV (£m)	429	430	440	na	450	450
[including transferred risks]	35	35	35	na	75	50
Retained risks (£m) *Assigned as transferable:*						
DBFO	transfer	transfer	transfer	na	transfer	transfer
Maintenance	transfer	transfer	transfer	na	10	transfer
Assigned as negotiable Health and Safety Legislation	10	10	10	na	transfer	10
Technology	15	15	15	na	transfer	transfer
Assigned as retainable Client changes	25	25	25	na	transfer	25
Discriminatory Legislation	20	20	20	na	20	20
Risk adjusted NPV	**499m**	**500m**	**510m**	**na**	**480m**	**505m**

Notes

1. The expected cost of the DBFO risk is 25
2. “na” means no bid
3. The allocation of risks identified in this simple example owes as much to neatness and convenience as to advised direction or usual experience. For example, it would generally be expected that technology risk would be transferable, and would in fact be transferred (although there may be circumstances, such as security, where this

61. Note that the cost of each risk added to each bid is at the public sector valuation of each risk, not at the private sector valuation of the cost of the risk (which in any case is unlikely to be known by the client team as it will of course be implicit in the total price of the private sector bid). These costs therefore have to be evaluated a priori, without reference to the private sector's valuation which may be very different.

62. The example in Table 2 above illustrates the key point that the comparison of bids should be done at the total or risk adjusted cost line, which includes costs reflecting all the risks which are taken by the private sector under any admissible bid. The only risks which may be excluded are risks not taken by the private sector under any admissible bid. For example, discriminatory legislative risk might be excluded from the VFM comparison.

Transfer of assets for a nominal sum

63. Note that the allocation of risk to the private sector in order to confer optimal incentives to control costs, to maintain service delivery and to improve outcomes will usually involve the private sector raising finance at rates in excess of the public sector's costs of capital. This is generally unavoidable. The benefits of better management arise precisely from the transfer of risk to private managers: the contract puts their capital at risk throughout the length of the contract, and thereby gives them an incentive not only to control costs but also to maintain service quality. These incentives are weakened to the extent that the public sector retains financial risk.

64. Consider, for example, a proposal that involves sale of a property portfolio to a private contractor, who then contracts to provide office services to the public sector using the assets. An apparent saving may be secured by allowing the initial transfer of the ownership of the assets to go through for a peppercorn payment in return for a reduction in the unitary fee charged for provision of the office services. Such an arrangement involves an implicit loan of the value of the properties to be repaid over the course of the service contract. The arrangement may appear attractive to both parties because the contractor's cost of funds may exceed by a significant margin the Treasury Discount Rate. However, in such a case it is important to appraise:

- The implicit risk that remains in the public sector as a consequence (e.g. the default risk on the implicit loan should the contractor sell assets and then fail, or should the public sector charge on the assets prove inadequate);
- The fact that the private contractor's incentive to deliver good service is weakened precisely to the extent that they have effectively received payment in advance.

65. Proposals to transfer assets to the private sector for a nominal sum must be subjected to an investment appraisal to demonstrate that the terms offered represent value for money to MOD.

Project Evaluation

66. As with traditional procurement projects there is a need to evaluate the performance of the selected option following implementation. While the performance of the contractor in meeting the Statement of Requirement will be continually monitored, a more substantive evaluation will be needed to see if there are any lessons to be learnt from the negotiation process and the private sector's perception of risk. An area to be specifically addressed is the extent to which the project objectives detailed in the appraisal have been met. For more detailed guidance on project evaluation, see JSP 507 (MOD Guide to Investment Appraisal and Evaluation).

67. It is best practice to monitor the risk mitigation procedures adopted by PFI suppliers so that any lessons that can be learnt may be applied to subsequent management of risks retained by MOD. Continual improvement of risk management in MOD may feed back into better out-turns and affect the quantum of risk adjustments applied to future projects.

Stage 3 Documentation

68. The project team will need to document their findings as part of the ongoing Stage 3 assessment:

PFI Reference Model (Should Cost Model).

69. A PFI reference model should be developed and maintained by the project team from the inception of the project. The PFI reference model should be constructed on the basis of a 'Should Cost Model', where it represents the Department's interpretation of what a potential PFI for the stated requirement may look like in terms of cost.

70. The PFI reference model serves two main purposes:

- To provide the basis of a realistic affordability calculation based on a PFI profile;

- To provide a tool for bid evaluation purposes.

Please note the PFI reference model is not to be used as a VFM benchmark or public sector comparator.

71. To achieve these aims, the reference model should be developed at the earliest opportunity and to an appropriate level of detail to make informed decisions. The inputs for the reference model can be derived from the best value for money conventional option identified at Stages 1 and 2. However, assumptions for PFI financing and risk transfer will need to be reflected in the model to convert the inputs into a PFI profile. The inputs to the PFI reference model can also form the basis of an alternatively funded fallback solution, which could be adopted should PFI fail.

72. DASA DESA will provide support and advice on preparation of the PFI reference model and fallback solution. Further guidance on constructing the PFI reference model is being developed and will be issued in due course.

Further Information

Relevant Guidance for Acquisition Teams

HM Treasury Value For Money Assessment Guidance November 2006

Smart Approvals