MOD COMMERCIAL

MOD Private Finance Unit Guidance Note:

Introduction to Private Finance Initiative (PFI) in Defence

Version 2

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Defence Equipment & Support

MINISTRY OF DEFENCE

MOD PFU Contacts

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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CONTENTS LIST

MOD PFU GUIDANCE NOTE: INTRODUCTION TO PRIVATE FINANCE INITIATIVE (PFI) PROCUREMENT

CONSTRAINTS

1. This guidance is designed for members of the defence acquisition community involved in projects and programmes considering or using the Private Finance Initiative (PFI). The guidance is designed to help readers understand the key characteristics of a PFI procurement approach and to give them an overview of the issues and processes associated with the use of the PFI in MOD. It does not attempt to cover the subject in detail and should not be used as the sole source of information. More detailed guidance on specific topics is published on the MOD Private Finance Unit (PFU) Defence Intranet and MOD Internet sites and referenced in the guidance. It should also be read in conjunction with the MOD Acquisition Operating Framework (AOF) as it does not provide guidance on many facets of MOD acquisition not specific to PFI.

2. It is MOD policy that the following mandatory requirements regarding PFI are adhered to:

    - MOD PFU **must** be consulted on all defence projects and programmes considering or using PFI or where there is a clear case for PFI.
    - A decision to use PFI **must only be made** after a stringent assessment of whether it offers better value for money than conventional or other procurement approaches.
    - **All** IAB Category A-C projects **must** consider using PFI.
    - **All** PFI projects/programmes **must** use HM Treasury and MOD PFU mandated specific PFI terms and conditions.
    - Acquisition teams **must** obtain MOD PFU's approval prior to issuing any PFI invitation to tender/negotiate/participate in dialogue to industry.
    - MOD PFU **must** be consulted prior to the appointment of financial advisors.
    - Functional lead assurors **must** consult the MOD PFU as subject matter experts before forming an assurance opinion.

AUTHORITATIVE GUIDANCE SUMMARY

3. This note provides guidance to the MOD acquisition community on the key issues to be aware of when considering PFI as a procurement approach.

AUTHORITATIVE GUIDANCE AIM

4. The aim of this guidance is to:

   - provide general guidance to the defence acquisition community on the acquisition of PFI projects and programmes by the Ministry of Defence (MOD);
   - provide an overview of those MOD processes that are specific to PFI acquisition;
   - set out the key considerations that need to be addressed when undertaking a PFI acquisition and act as a signpost to other relevant guidance.

5. This guidance should be read in conjunction with other MOD guidance on the management of acquisition projects contained in the AOF.

6. This guidance has been prepared by the MOD PFU. It reflects current PFI policy and best practice laid down for central government departments by HM Treasury (HMT), and lessons learned from previous MOD PFI deals. It should be read thoroughly and the MOD PFU consulted before any work on a potential PFI procurement begins. Any perceived conflicts between this guidance and other acquisition guidance contained in the AOF should be discussed and resolved with the MOD PFU.

INTRODUCTION

7. The Government's Private Finance Initiative (PFI) was introduced in 1992 for consideration by the public sector in its procurement of public infrastructure and services. Since its introduction, the UK Government has established clear criteria for where PFI is likely to provide better value for money than other forms of acquisition and has made a number of policy reforms to ensure that PFI continues to deliver value for money. As a result the PFI is supported by a considerable body of specific guidance, such as standard contract and value for money guidance, which have become core templates in how to procure a PFI service successfully.

8. PFI is a small but important procurement tool for the MOD in the delivery of its investment programme. Spending on PFI represents about 5% of the Defence Budget. The Government has no preference between conventional procurement, PFI and any other procurement approach. However, MOD remains committed to using PFI wherever this delivers best value for money, regardless of accounting treatment, but not at the expense of operational effectiveness or terms and conditions of staff. A decision to use PFI is only made after a stringent assessment of whether it offers better value for money than the traditionally procured alternative.

9. PFIs bring together the best of both public and private sectors to help deliver a higher quality of public service than is possible through the public sector alone. MOD is seeing PFI deliver value for money in practice. A review undertaken by the MOD PFU in 2005 found that: 100% of Defence

PFIs were delivered on budget; 88% were within 2 months of the agreed date or early; and 97% were rated as performing satisfactorily or better. This is far better than conventional procurement. PFI is delivering substantial new investment in Defence, with 54 signed deals bringing over £9Bn of private sector capital investment.

10. MODs operational PFI portfolio covers four broad categories of project: accommodation, training, equipment and other infrastructure with an equal split of projects across these four categories. The portfolio covers the delivery of services in the air, sea, land and space arenas. The MODs PFI projects are critical to maintaining operational capability. Several projects directly support frontline military operations, such as the Future Strategic Transport Aircraft, Skynet satellite communication system, Strategic Sea Lift Roll-on Roll-off Ferries and the Heavy Equipment Transporter (using sponsored reserves) – and go physically close to the ‘front line’. Other projects provide indirect support to front line operations, for example by providing training for front line troops. These include simulator training projects such as those for the Medium Support Helicopter Aircrew Training Facility. The MOD has also used PFI to provide other services such as accommodation (for example, office accommodation and barracks e.g. Allenby Connaught) and infrastructure (e.g. water and sewerage services to defence sites).

SECTION 1 – GENERAL BACKGROUND TO PFI

What PFI is

1. PFI is an arrangement whereby the public sector contracts to purchase services, usually derived from investment in assets, from the private sector on a long-term basis, often between 15 to 30 years. Under PFI, the private sector puts its own money on the line, and only gets paid if it actually delivers the contracted services to an acceptable standard. If costs overrun, or if the service is not provided, the private sector bears the financial consequences. Compared with more conventional forms of asset procurement, the PFI is structured to provide a real incentive on the contractor to deliver the underlying asset/s on time and to budget and provides clarity on the level of service expected throughout the contract term against a fixed price. Typically:

    - the private sector will design, construct and maintain infrastructure in order to deliver the services required. The project thus entails a construction phase followed by an operational phase;
    - the private sector party contracting with the public sector is usually a Special Purpose Vehicle (SPV): a company formed with the specific goal of delivering the project, and can have one or more shareholders;
    - much of the risk assumed by the SPV in the contract is passed to other entities (which sometimes are also shareholders in the SPV) through sub-contracts;
    - the SPV manages and delivers the required services to specified standards, while sustaining the quality of underlying assets;
    - the SPV uses private finance, usually a mix of equity (share capital injected into the SPV by the project sponsors and/or third party investment companies) and debt (bank loans or bond finance), to fund the construction works or capital assets;
    - the SPV is paid a fee for the service it provides to the public sector. There is no separate income stream in respect of the infrastructure or assets. The fee is often referred to as a unitary payment and covers costs related to debt repayment (principle and interest), expected operating costs associated with providing the services delivered and maintaining the assets, and a return to the SPV's shareholders;
    - the public sector normally starts to pay the SPV only when construction is complete and once services start being delivered. The pre-agreed unitary payment continues to be made over the rest of the contract life.
    - The unitary payment is at risk to the SPV's performance during the life of the contract, such that payment is reduced if performance falls below the required standard.

The Benefits of PFI

2. The Government remains strongly supportive of the performance, cost and time benefits that PFI can deliver over conventional procurement.

3. One of the original drivers behind the introduction of the PFI was the emphasis it places on the transfer of construction cost and time overrun risks to the contractor. Experience has demonstrated that, under a PFI arrangement, the public and private sectors have become much better at identifying risk factors, valuing them in the contract and managing them over the duration of the contract than is the case under conventional arrangements. The advantages of this are that:

    - Project risk can be effectively managed and shared between the private sector partners to the deal;
    - Effective risk allocation creates incentives to ensure that projects are delivered on time and to budget;
    - Clear lines of accountability for project performance increase transparency and individual responsibility.

4. Unlike conventional procurement where assets tend to be procured under one contract and maintained under another (or in-house), under PFI, the contractor is generally responsible for designing and constructing the asset and also for delivering the ongoing services employing that asset. This approach is a key factor in achieving value for money in the operational performance because it incentivises the contractor to:

    - design the asset to maximise the efficiency of its long term maintenance and value,
    - seek innovation so that operating costs and quality over the whole life of the contract are optimised, and
    - make suitable provision for lifecycle expenditure to ensure that the asset is maintained to a suitable and serviceable standard.

5. The disciplines of PFI transparency and accountability are having the effect of improving financial management and planning capability within public sector organisations. The ongoing cost of maintaining infrastructure and assets and delivering high standard public services are identified and budgeted for from the outset and regular benchmarking/market testing/value for money reviews ensure economic delivery of the ongoing service.

SECTION 2 – PFI POLICY AND KEY CONSIDERATIONS

HMT policy on PFI

1. HMT reiterated its policy on PFI in its publication Infrastructure procurement: delivering long term value[1]. This confirms that the Government has no preference between conventional procurement, PFI or any of the other public private partnership (PPP) procurement approaches outlined in the document. Its policy remains that PFI should be used for value for money reasons, regardless of accounting treatment, but not at the expense of staff terms and conditions.

2. Since its introduction, PFI has evolved and a standard approach to risk allocation between the public and private sectors has been established. PFI contracts must be drawn up in accordance with HMT's Standardisation of PFI Contracts (SoPC) which includes mandatory principles and drafting for certain key contractual clauses. Deviation from this standard is acceptable only if HMT agreement to the particular derogation has been obtained.

3. In response to HMT's recommendation that it "would encourage procuring bodies to develop SoPC compliant sector specific contracts" the MOD PFU prepared a standard form of MOD PFI contract - MOD PFI PA, first issued in August 2006 - which is mandated for all MOD PFI deals in procurement at that time and all subsequent PFI deals. Further detail on this topic is provided under the heading "Standardised Contract" in Section 3.

MOD Policy

4. The MOD wholly adopts HMT's PFI policy with PFI being just one of a range of procurement approaches used by MOD in the delivery of its investment programme. The MOD PFU has overall responsibility for the MOD's PFI programme – covering both projects in procurement and operational projects. It provides a central focus for PFI policy and support within the Department and offers corporate assurance about individual PFI projects to the Investment Approvals Committee (IAC) and HM Treasury. Its role is also to provide advice, assistance and support, as subject matter experts, to the acquisition community.

Legal Framework

5. PFI procurement must follow the EC Public Procurement Regulations and advice should be sought from Central Legal Services Commercial Law (CLS-CL) on the application of the Regulations before commencing a PFI procurement.

6. PFI procurement can involve private sector delivery of a service previously delivered by MOD employees. If this is the case, the Transfer of Undertakings (Protection of Employment) Regulations (TUPE) will apply. Advice on this subject is available from the Defence Business Services organisation (formerly People, Pay & Pensions Agency) and project teams should be aware of TUPE considerations early in the procurement process.

[1] Published on HMTs website and dated March 2008

When to consider PFI

7. A PFI contract may be suitable where:

- The required capability needs a major capital investment (greater than £20 million) in new or refurbished capital assets (e.g. infrastructure or equipment);
- the nature of the required capability allows the Department to define its needs as service outputs in an output based specification that can be adequately contracted for in a way that ensures effective and accountable delivery of public services over the long term,
- the allocation of commercial risks between the public and private sectors can be clearly made and enforced, and the private sector has the ability and willingness to accept significant levels of risk transfer[2] and is able to effectively manage those risks through life, especially those associated with construction and delivery;
- the private sector has the necessary skills and competencies to provide the required service and there is sufficient market capacity and interest to generate and sustain healthy competition;
- the nature of the assets and services identified as part of the scheme, as well as the associated risks, are capable of being costed on a whole-life, long-term basis;
- the overall value of the contract is sufficiently large to ensure that procurement costs are not disproportionate;
- the contractor can be robustly incentivised to provide the required level and quality of service through-life;
- the requirement and associated technology and other aspects of the sector are stable over the contract term, and not susceptible to fast-paced change;
- planning horizons are long-term, with confidence that the assets and services will be required for a long period into the future (typically greater than 15 years);
- the scope of the service has clear boundaries with manageable interfaces with other systems, services or projects and lends itself to providing the service provider with "end-to-end" control of the relevant functional "input" processes;
- there is scope for innovation in either the design of the solution or in the provision of services;

[2] E.g. design, construction, operation, availability, obsolescence, financing, and residual value.

When PFI may be appropriate for Defence

8. In addition to the generic criteria above, a PFI contract may be suitable in the delivery (in whole or part) of a defence capability (subject to demonstration of value for money) where:

- the service can be implemented without constraining the delivery of military operational objectives (see table below);

> **<u>PFI IN "FRONT-LINE"/DEPLOYED OPERATIONS</u>**
> *If the project is to operate or directly support deployed operations, the following should also be considered.*
>
> **Military powers**
> *Are the functions nominally within the service boundary currently free from the need to exercise special military powers or privileges?*
>
> **Transition to war and conflict**
> *Is the delivery of the service (in terms of management or operation) likely to be unchanged (in terms of function and volume) in moving from peacetime operations to transition to war and conflict?*
>
> **Security**
> *Is the service free from any impact on the safety or security of the UK and/or Armed Services personnel?*
>
> **Operational performance/effectiveness**
> *Is there confidence that the performance/availability of a contractor delivered service will be able to meet the operational effectiveness targets defined by the requirement under all scenarios or situations?*
>
> **Operational flexibility**
> *Is there confidence that the performance/availability of a contractor delivered service will be able to meet the requirement for operational flexibility?*
>
> **Performance Risk**
> *Could any shortfalls in service performance/availability/flexibility be managed without a significant performance/operational impact on MOD?*
>
> **Loss of core skills**
> *Would the contractor delivered service provision be free from causing any loss of core skills that have strategic and/or long term importance to the Services?*
>
> **Other organisational inter-dependencies**
> *Would the operation of the service by private sector contractors be free from material inter-dependencies with other operations or agencies?*

- the Department has the capability and desire to focus the necessary skills and resources needed to manage and deliver a PFI acquisition through life;
- good previous experience of similar type requirements or projects being delivered by PFI is a useful indicator, although MOD has also successfully delivered a number of pathfinder PFIs. The effort and commitment needed to deliver PFI projects in new areas should not however be underestimated; and
- where in addition to <u>all</u> the above characteristics, the project can adequately address the critical success factors outlined in Section 5.

When to rule PFI out

9. PFI must not be used:

- for Information Technology based projects,
- where the capital investment is small (i.e. less than £20 million) and the benefits of PFI do not justify the significant costs of procurement,
- where the pre-conditions of equity and accountability in public service delivery cannot be met i.e. where it is not appropriate to attempt to transfer the end-service delivery risk to the private sector, as in most forms of frontline service delivery, or
- where a significant degree of short-term flexibility due to uncertain or fast-changing service requirements is required.

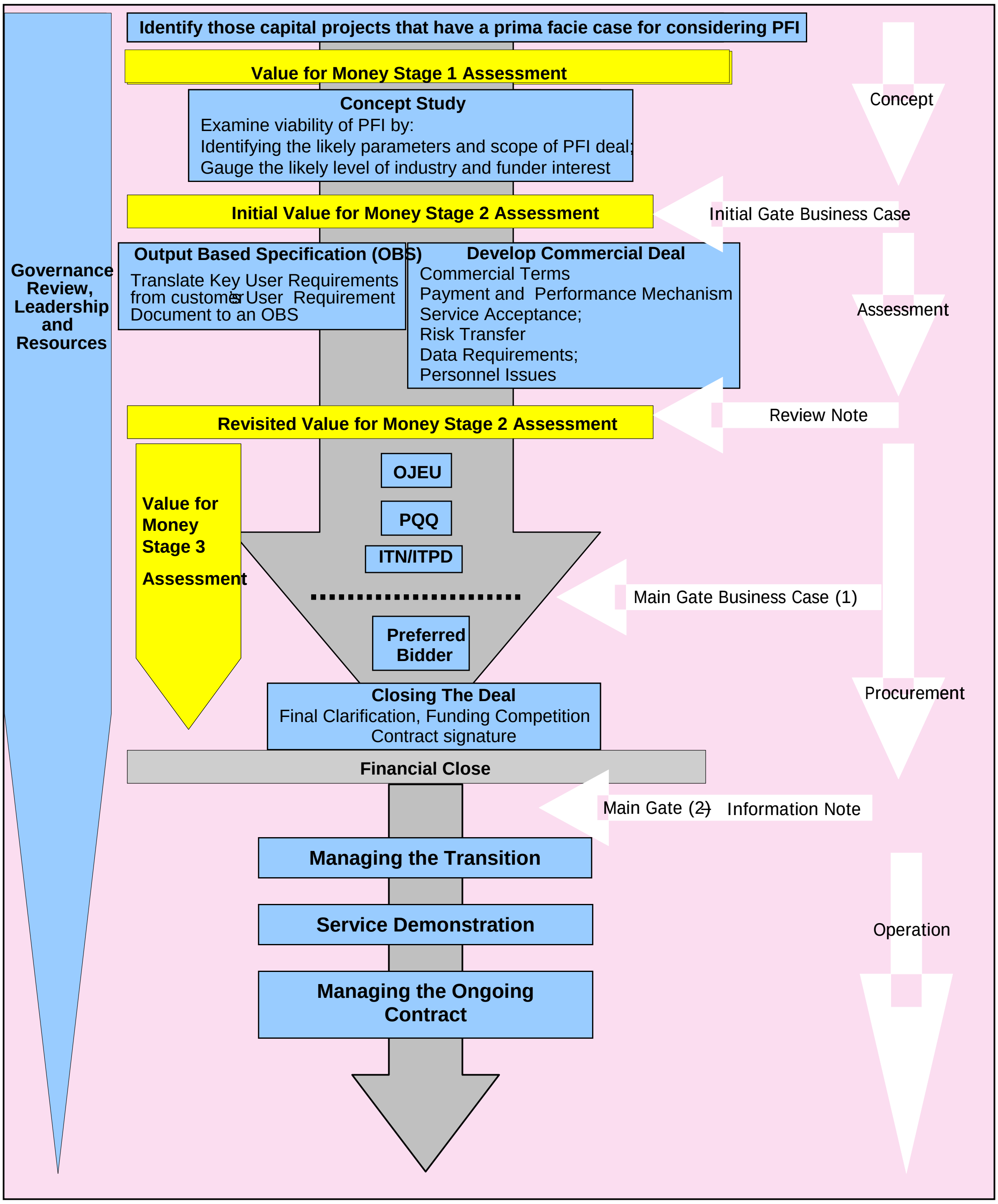
When to consult the MOD PFU

10. Acquisition teams should contact the MOD PFU early in their project's concept phase to assess whether PFI could be a suitable procurement approach for their project, whether further evaluation of the VfM potential is recommended, or whether PFI should be ruled out.

11. Project Teams pursuing a PFI procurement approach will be allocated a MOD PFU Project Support Officer (PSO) with whom regular contact should be maintained throughout the project's procurement, transition and operational phases. Further information on the role of the PSO and MOD PFU support to PFO projects is available on the MOD PFU website (see page 2 for link).

SECTION 3 – THE PFI ACQUISITION PROCESS

1. In general terms PFI acquisition follows a very similar process to other types of procurement conducted under the Negotiated or Competitive Dialogue procedures. A diagram of the key stages of the PFI acquisition process is provided below.



Some aspects of the process are peculiar to PFI acquisition and these are described in outline below.

Value for Money Assessment

2. In order to obtain the benefits of private finance there is an associated risk

premium payable compared with publicly funded projects. This risk premium represents the cost of the private sector taking on and managing certain risks within a project that would otherwise be managed by the public sector and borne by taxpayers. In successful PFI contracts, this risk premium is more than offset principally by the long term focus it brings on whole life costs, the private sector's risk management expertise incentivised by having private finance at risk and the certainty it provides of specified outputs being delivered at the cost contracted for.

3. In 2004 HMT released its Value for Money (VfM) Assessment Guidance and this was updated in 2006. This guidance introduced the three stage VfM assessment process that is currently employed to test the suitability and VfM of PFI. The three stage process has been slightly adapted to meet the needs of the MOD and has been agreed as follows:

   a. <u>Stage 1 - Programme Level Assessment</u>

      The 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 Programme Level Assessment tests the potential value for money of procurement options when overall investment decisions are made, to ensure PFI is used only for projects where it is appropriate and where there is a good value for money case.

   b. <u>Stage 2 – Project Level Assessment</u>

      The Project Level Assessment should be carried out as part of the project's assessment phase and before there is any formal engagement with industry. Stage 2 tests the Stage 1 programme level assumption that PFI is the most appropriate procurement route in light of further project specific evidence and requires the Stage 1 qualitative and quantitative assumptions and assessments to be revisited.

      Both the Stage 1 and 2 assessments comprise two parts - qualitative and quantitative. At both stages the qualitative assessment should be undertaken first. Assessment of factors affecting the viability, desirability and achievability of VfM in PFI underpins the qualitative assessment methodology. If qualitative considerations indicate that PFI has the potential to deliver a VFM outcome then the quantitative assessment should also be used as a support tool for making an overall assessment. If, however, the qualitative assessment indicates that PFI would not deliver VFM at either of the stages, the project team, with the agreement of the MOD PFU, need not complete the quantitative assessment and it is likely that PFI will be ruled out as the procurement strategy.

   c. <u>Stage 3 – Procurement Level Assessment</u>

      For projects continuing to pursue a PFI approach, this stage follows on directly from the Stage 2 assessment. It is more iterative than either of the previous two stages. The emphasis at this stage is a continuous assessment of whether the key drivers of VfM for the project are maintained through to award of contract. The Stage 1 and 2 underlying assumptions are continuously retested to ensure that no material changes which undermine the VfM case have occurred. Key VFM indicators during this phase are associated with:

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

4. If at any point the Stage 3 assessment suggests that the VfM case is being eroded, the project team and the MOD PFU will have to consider whether the PFI procurement should continue or be halted.

Approvals

5. HMT guidance identifies the nature and maturity of the evidence required to support the VfM argument at each of four key decision points. This has translated into a four decision point IAB approvals process for PFI projects as follows (see diagram at Section 3 paragraph 1 for linkage to VfM stages):
   - Decision 1 - Initial Gate - Pursue a PFI procurement strategy into Assessment Phase.
   - Decision 2 - Review Note - Industry Engagement (formal engagement of industry in a competitive tendering exercise).
   - Decision 3 - Main Gate Part One (MG1) - End the competition and select a Preferred Bidder.
   - Decision 4 - Main Gate Part Two (MG2) - Commit to the contract.

6. As with the wider guidance on MOD Approvals, these points will be tailored to meet the particular needs of the project/business.

7. Detailed guidance on the approvals process for PFI projects is contained in Sec EC's SMART Approvals Guidance which is available on the Defence Intranet.

Output Based Specification

8. A key task for any team pursuing a PFI deal is translating the Customer's requirement (normally expressed in a User Requirement Document (URD) containing Key User Requirements (KURs)) into an output based specification (OBS) document. The OBS must clearly describe the service outputs and performance standards required to be met by the contractor, together with any regulatory, security or other constraints within which the service has to be delivered. The payment and performance mechanism will link directly to the OBS ensuring that the contractor is appropriately incentivised to deliver the required output. It is therefore important for both these elements of the deal to be developed in tandem.

Standardised Contract

9. In a PFI the public sector does not seek to transfer risks to the private sector as an end in itself. The key principle is that the many different risks inherent in a major investment programme and on-going service are borne by the party best placed to manage those risks. Where risks are transferred, it is to create the correct disciplines on the private sector, which then drive VfM through more effective risk management.

10. HMT has produced guidance, in the form of the Standardisation of PFI Contracts (SoPC), to promote a common understanding of the main risks that are encountered in a PFI project. In 2006, taking account of SoPC guidance, MOD produced a standard form of MOD PFI contract - MOD PFI PAv1. This covers the 60-70% of any project agreement that should be common to all MOD PFI projects and, by mandating its use for future MOD PFI deals, ensures that a common balance of risk for these areas is achieved across those MOD PFI contracts. The remaining 30-40%, which needs to be developed on a project by project basis, includes:

- specification (in the form of the Asset Provision Requirements, Service Provision Requirements and Services Availability Requirements), Contractor's Asset Provision and Service Provision Proposals and programmes;
- payment and incentive mechanics and performance monitoring regimes;
- provisions to cover specific land issues, and, if relevant, development of any property leases;
- completion of the blank Schedules,

as well as any other area that is genuinely peculiar to a specific project or group of projects. Completing these areas of the project agreement should not extend to project teams seeking to change the risk balance in the contract, unless derogation is requested on project-specific grounds from HMT/PUK through the MOD PFU.

Involvement of the Funders/Banks

11. Typically banks will provide between 80-90% of the capital required to fund a PFI deal by way of a loan to the bidding entity. Before agreeing the terms of the loan the bank will ensure that it understands the risk profile of the deal and that it is content with the way the risks are allocated under the terms of the contract. It achieves this through a process known as funder’s due diligence where it conducts an in-depth review of the commercial, legal, financial and technical aspects of the deal. As a result of its due diligence, the bank may wish to conduct further negotiations to resolve any remaining concerns. Under either the Negotiated or Competitive Dialogue procedures funders are unlikely to become fully committed to financing terms until after the selection of a Preferred Bidder (PB).

12. It is also the default position that a Preferred Bidder Debt Funding Competition (PBDFC) be run to secure the best financing terms for

individual PFI projects[3]. Such competitions are managed by the PB but the MOD will have the ability to oversee it, through its external financial advisers and the MOD PFU, to ensure the most cost-effective solution is accepted.

Accounting for PFI Transactions

13. PFI transactions should be **accounted for** in Departmental Resource Accounts (DRAc) based on the guidance found in IFRIC 12 – Service Concession Contracts as amended in the Financial Reporting Manual and JSP 472 Resource Accounting Policy Manual.

14. To be within the scope of IFRIC 12, the PFI contract arrangement must contractually oblige the private sector contractor to provide the services related to the infrastructure asset to the public sector. Contracts that do not involve the transfer or creation of an infrastructure asset for the purpose of the contract fall outside the scope of IFRIC 12, as do arrangements that do not involve the delivery of services to the public sector.

15. The assets will be recognised on the Department's Balance Sheet specifically where:

- The Department controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them and at what price; and
- The Department controls, through beneficial entitlement or otherwise, any significant residual interest in the infrastructure at the end of the term of the arrangement;

16. Project Teams are advised in the first instance to consult with their Financial Controller/Chief Accountant on the specifics of the accounting treatment for their project or when the substance of the contract falls outside the scope of IFRIC 12. Further guidance on how to account for PFI transactions for the DRAc can be found in JSP 472 and the Accounting Policy team within the Director Financial Management (DFM) organisation will be able to assist with any technical accounting queries.

Budgeting for PFI Transactions

17. PFI transactions are currently **budgeted** using UKGAAP i.e. FRS 5. HMT put forward proposals that Departmental budgets (as of 1st April 2009) must follow National Accounting standards. These standards are laid out in Part IV of the Manual on Government Deficit and Debt ("MGDD") which provides guidance on the application of the European System of Accounts 1995 ("ESA 95")).

18. The MGDD states that the assets that underlie PFI and similar transactions can only be considered as being off the public sector balance sheet where there is strong evidence that the private sector is bearing most of the risk and reward attached to the asset in question. For the purposes of

[3] Subject to some exceptions

simplicity, this determination focuses on the following three main categories of risk:

- Construction risk,
- Demand risk, and
- Availability risk.

19. Having analysed these risks, determination is made as follows:

- If the public sector carries construction risk, the assets are viewed as being on the public sector balance sheet for the purposes of the National Accounts.

- Where the private sector holds construction risk **and** either demand or availability risk, the assets are not considered to be on the public sector balance sheet for the purposes of National Accounts.

20. At the time of writing, further HMT guidance is awaited on when these proposals are to be adopted as Government policy and how Departments should implement it. For up to date policy and advice on budgeting for PFI transactions, project teams should, in the first instance, consult with their Financial Controllers/Chief Accountants.

Affordability

21. The service nature of PFI contracts often means that the funding for the project lies in more than one TLB. In 2008 Director General Resources and Programmes (now Director Strategy & Resources) advised that the key tool required to be used to capture and preserve all funding for a PFI project is the Project Funding Responsibility Matrix (PFRM)[4]. This provides the mechanism, in both the TLB and the Equipment Capability (EC) plans, for all sources of funding, including the core allocation for the system/infrastructure, to be identified and agreed by all parties. It also ensures that the parties involved in the planning process are able to ensure that funding is maintained at the agreed level and is available to fund the PFI project at the time it is required.

22. The relevant Resources and Plans Division decides on the need for a PFI project to have a PFRM in place. The Head of Capability or other project sponsor, has the responsibility for the direction of the process to get the PFRM agreed and the Project Team Leader is responsible for its initial preparation and for keeping it up to date. Active direction by RP Divisions and EC colleagues together with regular update activity by the project team are essential to ensure that the PFRM is properly integrated into the approvals process and programming round control total negotiations. A particular risk to be guarded against is the erosion of funding after the approval of the Main Gate Business Case.

[4] RP-10-01-07 (DG/092/08) dated 14 October 2008 – Funding of PPP/PFI Projects

Engagement of External Advisers

23. PFI acquisition involves a number of specialist skills that are not available to MOD in-house. In general, specialist external advice will be required on financial, legal and insurance matters, for example:

Financial

- Private financing issues (bank or bond financing).
- Financial modelling.
- Payment and performance models.
- Funding competition.

Legal

- Negotiating and drafting project specific contract schedules.
- Negotiating derogations from SoPC.
- Developing the corporate, funding and sub-contract documents

Insurance

- Identifying what cover is required and what is available in the market.
- Pricing of insurance policies.
- Inter-relationship between transferred risk and insurance requirements.

24. The MOD PFU requires advisers to confirm to acquisition teams (via a clear written endorsement of all key decisions) the following. Should advisers not support proposals to proceed, this should also be formally recorded.

a) Whether the deal proposed is appropriately structured to deliver the commercial outcome that MOD is seeking and is a realistic commercial position that represents value for money and is both deliverable and financeable in the current PFI market. In particular to highlight any material areas where the private sector bidders have raised concerns regarding deliverability and what steps are being taken to address them.
b) Whether the commercial aspects of the project (and bids received, if appropriate) have reached an appropriate level of maturity to support the current phase of engagement with the market. In particular drawing attention to any significant areas outstanding where the MOD could be exposed to risk of increased cost or delay through a lack of maturity.
c) Whether the timetable proposed to deal close is realistic indicating any key risks that may impact on the delivery of the timetable with details of the consequences (i.e. renegotiation of the price) that the MOD may be exposed to if the timetable is not met.

25. Advice should be sought from the MOD PFU on when and how to appoint external advisers and what their role might be. In addition, guidance on

how to engage external financial advisers using Framework agreements is published on the MOD PFU website.

SECTION 5 – PFI CRITICAL SUCCESS FACTORS

1. A number of factors have been identified as key to the successful delivery and ongoing operation of MOD PFI projects. An outline of each of these is provided below together with information on sources of further guidance.

Robust Commercial Risk Allocation, Transfer and Management

2. The focus here is to have a clear understanding of the full extent of the project risks, how these risks are allocated within the contract and how they are managed throughout the contract term. The objective is that all commercial and financial risks are identified, analysed, allocated and managed in accordance with mandated policy and best practice. Risk analysis should be supported by good historical data and risks should be allocated to the party best placed to manage and cost them in a value for money way.

3. Risk allocation within a project can change during the course of the procurement process and it is very important to track these changes throughout the process, and to maintain clear and auditable record of the changes. For Cat A/B projects it is recommended that a Commercial Risk Allocation Matrix (CRAM) be completed to inform the project risk register. This records details of the contractual allocation of commercial risks between MOD and the contractor and provides an audit trail of any changes to the risk allocation profile throughout the procurement process. The CRAM should be maintained post contract award and will be of particular benefit if a major contract change is being considered.

4. A key issue to guard against is re-circulation of risk. This describes a situation where a risk that the MOD has transferred to the contractor is transferred back to the MOD by some other means. In such circumstances the MOD can end up paying the contractor for the management of a risk but finding itself responsible for the consequences of that risk should it materialise. Re-circulation of risk can occur for a number of reasons but commonly arises due to obligations passed back to the MOD in relation to the performance and/or timely provision of Government Furnished Equipment (GFE) or Services (GFS) or as a consequence of poorly articulated Output Based Specifications.

Relevant Government policy/guidance:[5]

- **MOD PFU Guidance Note – MOD Standard Project Agreement v1 for PFI Projects**
- MOD PFU Guidance Note – Allocation & Management of Risk in PFI Projects
- JSP 507
- JSP 525
- AOF guidance on commercial risk allocation
- **HM Treasury: Standardisation of PFI contracts (SoPC) Version 4**
- HM Treasury: The Orange Book, Management of Risk – Principles and Concepts
- HM Treasury: The Green Book, Appraisal and Evaluation in Central Government

[5] Note: Bullet point text in **BOLD** indicates mandatory requirements.

- HMT Application note: interest-rate and inflation risks in PFI contracts
- OGC Achieving Excellence Guide 4 - Risk and Value Management

Robust and Clearly Articulated Requirement

5. The focus here is firstly to ensure that the requirement is sufficiently well understood and mature to determine that it is suitable for the principles of PFI – e.g. stable and long-term. Following on from this, the focus moves to ensuring that the requirement is articulated in a manner that is clear, is presented in output terms and is legally enforceable. Further, the ability of the contractor to deliver the service to the standards set out in the contractual requirement document must be able to be demonstrated, certified and verified against objective criteria consistent with the commissioning tests, the base requirements documents (SRD, URD etc) and the Key User Requirements. Also of key importance is the need to ensure that the ongoing delivery of the services by the contractor to the required standards is appropriately incentivised by aligning the requirement document fully with the payment and performance mechanism and any performance indicators to ensure outputs are measurable and any degraded performance appropriately adjusts the rewards/revenues.

6. It is stressed that the advantages of investing time and effort on developing the requirement and related documents in the early stages of the project must not be underestimated.

Relevant Government policy/guidance:

- **MOD PFU Guidance Note – MOD Standard Project Agreement v1 for PFI Projects**
- MOD PFU Guidance Note – Demonstration & Certification of PFI Services
- MOD PFU Guidance Note – Output-Based Specifications for PFI/PPP Projects
- **HM Treasury: Standardisation of PFI contracts (SoPC) Version 4**
- OGC Achieving Excellence Guide 9 - Design Quality
- OGC Achieving Excellence Guide 10 - Through Health and Safety
- **OGC Common Minimum Standards**
- HMT Technical Note 7: How to Achieve Design Quality in PFI Projects

Robust Project Plans and Programmes

7. As with any project the focus here is to ensure that proposed project plans and timescales are realistic and are based on a full appreciation of the activities involved in the acquisition process. For PFI projects it is important to be aware of the processes that are not led or controlled by the MOD e.g. funder due diligence, funding competition etc. and to take advice on timescales for such activities based on past performance. The level of resources and skills available within the MOD and industry project teams will have a bearing on the project timescales and should be taken into account when formulating project programmes.

8. Industry teams should be encouraged to agree and work to the overall project timetable but MOD should also be open to industry's perception of

programme risks and timescales. MOD must resist temptation to be too optimistic and must be open to the need for flexibility to accommodate programme changes.

9. Project teams should be aware that there are target procurement timescales[6] for future MOD PFI projects which are:

- Accommodation (Housing) – target 27 months
- Accommodation (other) – target 36 months
- Facilities (incl CIS etc) – target 27 months
- Training – target 27 months
- Equipment – target 36 months

Relevant Government policy/guidance:

- MOD PFU Guidance Note – Preferred Bidder Negotiations on PFI Projects
- AOF guidance

Robust Affordability Assessments

10. As with any project the focus here is to ensure that the project whole life cost estimate is comprehensive and accurate and that adequate and appropriate budgetary provision exists to pay for and account for the services delivered through the contract (as identified in the PFRM described in Section 3 paragraph 21). For PFI projects the main challenges lie in producing a robust cost estimate during phases before bidder financial models are submitted, compiling and maintaining a robust reference or should cost model, identifying and managing the funding for the project, which may lie in several TLB areas and determining the appropriate accounting treatment for the project assets.

11. This is an area where the expertise of external financial advisers will be of particular benefit.

Relevant Government policy/guidance:

- **MOD PFU Guidance Note - Assessing Value for Money for PFI Projects**
- MOD PFU Guidance Note - Accounting for PFI Projects
- JSP 507
- Resource Accounting Bulletins (e.g. RAB 472/462 & RATb13)
- Departmental budgeting guidance
- Departmental plans
- **International Accounting standards (e.g. IFRS and/or ESA95)**
- OGC Achieving Excellence Guide 7 - Whole-Life costing
- HMT Value for Money Assessment Guidance, dated Nov 2006

[6] Time taken from OJEU advertisement to Financial Close

Robust Value for Money Assessments

12. As described in Section 3 there is a specific process that project teams must follow during the procurement phase, in addition to the standard investment appraisal process, to assess whether the project represents value for money.

13. It is also important to ensure that the contract makes suitable provision for periodic value testing of the soft services delivered through the PFI contract, preferably through a market testing exercise.

Relevant Government policy/guidance:

- **MOD PFU Guidance Note - Assessing Value for Money for PFI Projects**
- **MOD PFU Guidance Note – MOD Standard Project Agreement v1 for PFI Projects**
- MOD PFU Guidance Note – VFM reviews
- JSP 507
- HMT Value for Money Assessment Guidance, dated Nov 2006
- HMT Value for Money Quantitative Assessment Guide, dated Nov 2006
- **HM Treasury: Standardisation of PFI contracts (SoPC) Version 4**
- Value Testing HMT/PUK guidance
- OGC Getting Value for Money from Construction Projects through Design
- Operational Taskforce Note 1: Benchmarking and Market Testing Guidance
- HM Treasury: The Green Book, Appraisal and Evaluation in Central Government
- OGC Best Practice - VFM - Evaluation in Complex Procurement

Robust Project Agreement

14. As described in Section 3 some 70% of a PFI contract is covered by an agreed standard which project teams are mandated to adopt. Any deviation from the standard is not acceptable unless a project specific derogation is obtained from HMT/PUK. Care must be taken to ensure that completion of the 30% of the contract that is project specific does not affect the risk balance intended for the overall contract.

Relevant Government policy/guidance:

- **MOD PFU Guidance Note – MOD Standard Project Agreement v1 for PFI Projects**
- **MOD PFU Guidance Note – MOD PFI Project Agreement Derogations Process**
- MOD PFU Guidance Note – Preparing the Invitation to Negotiate for PFI Projects
- MOD PFU Guidance Note – Market Soundings for PFI Projects
- MOD PFU Guidance Note – Pre-Qualification Questionnaires for PFI Projects
- MOD PFU Guidance Note – Selection of a Preferred Bidder for PFI Projects
- MOD PFU Guidance Note – Convergence Phase for PFI Projects using the Negotiated Procedure
- MOD PFU Guidance Note –Estates Matters in PFI Projects
- MOD PFU Guidance Note – Suspension of Import Duty for PFI Projects

- **Legislation, EU Procurement Rules & MOD procurement policy**
- **HM Treasury: Standardisation of PFI contracts (SoPC) Version 4**
- Treasury Taskforce Technical Note 4: How to Appoint and Work with a Preferred Bidder
- HMT Operational Taskforce Note 2: Project Transition guidance
- Competitive Dialogue in 2008: OGC/HMT Joint Guidance on using the procedure
- OGC Achieving Excellence Construction Projects Pocketbook
- OGC Making competition work for you
- OGC Early Market Engagement: principles & examples of good practice
- OGC Achieving Excellence Guide 6 - Procurement and Contract Strategies
- OGC Achieving Excellence Guide 3 - Project Procurement Lifecycle
- OGC Achieving Excellence Guide 1 - Initiative into Action
- OGC Best Practice - Improving procurement efficiency to achieve faster delivery
- HMT Guidance Note: The Use of Internal Rates of Return in PFI Projects
- HMT Guidance: Opinion Letters

Robust Payment and Performance Mechanism

15. The focus here is to design and agree a payment and performance mechanism which produces the appropriate incentives on the contractor to deliver the requirement, which contains a practical performance monitoring process, which levies appropriate deductions for poor performance and which escalates to the right to terminate when performance is consistently unacceptable.

16. An outline mechanism should be constructed by the project team (with the assistance of its advisers) and included in the documentation released to bidders at the ITN/ITPD stage. This will ensure that all bidders' proposals are formulated from the same basis which aids the bid evaluation process. The calibration of the mechanism is key in determining the appropriate balance between incentivisation and value for money. Disproportionately harsh deductions for minor service failures are likely to be poor value for money as the risk of service performance failures will be priced in the bids. It is also likely that hair triggers which lead to contractual default will be unacceptable to lenders and will not be "bankable". It is important therefore, throughout the procurement phase, to have a clear understanding of the relationship between the payment and incentive mechanism and the price.

17. Post contract award and prior to service commencement it is advisable to plan for a series of "dry runs" of the mechanism to ensure that both parties agree that it is workable, produces accurate and meaningful performance data and generates management information against which payments and deductions can be made.

Relevant MOD policy/guidance:

- **HM Treasury: Standardisation of PFI contracts (SoPC) Version 4**
- [MOD PFU Guidance Note – Payment & Incentive Mechanisms for PFI Projects][7]

[7] In draft.

Robust Change Strategy

18. The focus here is to ensure, given the long term nature of PFI deals, that the initial project agreement takes account of the MOD's long term requirements, anticipating any changes that can reasonably be foreseen. Accordingly an appropriate amount of flexibility should be designed into the solution to cope with anticipated changes. Also a well developed change mechanism, including pre-pricing wherever possible, should be put in place in the contract to deal with unanticipated changes over the length of the contract period. Good change mechanisms should seek to achieve at least the following outcomes:

- Clear process with clearly defined roles, responsibilities and timescales;
- Quick and efficient procedures (appropriate to the scale and complexity of the change required) with transaction time and cost kept to a minimum;
- Transparent pricing; and
- Value for money.

19. For projects requiring a considerable degree of long term flexibility consideration of shorter contract lengths, financial structures and inclusion of break points or early termination rights may be appropriate.

20. Throughout the operational phase robust control of customer requirements together with robust management and operation of the change process will be a key responsibility of the contract management organisation.

Relevant MOD policy / guidance:

- **MOD PFU Guidance Note – MOD Standard Project Agreement v1 for PFI Projects**
- MOD PFU Guidance Note – Making a Change in PFI Contracts
- **HM Treasury: Standardisation of PFI contracts (SoPC) Version 4**
- Operational Taskforce Note 3: Variations Protocol for Operational Projects

Robust SPV and Financing Structures

21. In general the equity investors in a PFI Project Company are those who are responsible for bidding for, developing and managing the project i.e. the project sponsors. Typically, private sector sponsors for PFI projects can be divided into two main categories:

- "operational" investors, being companies for whom investment is part of a strategy for securing other business as sub-contractors to the Project Company (PC)/Special Purpose Vehicle (SPV), and

- "financial" investors, being entities only interested in the investment and not in ancillary business as Subcontractors e.g. banks and specialised PPP investment funds.

22. To assess the appropriateness and robustness of the PC/SPV the project team should make sure that bid documentation contains sufficient information on the proposed PC/SPV structure so that following factors can be taken into account:

- Whether the sponsors have experience in the sector concerned and, hence, the ability to provide any technical support required by the project.

- Whether the sponsors have worked together successfully before.

- Whether the sponsors have the financial ability (although the obligation to may be limited) to support the PC/SPV if it runs into difficulty.

- Whether the sponsors have a reasonable amount of equity invested in the PC/SPV, which gives them an incentive to provide support to protect their investment if it gets into difficulty.

- Whether the sponsors have arm's-length contractual arrangements with the PC/SPV e.g. where they act as subcontractors for the construction of the project facility.

- Whether there is a reasonable return on the sponsors' investment.

- Whether any of the sponsors have a clear interest in the long-term success of the project.

23. The general assumption for PFI projects is that the PC/SPV contracts with the MOD (with subcontractors providing the actual performance on its behalf) and makes use of a significant level of limited-recourse debt to finance the project. This structure is known as "project finance", meaning that the debt financing – provided by the banks or the bond market – is raised on a project specific basis, relies primarily on the PFI contact and the various subcontracts for security and on specific project cash flows for repayment.

24. All bids should be examined from the perspective of how resilient the proposed project structure is to the contractor/subcontractors experiencing financial distress. Evaluation of and advice on the robustness of the bidders' proposed financial structures should be a key task for the project team's financial advisers.

Relevant Government policy / guidance:

- **MOD PFU Guidance Note – MOD Standard Project Agreement v1 for PFI Projects**
- MOD PFU Guidance Note – PFI Refinancing
- MOD PFU Guidance Note – Preparing the Invitation to Negotiate for PFI Projects
- **HM Treasury: Standardisation of PFI contracts (SoPC) Version 4**
- HMT Guidance: Preferred Bidder Debt Funding Competitions - draft outline guidance for feedback

- HMT Guidance: Refinancing of Early PFI Transactions - Code of Conduct
- HMT Guidance Note: Calculation of the Authority's Share of a Refinancing Gain
- HMT Covering Note: Value for Money in Refinancings
- HMT Application Note: Value for Money in Refinancings

Robust MOD Project Governance and Leadership

25. The focus here is to ensure that the project has effective governance and leadership, involving routine engagement at senior levels. Where projects proceed without these in place they are often insufficiently mature at key decision points with the result that later stages of the deal take far longer than should be the case, valuable MOD and Industry time and resources are wasted and, in the worst of cases, the entire procurement can be jeopardised.

26. A good governance structure will ensure that:

- the project is actively owned, sponsored and directed at a senior level within the department, with a single post having accountability for delivering the required project outcomes;
- an effective project management structure is in place and fully resourced to manage the project effectively;
- effective and open communication and reporting processes are in place to ensure that all stakeholders are appropriately consulted and informed on project business.

27. The need for an effective MOD governance structure is not unique to PFI projects. It is important, however, that the governance structure for PFI projects during the preferred bidder and operational phases includes a "joint" forum where both MOD and industry are represented. This will help to overcome the potential for 'off-line' senior stakeholder discussions with the Contractor and shareholders to take place and possibly undermine positions achieved during negotiations at the working level.

Relevant Government policy / guidance:

- HM Treasury guidance "Project Governance: a guidance note for public sector bodies"
- Association for Project Management "Directing Change: A Guide to governance of project management"
- OGC Common causes of project failure

Robust Resourcing of the Acquisition and Management Teams

28. As with any complex acquisition project, for the project to be successful, the acquisition team must have sufficient, suitably skilled and experienced staff resources to manage the project effectively. The full range of in-house acquisition skills will need to be present within the project team. Further, it is recognised that the specialist nature of certain aspects of PFI procurement requires specialist skills that are not available in-house - particularly legal, financial and insurance. Individual projects should seek

advice from the MOD PFU on the appropriate level of resources for the various phases of their PFI project.

29. Key learning from experience points on this topic are reproduced below.

a. In-house team:

- PFI projects take several years to procure and benefit greatly from stability in the procurement team, particularly for the phases between OJEU and financial close. Project teams should take this into account when planning resources, recruiting team members and preparing succession plans.

- It is essential to have senior team members who are dedicated to the project. Change in this group adds to the project timeframe and exposes the project to the risk of adopting different approaches. Further, there is a risk that bidders may seek to exploit changeover in the MOD team for their gain or to re-open negotiated positions. Where staff turnover in the team is unavoidable the effects can be mitigated to some extent by securing continuity of external adviser teams.

- During negotiations and from preferred bidder through to financial close the pressure on the team, particularly the project manager and the senior commercial officer, is considerable. A realistic assessment of the workload is essential to ensure that people understand the commitment they are making when they accept such positions.

- The negotiation team should comprise people with prior experience of negotiating large and complex deals. These would ideally, but not necessarily, be PFI deals.

- It is very important to plan for continuity of key team members through the transition and service demonstration phases. It is also recommended that the MOD's contract manager is brought into the project team at least at the preferred bidder stage in order to gain a full understanding of the agreement prior to taking on the contract management role.

b. External Advisers

- Identify at the outset the need for and scope of engagement of the External Advisers. At the initial stages of the project it might not be clear what assistance will be required later but teams should seek guidance so that they can plan and budget for the later phases. However there is a requirement for External Advisors to provide "comfort letters" at key project stages on the maturity of the project to proceed.

- Adequate budgetary provision should be made for External Advisors and sourcing must be made in accordance with MOD and wider Government policies and processes.

- Effective working practices should be established from the outset. EA engagement should be managed through specific tasking and regular performance reviews (it is important to maintain the discipline of holding such reviews even in the “thick” of negotiations). Build relationships on a social, as well as working, level and encourage the advisors to identify with the team objectives. It is also very important to ensure that there are open channels of communication and that the advisors are able to provide their advice in a non-adversarial environment.

Relevant Government policy / guidance:

- MOD PFU Guidance Note – Contract Management in PFI/PPP Projects
- Portfolio, Programme and Project Management Maturity Model
- Defence Instructions & Notices: PPP/PFI Legal Framework Agreement, 2006DIN04-110 dated Aug 2006
- Defence Instructions & Notices: Framework Agreement for Financial Advice & Support for PFI & Partnering Projects, 2007DIN05-003 dated 2007
- Defence Instructions & Notices: General Insurance Brokerage advice & assistance, 2007DIN08-020 dated 2007
- HMT Operational Taskforce Note 2: Project Transition guidance
- OGC Best Practice Portfolio
- Programme & Project Management Specialism Brochure
- Skills Framework & Skills Framework Assessment Guide
- Achieving Excellence Guide 2 - Project Organisation
- Achieving Excellence Guide 5 - The Integrated Project Team
- HMT Technical Note 3: How to Appoint and Manage Advisers to PFI Projects

Robust Service and Relationship Management Strategies

30. Whilst Contract Management focuses on the management of the contract once signed, the success of contract management activities are strongly determined by the plans and activities during tendering/contract award phase, in terms of both ‘hard’ outputs, such as the contract specification and contract terms and conditions, and, the type of relationship between customer and supplier. In this way, the tendering/contract award phase and the contract management phase should be seen as a continuum rather than distinct phases, with the succes of contract management planned for from the start of the procurement process.

31. As the partnership between the public sector and private sector in a PFI contract is intended to be long term, it is also important that a strong relationship is built and maintained across all the parties involved – private sector, acquisition/contract management team, end users - with a clear understanding of each party’s responsibilities together with recognition of the cultural differences across the parties. The desired outcome is to establish effective management of these relationships to achieve and secure long-term success.

32. Prior to the signature of the contract all acquisition projects shall have a plan (the “Contract Management Plan” or “CMP”) that sets out the plan for

the management of the contract, for use by commercial and project management staff, senior managers and those involved in the assurance and approval of the project.

33. Following the signature of the contract, or very soon afterwards, the contract management team should have a suite of documents (the “Operational Contract Management Manual” or “OCMM”) for use by the Contract Management Team that sets out the instructions, policies, information, and guidance that govern the day-to-day management of the contract.

34. Key factors that contribute to an effective working relationship include:

- understanding of and respect for each party’s point of view;
- shared knowledge and objectives;
- sound understanding of the contract and contractual documents;
- good flow of information and open channels of communication;
- a willingness to resolve issues across all parties;
- effective decision making processes; and
- desire for the project to succeed.

Relevant Government policy / guidance:

- **MOD PFU Guidance Note – MOD Standard Project Agreement v1 for PFI Projects**
- MOD PFU Guidance Note – Contract Management in PFI/PPP Projects
- **HM Treasury: Standardisation of PFI contracts (SoPC) Version 4**
- OGC Best Practice - How Major Service Contracts Can Go Wrong
- HMT Technical Note 6: How to Manage the Delivery of Long Term PFI Contracts
- HMT Operational Taskforce Note 1: Benchmarking & Market Testing Guidance
- HMT Operational Taskforce Note 2: Project Transition Guidance
- HMT Operational Taskforce Note 4: Contract Expiry Guidance
- OGC Best Practice - Managing partnering relationships
- OGC Best Practice - Forming partnering relationships with private sector in an uncertain world
- OGC Advice to Government Departments: Opinion Letters

SECTION 6 – FURTHER GUIDANCE

This guidance gives a high level introduction to the subject of PFI procurement in the MOD. For those readers requiring more detail on particular topics, the MOD PFU websites contain further guidance and sources of advice. These can be accessed through the following links:

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

http://defenceintranet.diiweb.r.mil.uk/DefenceIntranet/SiteTools/BusinessFinder/PrivateFinanceUnitpfu.htm