



MINISTRY OF DEFENCE

MOD Private Finance Unit Guidance Note Making a Change in PFI Contracts

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DOCUMENT CHANGE RECORD

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A	First draft for internal review	S Fraser	February 2009
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Making A Change in PFI Projects

Constraints

1. The majority of the content of this document is intended to provide guidance, rather than mandatory rules. It highlights the key considerations that acquisition team members should bear in mind when considering/implementing a Change and provides examples showing the principles which may be adopted to put in place a more robust and efficient process than that contained in some extant PFI contracts. These may be adapted to suit the circumstances of particular projects.
2. Standard drafting for change management in MOD PFI contracts is contained in Addendum 2 to MOD PAv1. Where an acquisition team proposes to utilise this drafting, it must do so wholesale, unless there are project-specific or value for money reasons to do otherwise. Any such revisions to reflect these principles will require prior approval from the MOD Private Finance Unit (PFU).

Authoritative Guidance Summary

3. The National Audit Office (NAO) Report of 14 January 2008 entitled "Making Changes in Operational PFI Projects"¹ recognised that, given that PFI contracts are usually entered into for long periods, it is inevitable that changes to the assets and services provided through these contracts will need to be made. Indeed, when surveyed, over 70% of Operational PFI Projects in the MOD had processed at least one Change.
4. It is important that these Changes can be implemented in a way which represents best value for money to the MOD. With the recent shift of focus on PFI in the defence sector from procurement to operations, the MOD has seen the need to produce updated guidance which supports acquisition team members in doing so, as well as providing an improved baseline for projects in procurement. This should be of benefit to both parties involved in the relevant Project².
5. The MOD recognises that a wide variety of approaches have been taken to Change drafting in the PFI contracts placed to date. However this guidance accommodates these differences and should be applied in all cases, notwithstanding the differences in the drafting of extant contracts.
6. This guidance is divided into two principle parts:

¹ Report by the Comptroller and Auditor General HC 205 Session 2007-2008, dated 14 January 2008, page 4, para. 1.

² See paragraph 12 for further comment on the advantages of having an efficient and robust Change mechanic.

- (a) Guidance on how to achieve best value in processing Changes in Operational PFI Projects; and
 - (b) Exemplar drafting, reflecting MOD's view of best practice for contractual Change drafting in PFI contracts (see Addendum 2 to MOD PAv1) for adoption by PFI projects in procurement and in operation.
7. In preparing this guidance, MOD PFU has drawn from a number of source documents which are available to the public sector, and in particular:
- HM Treasury's "The Standardisation of PFI Contracts version 4" dated April 2007 ("SOPC 4");
 - HM Treasury's "Change Protocol Principles" dated August 2007³;
 - The National Audit Office Report of 14 January 2008: "Making Changes in Operational PFI Projects";
 - Partnerships UK's Operational Taskforce Note 3: "Variations Protocol for Operational Projects (entered into prior to Standardisation of PFI Contracts version 4)" dated March 2008⁴;
- The MOD PFU also consulted acquisition team members who have been involved in Change on operational PFI Projects, in order to learn the lessons from their experience and allow the benefits of these lessons to be shared throughout the MOD.
8. In preparing this guidance, the MOD PFU has focussed primarily on instances where Changes are being put forward by the MOD as experience shows that the majority of Changes on operational PFI Projects are proposed by the MOD⁵. Many of the same principles should apply in the case of changes in law and/or contractor-led Changes.

Authoritative Guidance

A Practical Approach to Adopting Best Practice

9. Experience has shown that the contractual Change mechanisms in existing MOD PFI contracts, and particularly those that were signed some years ago, are not always adequate in practice especially for high value Changes or multiple low value Changes⁶.
10. Through practical experience of implementing Changes in defence PFI projects over time, which has been shared with and influenced by

³ This is a voluntary protocol to be read in conjunction with this MOD PFU Guidance Note although the latter takes priority.

⁴ This is a voluntary protocol to be read in conjunction with this MOD PFU Guidance Note although the latter takes priority.

⁵ Report by the Comptroller and Auditor General HC 205 Session 2007-2008, dated 14 January 2008, page 10, para. 1.12. This is not defence-specific. However, from our survey of acquisition team members, it would appear that similar trends prevail in defence.

⁶ This is a direct quote from para 1.4 of Partnerships UK's Operational Taskforce Note 3: "Variations Protocol for Operational Projects (entered into prior to Standardisation of PFI Contracts version 4)" dated March 2008.

other Government departments, best practice has evolved. This is reflected in the exemplar drafting set out at Addendum 2 to MOD PAV1⁷.

Adopting the new change drafting

11. All PFI Projects in procurement are required to adopt this drafting in their contracts.
12. MOD PFU recommends that all operational PFI Projects adopt this drafting in their contracts, where this would be of benefit. The advantages of doing this are that the Change process should be more efficient, ensuring cost and time saving on the part of both parties, and that good relations can be maintained in the partnership⁸. It should also ensure that the MOD has the best chance of achieving value for money ("VfM") through life and that this can be demonstrated transparently to external stakeholders, such as HM Treasury.
13. It may be possible to agree a new approach to the Change drafting at key points in the deal, such as during any negotiations over the terms of a major change to the project, a market test/benchmarking exercise, a VfM review or a refinancing. At such key stages, other stakeholders in the deal (such as sub-contractors and funders) are likely to be involved and these parties can consider the new Change process drafting at the same time. This is likely to be a more economical approach than agreeing a variation to the contractual drafting on Change in isolation.

Adopting a Change Protocol

14. However, the MOD recognises that this may not always be possible for a number of reasons. In instances where it is not possible to introduce the drafting at Addendum 2 to MOD PAV1 wholesale, MOD PFU recommends that acquisition team members engage with their counterparts in the contractor's⁹ staff to agree informal Change protocols. These should reflect the original contract provisions but follow the principles set out in Addendum 2 to MOD PAV1 as closely as possible in order to provide more detail where this was originally lacking. These protocols should then form the basis of a new method of working between the parties, to be applied in processing Changes on the Project. This approach of putting in place an informal protocol to compliment existing contractual drafting on Change has already

⁷ This has been drafted using sources which are recommended for accommodation Projects. However, in our survey of acquisition team members, very few significant differences in approach to Change were identified between different types of deals (equipment/accommodation etc). Where significant differences of approach were identified (e.g. competitive tendering for costs of Major Changes may not be feasible in synthetic trainer-type projects), we have tried to indicate this in this Guidance Note.

⁸ In the Report by the Comptroller and Auditor General HC 205 Session 2007-2008, dated 14 January 2008, page 19 para. 2.26, it was noted that "both public and private sector contract managers believe that efficiencies can be made." This suggests that the private sector, too, is frustrated by the existing processes for Change on PFI Projects.

⁹ Contractors under PFI contracts generally set up a consortium referred to as a Special Purpose Vehicle (SPV).

been adopted in a number of cases, such as the Flight Simulators and Synthetic Trainers ("FsAST") acquisition team.

15. If an acquisition team proposes to adopt this latter approach, then it is important to bear in mind the contractual framework within which the parties are operating. For example, if the parties are seeking to amend the actual contractual conditions, then this should be formally documented. This is necessary to avoid disputes and to ensure that agreements reached are legally enforceable. However, this should not preclude informal methods of working from being adopted by the parties, to improve the efficiency of the day-to-day interface between them.

Timing of Change

16. The timescales for implementing Changes are important as delay can add cost and postpone or prevent the end user from getting what it needs to support operational output.
17. It is impossible to meaningfully benchmark how long a Change should take to process from inception to implementation - huge variations exist from a few months to a number of years. These differences are driven by a number of factors. When considering a Change, acquisition team members should be aware of these issues and should put in place a strategy for managing them.
18. Factors which need to be taken into account when implementing Changes include:
 - (a) Complexity – for example, an amendment to operating software in a synthetic trainer type project may take longer to scope and agree than a Change to opening hours at office accommodation;
 - (b) Getting used to the process – in the MOD PFU's survey of acquisition team members, this seemed to be one of the most significant time factors. Changes at the beginning of a Project could take a very long time, but once the parties were familiar with the processes involved, Changes could be processed more quickly;
 - (c) Change of Contract Management Personnel – this is connected to (b), above. Where personnel change, there will be a need for new staff to get up to speed on Change processes;
 - (d) The contractual Change mechanism – if this is cumbersome and unworkable, it may add time itself;
 - (e) Fluctuation in the scope of the requirement while the Change is being processed; and
 - (f) Timescales involved in obtaining MOD and private sector partner approvals. Many changes made to a contract will fall within existing IAB approval limits and will not therefore require separate approval. However in circumstances where separate

Business Case approval is required then the MOD acquisition team needs to consider whether a change:

- (i) should be contained within a new Business Case for approval at the level appropriate to the value of the proposed change; or
- (ii) is sufficiently significant (such as a change in the scope of the requirement, or an extension of the contract duration) to result in the need for re-approval of the original Business Case (for example through a Review Note). MOD approving authorities should be consulted as required.

Costs of Change

19. In many instances, Changes will be driven by necessity, perhaps for operational reasons or because the MOD's requirement has changed to such an extent that the service being delivered is no longer required. In such cases, it will be difficult to manage the timing of a Change and the MOD may have little choice but to pursue a Change, even where preferential terms are not achievable. However, acquisition team members should be mindful of the potentially significant costs involved in Changes and should not pursue individual Changes where the costs involved are prohibitively expensive or disproportionate to the overall costs of the Change. Similarly, the benefits of employing external advisers, such as quantity surveyors to audit the costs of Changes, should be weighed against the cost of doing so.
20. One method of managing the costs of Change is to adopt a strategic approach to Change. For example, if a number of Changes are foreseeable within the short to medium term, then these should be bundled together to ensure that economies of scale can be achieved in the costs of processing the Change.
21. The exemplar drafting in Addendum 2 to MOD PAv1 allows the contractor to recover third party costs involved in the preparation of an estimate of the cost of a change (the "Estimate") (in relation to changes designated as Major Changes), where the MOD does not go ahead with the Change. This is in keeping with the SOPC 4 position and could generally be considered to be "on-market" for PFI projects in most sectors. MOD PFU is aware that some acquisition teams have achieved a better position on this point with their private sector partners, i.e. that no costs incurred in preparing the Estimate should be re-imbursed. This may be considered to be a best case scenario outcome, but is considered unlikely to be achievable in most instances. See paragraph 18 of Appendix B for further comment.
22. Further detail on costs of change, with particular reference to contractor's management fees, is set out below under **"SPV Margin on Change"** (paragraphs 50-56).

Governance

23. The MOD PFU's survey of acquisition team members dealing with operational PFI projects suggests that, in some instances, contract managers on these projects were unsure of their delegated spending authority and that this had led to cases where these delegations had been exceeded. It is essential that acquisition team members (including contract managers) work within the scope of their delegated authority.
24. Each project should have a governance arrangement which sets out the level of seniority within each of the parties' organisations at which Small Works Changes, Medium Value Changes and Major Changes¹⁰ are considered and approved.
25. Acquisition team members should carefully consider the appropriate timing of obtaining approvals. While there would be little point in pursuing a Change if no funding were available for the Change a reasonable degree of certainty is required concerning the costs and other impacts of a Change before approval is sought. The desire to avoid delays in implementing the Change may also mean that approval is sought in parallel with the engagement with the contractor on the Change.

Preparing to discuss a Change

26. The NAO's report referred to above advises that contract managers should: *"[understand] the contract to be sure that a change request is actually a change and not covered under the existing agreement and pricing structures."*¹¹ This may be particularly relevant in defence projects where some payment mechanisms are driven by "take or pay" regimes or allow for flexible hours of availability for asset/services time.
27. Another element of good practice which is recommended by the NAO is that the public sector party should provide its private sector counterpart with the fullest possible specification of a Change at as early a stage of engagement as possible. This helps to ensure that the MOD achieves its objectives and that it can influence the performance, cost and time parameters for the Change as much as possible. It should also drive efficiencies into the process. The benefits of early engagement are recognised in SOPC 4 and the exemplar drafting in Addendum 2 to MOD PAv1 has been drafted accordingly.
28. One of the factors which will determine whether an acquisition team can provide a proper brief for a Change will be the extent to which the MOD customer/user is engaged and bought-in at an early stage. Acquisition team members should ensure that internal stakeholders

¹⁰ For definitions of these change terms see the amended MOD PAv1 Part 18 change text in Addendum 2

¹¹ Report by the Comptroller and Auditor General HC 205 Session 2007-2008, dated 14 January 2008, page 6, para. f

are engaged as early as possible in the Change and that, once an initial specification is agreed, variations away from that are managed. In the same way as may be experienced in the initial procurement, variations made by the MOD during the negotiation of a Change can lead to delays and increase cost.

29. If a Change is being considered by acquisition team members who do not have a great deal of experience in processing Changes in operational PFI contracts, MOD PFU recommends seeking advice from as many different sources as may be possible or appropriate given pressures of time etc. Major Changes should be notified to and discussed with the MOD PFU. Other sources of advice include members of other PFI acquisition teams and PUK's Operational Task Force.
30. In the context of a Major Change, acquisition team members should ensure that their team is sufficiently resourced and include appropriate expertise to meet the challenge of implementing a Change, which can be resource intensive at times. This may include supplementing internal resource with, for example, external advice. Further advice may be obtained from the PFU on team resourcing and the need for/process involved in appointing external advisers.
31. More generally, acquisition teams within the MOD that are managing operational PFI contracts should identify an individual whose role includes responsibility for processing Changes. This should help to ensure that Changes are processed efficiently and that the principles of best practice (e.g. managing stakeholder input, as described at paragraph 28, above) are followed. The NAO recently emphasised the need for public authorities to properly resource the management of their PFI contracts.¹²
32. Where the original contract was let following a competition run in accordance with the European Procurement Regulations, acquisition team members considering Major Changes should consult with MOD Central Legal Services – Commercial Law in relation to possible procurement issues that may arise from these Changes¹³.

Access to Information for audit purposes

33. It is an important principle of the Change process that the MOD must be able to obtain appropriate levels¹⁴ of disclosure of information

¹² See Report by the Comptroller and Auditor General HC 205 Session 2007-2008, dated 14 January 2008, page 5, para. d.

¹³ Note that Partnerships UK's Operational Taskforce Note 3: "Variations Protocol for Operational Projects (entered into prior to Standardisation of PFI Contracts version 4)" dated March 2008, paragraph 2.21 suggests that "SPVs are private sector organisations and are therefore not required to follow the procedures set out in the EU Procurement Services Directive..." Nonetheless, the application of the Procurement Regulations should be considered for each Major Change.

¹⁴ Whether or not it is appropriate for the MOD to pursue a high degree of disclosure will depend, in part, on whether the Change is a Small Works Change or of higher value. If it is a Small Works Change, we recommend that a Schedule of Rates approach is taken to pricing, which will limit the amount of discussion over the costs of the Change.

relating to costs claimed by the contractor. Disclosure will be the MOD's first priority, to ensure transparency of pricing. However, it is also an accepted principle in single source defence contracting that requests by acquisition team members for further information relating to a Change should be limited to details which are required for price fixing purposes.¹⁵

Achieving Value from Change

34. If a Change is going to be processed through the existing contract, then the MOD will necessarily be in a single-source situation, negotiating with the incumbent contractor. This means that the MOD may have a weakened negotiating position and, if the contractor is entitled to charge a margin on the underlying costs of the Change, then this may reduce the incentive on the contractor to manage its sub-contract costs. Change protocols should address methods of protecting VfM. This should also be a key consideration when discussing Changes with the private sector partners.
35. Analysis conducted by the NAO suggests that, where there are no contractual protections in place in relation to VfM, the resulting cost to the MOD may be greater.¹⁶ This emphasises the importance of aiming to introduce some of the principles of best practice, as described in paragraph 9 to 15 above.

Competitive Tendering in Major Changes

36. One of the ways in which to demonstrate that the costs of a Change represent VfM is through competitive tendering. This has not always been done in the past. However, competitive tendering of the underlying costs of Changes should be the default option for Major Changes unless the nature of the Project or the Change precludes this. Where competition is not viable other methods of testing VfM should be considered (e.g. independent analysis, benchmarking or cost audit) or by using existing costs and extrapolating these to the Change in question. Acquisition team members may also like to consult with the MOD Commercial Project Enablement Team – Cost Assurance & Analytical Service (CAAS). Appendix B sets out guidance on what should be included in a price breakdown relative to a Change and how the various aspects of Change may be value-tested. While this is not authoritative guidance it may provide useful suggestions for members of other acquisition teams who are considering Changes.
37. If competitive tendering is viable, acquisition team members should be as proactively involved in the competition as possible, for example by suggesting companies which may be invited to tender for the

¹⁵ See paragraph 9 of the 1968 Government Profit Formula Agreement: "The Government will therefore limit any demand for further information to what can reasonably be shown to be necessary for price fixing purposes."

¹⁶ Report by the Comptroller and Auditor General HC 205 Session 2007-2008, dated 14 January 2008, page 14, para. 2.9.

work. Care should be taken, however, not to do anything which could be seen as changing the allocation of risk between the parties.

38. The importance of achieving value in relation to Major Changes was demonstrated by a statistic in the recent NAO Report which stated that, *"Although major changes [are] relatively uncommon, they contributed 90 per cent of the total spend on changes in 2006."*¹⁷
39. While competitive tendering is helpful for identifying the lowest priced tender, it may also elicit other factors which may influence value for money. Examples of this would be where, if appointed, a particular tenderer may increase the likelihood of performance failures by the contractor, or would reduce the residual value of the underlying assets. These aspects may be taken into account in determining which tender offers the best value for money.

Incentive on Contractor to implement the Change

40. In most PFI contracts, once the Estimate is agreed, the contract will oblige the contractor to implement the Change¹⁸. However, in the majority of cases, the MOD has little sanction against the contractor for failing to do so and therefore the principal incentive on the contractor is increased revenue following the Change, which is in turn counter-balanced by greater obligations in respect of the services and potentially greater risk. This is in part due to the different incentives which may exist at the beginning of the contract from those at the time of undertaking a Change.
41. In light of the above, when discussing the Change with the contractor, acquisition team members should consider what incentives may be put in place to ensure that the Change is implemented appropriately. For example, the FsAST acquisition team Business Procedure on Pricing of PFI/PPP Change states that: *"These incentives may be linked to the value of service credits/deductions¹⁹ that would arise from the date agreed that the change will occur, or a specifically negotiated Standing Service Credit regime, or to a nominal figure if this is simpler. Whilst it is acceptable to include a limit to the total value of incentive that can be recovered (e.g. 10% of the value of the change), it may in some circumstances be appropriate to increase the incentives for lengthy delays. It should be*

¹⁷ Report by the Comptroller and Auditor General HC 205 Session 2007-2008, dated 14 January 2008, page 10, para. 1.10. Note that this statistic is not defence-specific. However, from our survey of acquisition team members, it would appear that similar trends prevail in defence.

¹⁸ This may or may not be affected by the addition of a KPI in the Service Provision Requirements in respect of processing of Changes, linked to service credits/deductions under the Payment Mechanism.

¹⁹ Service credits/deductions are a mechanism for assessing poor performance leading to payment service credits/deductions.

remembered that such incentives will attract a premium from the contractor to cover the potential risk that delivery will be late."²⁰

42. In addition to the incentives to complete a change, the MOD should also consider what can be done should a change not be implemented within a reasonable period, or where having been implemented it then fails to deliver the intended performance. Linkages to other aspects of performance, termination triggers in the Project and compensation arrangements must be fully considered and amended, where necessary, in the context of the Change.

Approach to Lifecycle impact of Changes

43. Where, as part of the process of preparing its Estimate of the impact of a Change, the contractor includes an element of increased lifecycle spend, PUK's guidance suggests that these costs: *"should be consistent with the rates quoted in the original bid."*²¹ Depending on the approach that the contractor took in pricing lifecycle in its original bid, it may be difficult to reconcile the proposed increase to a "baseline" figure in the original financial model. This is an area which must be carefully considered by acquisition team members.
44. Another challenge for acquisition team members is to evaluate which elements of Change should give rise to additional lifecycle spend and which should not. In most cases, this will be a matter of common sense and may be determined in part by the approach taken previously on the same Project or other projects.

Achieving value through a partnering approach

45. Maintaining a positive relationship with the contractor and its sub-contractors/funders can be a key factor in implementing Changes more efficiently and achieving value from those Changes. For example, in some instances, contractors have been known to waive their fees in relation to Small Works Changes where positive partnering relations existed. Moreover, a strong working partnership can encourage contractors to add value by suggesting ways to improve the Service provision on their respective Projects. These examples signify the importance of maintaining a close but robust working relationship with the private sector.

Small Works Changes

46. One of the areas in which a number of different approaches have been taken is on the costing of lower value changes (also known as "Small Works Changes"). This concept was not incorporated in early

²⁰ Flight Simulator & Synthetic Trainers Team Business Procedure Commercial Pricing of PPP/PFI Change FsAST BP/C003 Issue 2, Section 2.2. Other types of incentive that may be considered are set out in para. 2.35 of Partnerships UK's Operational Taskforce Note 3: "Variations Protocol for Operational Projects (entered into prior to Standardisation of PFI Contracts version 4)" dated March 2008.

²¹ Partnerships UK's Operational Taskforce Note 3: "Variations Protocol for Operational Projects (entered into prior to Standardisation of PFI Contracts version 4)" dated March 2008, paragraph 2.18.

PFI contracts. Over time, the value of these changes can become significant. Consequently, it is important that VfM can be achieved in relation to this type of Change; this has not always been the case in the past.²²

47. In this context, it is essential that an approach to costing these Changes is agreed with the contractor and applied for the remainder of the duration of the contract. The recommended approach is to agree a schedule of rates for the cost and labour elements of these Changes. In order for this approach to be effective, the rates must represent value for money at the time that they are agreed and adopted. It may also be helpful to review these over time, and to share benchmarking information (where possible) across defence and wider Government. Independent sources of benchmarking data may also be available, for example through the Royal Institute of Chartered Surveyors or similar body. The question of whether a margin should be applied to Changes of this type is dealt with below under "Contractor Margin on Change" (paragraph 50 to 56).
48. In some cases, acquisition team members may feel that the desirability of testing the costs of Small Works Changes is outweighed by the need to process these as quickly as possible and that these Changes are of insufficient value to justify the time involved in checking quotes. This gives rise to concerns over whether best value will be achieved. The "Schedule of Rates" approach may go some way to resolving these competing considerations.
49. A further way of achieving VfM in processing Small Works Changes is to bundle them together when agreeing any adjustment to the monthly payment (often referred to on a PFI contract as the Unitary Charge) which may be required. This is an approach which has been used by acquisition team members in practice and is encouraged by the NAO and PUK. This means that the time and costs involved in calculating any adjustments to the Unitary Charge can be incurred just once in any year, rather than a number of times.

SPV Margin on Change

50. In many instances, the contractor may seek to charge a management fee, or "margin" on top of its underlying sub-contractor's costs. Research suggests that the approach to these costs varies widely from Project to Project, in terms of whether margins are applied and, if so, what percentage fee is proposed.²³

²² See the report by the Comptroller and Auditor General HC 205 Session 2007-2008, dated 14 January 2008, pages 14-16, paras. 2.10-2.15. Prices charged by PFI Contractors to supply and fit an electrical socket ranged from £302.30-£30.81. Variations in pricing of Small Works have also arisen in the defence sector.

²³ See the report by the Comptroller and Auditor General HC 205 Session 2007-2008, dated 14 January 2008, page 17, paras. 2.18-2.22: "Management fees have ranged from 2 per cent to as much as 25 per cent of the value of the changes, adding up to an estimated £6 million paid in SPV fees for changes made in 2006."

51. Generally speaking, the level of margin should reflect the value added by the contractor. If it is taking an increased risk as a result of the Change or is likely to incur increased costs in managing sub-contractors' input, then a management fee may be appropriate. PUK's guidance on this point states that: "It is unlikely that low value or medium value changes will justify this type of mark-up and where these are asked for on high value changes, [contractors] should demonstrate why these mark-ups are justified and where they were agreed to in the procurement."²⁴
52. Appendix A sets out some examples of where contractors may suggest adding a margin to the costs of a Change, together with a recommended approach in each case. This information has been provided by the FsAST acquisition team and has been tested with some industry partners in that sector and is acceptable to them.
53. Where the MOD has asked the contractor to obtain additional funding for a Change, no separate mark-up should be included in the costs of the Change in respect of sub-contractor performance risk, because this will already have been factored-in to the costs of the additional finance²⁵.
54. If best practice were being applied during procurement, the MOD's statement of requirement should include an obligation on the contractor to process changes. That way, the service of processing Changes would be included by the contractor in the original Project costs and make claims for management fees less justifiable. It could also form part of the payment mechanism, which would allow the MOD to incentivise the contractor to process Changes efficiently. As mentioned earlier in this guidance in many existing contracts, there is no direct incentive on the contractor to do so. This principle may be considered by acquisition team members seeking to re-negotiate existing Change drafting or to put in place informal Change protocols, as described at paragraph 14, above. However, a careful approach is necessary to ensure that any price increases proposed by the contractor to meet such an obligation represents value for money.
55. As a matter of policy, a margin should not be charged where shareholders of the contractor are also affiliates (i.e. holding companies or subsidiaries) of the sub-contractors involved in the Change. To do so would allow the companies involved to obtain "profit on profit". This position would not be acceptable to the MOD.²⁶

²⁴ See Partnerships UK's Operational Taskforce Note 3: "Variations Protocol for Operational Projects (entered into prior to Standardisation of PFI Contracts version 4)" dated March 2008, Section 2.29.

²⁵ See Partnerships UK's Operational Taskforce Note 3: "Variations Protocol for Operational Projects (entered into prior to Standardisation of PFI Contracts version 4)" dated March 2008, Section 2.22, bullet point 5.

²⁶ In addition, Partnerships UK's Operational Taskforce Note 3: "Variations Protocol for Operational Projects (entered into prior to Standardisation of PFI Contracts version 4)" dated March 2008, Section 2.27 states that "Contractors and SPVs should not be charging mark-ups on mark-ups for example".

56. Experience has shown that contractors take different approaches to charging mark-up on Small Works Changes. These Changes are often carried out by sub-contractors, rather than the contractor and do not increase the level of risk borne by the contractor. Therefore, mark-up on Small Works Changes is “very often not justified”²⁷ and should be rejected. The contractor should be asked to verify any project management fee for Small/Medium Changes.

Contracting directly with sub-contractors for Changes

57. The MOD should not deal directly with sub-contractors in respect of works or services involved in a Change. PUK’s guidance summarises the reasons why:

- *“the Authority will have to manage the interface between the new works and the existing PFI services[; and]*
- *The SPV may try to charge a high fee for providing services and dealing with latent defects arising from works provided from a third party outside their control.”*

In addition such action could dilute SPV liability under the Contract and it is clearly better for MOD for the SPV to remain primarily liable. Similar views to those above have been expressed by acquisition team members within the MOD.

Due Diligence by Contractor Related Parties

58. Due diligence by the original Senior Lenders on a Project is likely to be required in most Major Changes, even where additional private sector funding is not being sought²⁸. In such cases, the MOD may be required to meet these outlays. This charge should be factored into the necessary costs of the Change and acquisition team members should consider the guidance in paragraph 19 in this regard.
59. By contrast, due diligence should not be required on more minor changes where neither the contractor’s ability to provide the services nor its risk profile will be affected. Depending on the terms of the principal funding agreements, the funders may still require/be entitled to perform due diligence on the Change, but it would be less appropriate in these circumstances for the MOD to meet these costs.
60. Again, it is difficult to benchmark the cost of funders' due diligence in relation to Changes, as this is driven by a number of different factors. Steps should be taken to ensure that the contractor has demonstrated that these costs have been managed²⁹, where possible,

²⁷ Report by the Comptroller and Auditor General HC 205 Session 2007-2008, dated 14 January 2008, page 5, para. c iv.

²⁸ Experience suggests that the capital element of the majority of Changes processed has been met by the MOD, rather than by additional borrowing.

²⁹ For example, it may be possible to reach agreement with the funders that subsequent changes may be considered at a lower cost from the first as much of the review work will already have been done.

and are reasonable. Further advice may be obtained from the MOD PFU on a case by case basis.

Recalculating the Financial Model

61. As a consequence of Changes made to the Contract it may be necessary to amend the Financial Model³⁰. However given the costs involved in making such changes, largely due to the need for both parties to appoint external financial advisers to deal with the complexity of such changes to financial models, it may be appropriate to consider amendments to the financial model no more frequently than on an annual basis.

Recording Changes made

62. It is essential that good records are maintained of Changes made in a Project with Major Changes formally documented by Deed. This is necessary for a number of reasons, including the need for an audit trail, the need to provide evidence if any disputes arise concerning the Change later, to re-set the "baseline" to be used in any future benchmarking/market testing exercises or VfM reviews and to avoid paying twice for items, such as lifecycle costs. Recorded information can also be used to identify trends in behaviours, which may in turn allow better practice to be developed. Our survey of acquisition team members showed that not all teams within the MOD maintained this discipline.

Further Reading

HM Treasury's "The Standardisation of PFI Contracts version 4" dated April 2007 ("SOPC 4");

HM Treasury's "Change Protocol Principles" dated August 2007;

The National Audit Office Report of 14 January 2008: "Making Changes in Operational PFI Projects";

Partnerships UK's Operational Taskforce Note 3: "Variations Protocol for Operational Projects (entered into prior to Standardisation of PFI Contracts version 4)" dated March 2008.

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³⁰ Part 12 of MOD PAV1 refers.

Appendix A Part 1³¹ – Allocation of risks in PPP/PFI Changes

This Appendix is not intended to be a definitive list but a guide to assist those considering agreement of SPV profit rates. Agreement with individual Special Purpose Vehicles (SPVs) will be reached on the basis of their approach to risk and the methodology applied to the calculation of profit rates by that contractor in building prices for work to be undertaken.

1. This Appendix identifies types of risk associated with PPP/PFI changes. For each risk identified consideration is given to whether it is more appropriate for the cost of this risk to be included in an element of the cost for a change or to the profit element. This is considered for the following two scenarios:
 - if this is a change to an existing part of the service provided under the contract (e.g. replacing an existing Global Positioning System with a new GPS). This is called a Replacement Change throughout this Appendix;
 - if the change increases the scope of the service provided under the contract e.g. if the change adds GPS functionality where none previously existed. This is called as Addition Change throughout this Appendix.

Capital Cost

2. This is the risk that the cost of buildings, facilities or equipment will exceed the price estimated by the PPP/PFI contractor. There are two elements to this. First there is the risk that the pricing estimate for the work is inaccurate and second, the potential for additional work to be required to meet the contract requirements. Both of these will be factored into the pricing of the building, facilities or equipment and are therefore included as a cost element of the price rather than included in the calculation of profit. This is likely to be a risk that is passed down from the SPV to sub-contractors. This is because payment by the SPV will only be made upon certification of the service which will only occur if it meets the contract requirements. Therefore, whether the change is a Replacement Change or an Addition Change, the cost for this risk should be included in the sub-contractor element of the price and should not be a factor to be considered in calculating the SPV's profit level.

³¹ This is a slightly amended and abridged version of Annex A to the Flight Simulation and Synthetic Trainers (FsAST) acquisition team BP/C003 Issue 2. Changes have been made to fit in with the AOF style template and the Guidance elsewhere in this document.

Installation/Integration Costs

3. This is the risk that the cost of installation/integration will exceed the price estimated by the PPP/PFI contractor due, for example, to technical problems that result in additional downtime to that included by the SPV in their quote. In many PPP/PFI arrangements within the FsAST acquisition team installation and integration is undertaken by a sub-contractor of the SPV who is also a major shareholder. Where this is the case the cost risk arising from installation or integration will lie with the sub-contractor. The reason for this is that the sub-contractor will bear the cost of undertaking any additional work, and any service credits/deductions likely to arise may be flowed down by the SPV. Whether the change is a Replacement Change or an Addition Change, the cost for this risk is likely to be included in the sub-contractor element of the price (e.g. its estimate of hours required will include a contingency to cover this risk), and should not be a factor to be considered in calculating the SPV's profit level. In cases where the SPV undertakes installation or integration, this risk should be included in the cost of the work undertaken by the SPV and should not be considered in calculating the SPV profit level.

Instructor Training

4. This is the risk that instructors will not be properly trained to meet the training requirement, that training will not be delivered effectively, or not available when required. The risk for this normally lies with the SPV and should be included in the cost of training the instructors. Therefore, whether the change is a Replacement Change or an Addition Change, the cost for this risk is likely to be included in the SPV cost element of the price and should not be considered in calculating the SPV profit level.

Service interruption during installation & testing

5. This is the risk that there will be additional disruption to the service over and above that which the contractor estimated when planning the work e.g. as a result of additional testing. The cost of this will fall to the SPV and the SPV will include a time and cost contingency in their price for this risk. Therefore, whether the change is a Replacement Change or an Addition Change, the cost for this risk is likely to be included in the SPV cost element of the price and should not be considered in calculating the SPV profit level.

Service credits/deductions (installation)

6. This is the risk that the installation will take longer than estimated. There are a number of aspects associated with this. First from service credits/deductions arising from the change not being available when originally planned. Second, and more importantly, service credits/deductions arising from the unavailability of the whole service. Generally it is likely that these risks will be at least partially mitigated

by the contractor:

- building some contingency into the downtime agreed with the MOD;
 - agreeing a period of grace under which no service credits/deductions will be applied following initial installation;
 - flowing down some or all of the risk down to the sub-contractor(s);
 - include a contingency in the price based on a calculation of the number of service credits/deductions that may arise (any such approach would require careful scrutiny by the MOD to ensure additional costs could be justified).
7. Alternatively the contractor may prefer to cover the risk of additional service credits/deductions through an element of the SPV profit. Therefore whether the change is a Replacement Change or an Addition Change the cost for this risk may be built into the cost build up or be an element for consideration when calculating the SPV profit level.

Certification process

8. This is the risk that the certification process is unsuccessful and has to be re-run. This risk lies with the SPV but may flow down to the sub-contractors. This is a risk that will be priced into the contingency of the sub-contractors or SPV's cost for certification. Therefore, whether the change is a Replacement Change or an Addition Change, the cost for this risk is likely to be included in the SPV or sub-contractor cost element of the price and should not be considered in calculating the SPV profit level.

Initial Spares

9. This will be a direct cost probably to the sub-contractor rather than the SPV. Therefore, whether the change is a Replacement Change or an Addition Change, the cost for this risk is likely to be included in the SPV or sub-contractor cost element of the price and should not be considered in calculating the SPV profit level.

Through-life maintenance

10. This relates to the cost of maintaining the change during the service for as long as its required. These estimated costs will be included in the cost build up for the change as a contingency relating to the risk of repairs to the element of the service covered by the change. The risk also considers the length of time that the change will be required in the service; this may not be the period of the contract as some systems may be updated regularly through the life of the platform. Therefore, whether the change is a Replacement Change or an Addition Change, the cost for this risk is likely to be included in the

SPV or sub-contractor cost element of the price and should not be considered in calculating the SPV profit level.

Service credits/deductions (Through-Life)

11. This is the risk that the change may result in additional service credits/deductions through the life of the contract. The risk of this will fall to the SPV who may be able to flow some or all down to the sub-contractor(s), although this practice is not widespread. Whether the change is a Replacement Change or an Addition Change, the cost for this risk is likely to be an element for consideration when calculating the SPV profit level. Note however that the Risk may reduce as a result of a Replacement Change.

Obsolescence Risk/Support Risk

12. This is the risk that there are inaccuracies in the estimates for the support elements of the Change, including: maintenance requirements, MTBF, equipment obsolescence dates, replacement costs, direct costs, labour (and associated) costs. Whether the Change is a Replacement Change or an Addition Change, the cost associated with this category of risks is likely to be an element for consideration when calculating the SPV profit level. Note however that the risk may lead to either an under- or over-estimate of costs and that Replacement Changes in particular may reduce the risk associated with elements of support costs.

Health and Safety obligations

13. This is the risk that additional H&S obligations will arise due to the Change arising from future legislation. Whether the change is a Replacement Change or an Addition Change, the cost for this risk is likely to be an element for consideration when calculating the SPV profit level.

Residual Value

14. This is the risk that the residual value of the Change will be less than that estimated by the SPV³². This is likely to be included in the cost build up of the SPV or the sub-contractor. Whether the change is a Replacement Change or an Addition Change, the cost for this risk is likely to be an element for consideration when calculating the SPV profit level.

Quality Assurance

15. This is the risk that planned QA activities will overrun. Pricing of this risk can be included in the cost build up of the SPV. Therefore, whether the change is a Replacement Change or an Addition Change, the cost for this risk is likely to be included in the SPV or sub-contractor cost element of the price and should not be considered in

³² It is considered unlikely that many Changes will benefit from Residual Value considerations.

calculating the SPV profit level.

Vendor investigation & reports

16. This is the risk that unplanned QA activities will be required during the life of the Change. Pricing of this risk will be difficult to cost. Therefore, whether the change is a Replacement Change or an Addition Change, the cost for this risk is likely to be an element for consideration when calculating the SPV profit level. It may be convenient to consider this risk under the general heading of 'Support Risk'.

Appendix A Part 2³³ – Allocation of risks in PPP/PFI Changes

Latent defects % risk premium

1. This is sometimes claimed where a change to the facilities involves new structural work which increases the risk of a latent defect occurring. **Contract managers should not accept this cost as an automatic mark-up.** For high value changes this risk premium may be appropriate for some construction based variations e.g. where there is new construction. However, authorities should be careful to protect risk transfer agreed in the original deal whereby the contractor will be taking risk on latent defects on the original facilities i.e. those handed over at service commencement. Where the benchmarking/independent technical adviser option is taken authorities should seek advice from the technical adviser. Where the competitive tendering option for high value changes is adopted, contract managers should review the tender documentation to identify whether this is to be priced (e.g. is this passed to the sub contractor?) to make sure that there is no double charging. If the sub contractor is responsible for managing both the Capex and the Opex, then there is no justification.

SPV margins in Capex and Opex

2. SPVs may also claim a separate fee or margin for accepting performance risk on the change and accepting an interface risk between the implementation of the change and the provision of the existing service. The MOD will also need to consider whether markups for performance risk and interface risks are justified. It is unlikely that low value or medium value changes will justify this type of mark-up and where these are asked for on high value changes, SPVs should demonstrate why these mark-ups are justified and where they were agreed to in the procurement. The % should be no higher than the original SPV cost %.

SPV management fee

3. In addition to the costs for materials, SPVs may argue that the labour cost for undertaking a variation and for processing it was not costed in the SPV management fee originally bid (see Agreed Daily Rate in the attached protocol). Contract managers should consult the original bid to see if this is the case. SPVs may try to argue that this type of mark-up is agreed custom and practice which may have been introduced after the deal was signed. For low value changes, the SPV is probably only acting as a "middleman" and passing through the

³³ This is a slightly amended and abridged version of paras. 2.26-2.34 of Partnerships UK's Operational Taskforce Note 3: "Variations Protocol for Operational Projects (entered into prior to Standardisation of PFI Contracts version 4)" dated March 2008.

requests to the FM sub-contractor and back again. For medium and high value changes, the SPV will be carrying out a more extensive role.

Change of law

4. A SPV may try to add a change of law risk percentage to reflect that some changes may be liable to attract a cost from a change in law which was not covered in the assumptions made in the original bid. The change in law provisions should already cover this eventuality and therefore an automatic mark-up should not be included in the estimate for a variation.

FM cost

5. Some changes will lead to an additional FM cost, e.g. the addition of a new space may lead to an increased cost in cleaning. Contract managers should look at this on a case by case basis. Provision should also be made in the protocol for any decrease in FM costs resulting from a change.

Maintenance and lifecycle fees

6. In addition to the capital cost of the change, the SPV will need to price in the cost of on-going maintenance of the item together with any lifecycle replacement cost. Because of the nature of low value changes, these costs are unlikely to apply. For medium and high value changes, contract managers should review maintenance and lifecycle fees on a case by case basis and not accept an automatic mark-up for all changes.
7. When a change is requested late in the operational phase, it is unlikely to need a lifecycle contingency and similarly, the related maintenance cost should be low. Authorities will want to know that the lifecycle replacement has taken place and may wish to impose conditions whereby the money is refunded to the authority if the lifecycle work is not carried out.

FM margin on Opex

8. Sub contractors may also charge a margin that provides a contribution to overheads and profits at the sub-contractor level. The percentages quoted for these will vary from contractor to contractor and from project to project. Authorities should interrogate the financial model to see what levels were set in the original deal. Sub contractors may try to argue that this type of mark-up is agreed custom and practice which may have been introduced after the deal was signed.

Appendix B – Guidance on Breakdown of Costs required for Changes (based on FsAST acquisition team guidance)

Breakdown of costs - what is required?

1. In many cases the MOD and the contractor have agreed a standard format of breakdown of costs, thereby preventing the need to discuss the issue for each subsequent change. The breakdown may vary for each contract or change but should include the following elements:

Direct labour

Rates

2. Where possible labour rates to be applied should be agreed with the contractor as part of the PPP/PFI negotiation whilst competition still applies. Where the PPP/PFI contractor is an SPV it is likely that labour rates will not have been agreed by Cost Assurance & Analysis Service (CAAS) and the company structure will not assist in agreement of these rates. In such instances the acquisition team commercial staff should seek to reach agreement with the PPP/PFI contractor on the labour rates to be applied to staff working for the PPP/PFI contractor. These rates may be agreed on the basis of:
 - advice from CAAS;
 - information on labour rates obtained from Government sources (e.g. job centres);
 - reference to rates for similar work undertaken in the relevant industry sector;
 - MOD agreed rates with the major sub-contractor where the main sub-contractor is the main shareholder in the SPV and MOD agreed rates exist with that sub-contractor.

Hours

3. A breakdown of hours to be undertaken by cost centre should be provided identifying grades of staff where appropriate. An assessment of the reasonableness of the quoted number of hours will be undertaken by one of the following methods:
 - CAAS are normally only employed for high value requirements (over £1m), but can be asked to advise on lower value requirements in certain circumstances. For instance, if this will provide information on which further changes can be assessed. CAAS could therefore be asked to advise on the first or subsequent changes to be implemented on a PPP/PFI arrangement to provide a confidence level for future changes. CAAS can also be tasked to provide a

"should cost" estimate. This is a less accurate estimate of what a particular job should cost and is generally more applicable to lower value tasks.

- Assessment against previous work undertaken on similar requirements. The FsAST acquisition team has a lot of expertise of changes to synthetic training equipment and has developed a matrix of changes across all PPP/PFI contracts. This provides visibility of changes placed and identifies the point of contact within the acquisition teams should other members of the acquisition team be addressing similar/same requirements. If individual acquisition team members do not have the experience or expertise to enable them to estimate if the number of hours quoted are reasonable for the work proposed they should consult their colleagues in the acquisition team (or other acquisition teams if appropriate) for advice. Note – as mentioned in paragraph 62 of the Authoritative Guidance above, information should be retained and shared, where possible, between different acquisition teams and across Government. Acquisition team members who are considering implementing Changes should take advantage of other sources of experience and expertise, as suggested by paragraph 29, of the Authoritative Guidance above.

Use of CAAS

- Up to £250K In such cases no written CAAS report should normally be required. Commercial staff may be able to get broad advice on hours quoted for the requirement from CAAS in order to ascertain whether the contractor's claim is of the right order.
 - £250K to £1M A simplified approach should suffice for changes of this value. If necessary a simplified CAAS report will normally be sufficient, perhaps in the form of an examination of the prime cost by CAAS cost engineers and of overheads by CAAS accountants, and preferably in a spreadsheet format to assist recalculation. In some cases it may be appropriate for CAAS to agree with contractors the prime costs (i.e. direct labour, materials, bought-out items and sub-contracts) and overheads on which the price will be based.
4. Unless CAAS are used, commercial staff will require a statement from the project officer responsible that the hours and materials are fair and reasonable for the task.

Materials

5. Details of any materials to be used by the contractor in support of the change should be provided with the associated cost. Project staff should review these costs to establish if they are reasonable for the work to be undertaken. This can be done by a number of methods:

- through CAAS where they have been asked to undertake a price investigation (they may also be able to provide general advice in certain circumstances);
- benchmarking to similar work undertaken on the contract in question or others across the acquisition team;
- by reference to information in the public domain such as catalogues.

Note: See paragraph 4, above, regarding the provision of a statement by acquisition team members that the hours and materials are fair and reasonable for the task.

Sub-contractor work

6. As with other requirements, the contractor should be asked to provide a breakdown of the sub-contract element of the price. Many contractors are reluctant to provide this and, in some instances, sub-contractors may refuse to provide such information. Where breakdowns of the sub-contract element are obtained an assessment of the hours quoted and rates used should be made where possible. Where this is not provided commercial staff should decide whether a breakdown is required. In many cases this will not be forthcoming. However, where the sub-contractor in question is a major shareholder in the SPV, or is a part of the same company group as the SPV, the sub-contractor element should always be subject to full scrutiny including the use of CAAS where appropriate. The labour, overhead and profit rates to be used in the sub-contractor quotation should, in such instances, be that which is agreed between the MOD and the sub-contractor annually by CAAS.
7. The need to obtain breakdowns from sub-sub-contractors must also be assessed and, where necessary, the SPV advised of the need to include the necessary terms in these contracts to enable breakdowns to be obtained. This is particularly relevant where the main sub-contractor is a major shareholder in the SPV. Due to commercial issues a sub-contractor may be reluctant to provide price breakdown to the PFI contractor, in such circumstances the sub-contractor may be willing to provide this information direct to the MOD. In order to overcome the provision of limited price breakdowns acquisition teams are encouraged to negotiate clauses for insertion in the sub-contracts which oblige the sub-contractors to provide the information required.
8. For changes where the sub-contract element is high value the MOD can try to obtain agreement from the PPP/PFI contractor to price the sub-contract directly on the basis of NAPNOC including the use of CAAS where appropriate. If this approach is being considered commercial staff should be consulted.

Specialist Tools

9. Details of any specialist tools required to undertake the change should be obtained. These costs should be assessed by reference to CAAS, previous experience on other FsAST projects or to information in the public domain.

Travel & Subsistence

10. Quotes that include elements for travel and subsistence should be scrutinised to ensure costs are reasonable. In general the rates used should be consistent with those used routinely by the contractor for the type of travel and grade of staff. Where appropriate commercial staff should seek confirmation of company policy towards travel. Particular areas of scrutiny may be use of hire cars, standard of travel (e.g. First Class flights), cost of hotel accommodation and subsistence.

Overheads

11. Overheads for PPP/PFI contractors are likely to be low as many do not have a large company structure to support. However, this may not be the case for all contracts. Commercial staff should endeavour to agree the approach to overheads with individual contractors to prevent the need to debate the issues for each change. Although it is unlikely that it will be worthwhile, or appropriate, for CAAS to agree overhead rates annually with the SPV as is done with other contractors, advice can be obtained from CAAS on a general agreement of overhead rates to be used. In some cases it may not be appropriate for any overheads to be applied to work undertaken by the SPV.

Profit

12. Profit for conventional non-competitive contracts is defined by the Government Profit Formula that is published, usually annually, by the Review Board for Government Contracts. The formula produces a percentage figure that is applied to the estimated costs agreed for the contract and this provides a return to contractors that is equal on average to the overall return earned by British Industry. However, application of the Government profit formula to PPP/PFI contracts may not be appropriate due to the SPV structure, which will fall into the unreasonably high or unreasonably low category under the profit formula, and to the approach taken to profit by the PPP/PFI contractor.
13. The PPP/PFI contractor may seek to approach profit on the basis of one of the Internal Rates of Return (IRR) quoted in the contract. There are often a number of IRRs quoted in PPP/PFI contracts. In simple terms the IRR on PPP/PFI arrangements equates to profit on conventional contracts plus an element to cover the cost of risk associated with the PPP/PFI arrangement. The MOD position on this approach is that the

contractor would not normally be entitled to the same rate of IRR on changes as on the original PPP/PFI contract. The reason for this being that the risks for changes will seldom be as high as the level of risk perceived at the time of contract award. For example the design risk for the facility as a whole will have been removed or considerably reduced. The Notice to Proceed for each Change will state whether that Change is to be included in the VfM Review.

14. There is no central policy on agreeing profit rates for PPP/PFI Changes. As a result, unless specific provision has been made in the PPP/PFI contract for the level of profit to be charged for future changes, commercial staff will seek to negotiate a profit level for all changes under the contract, or on a case by case basis. In agreeing the level of profit commercial staff will consider:

- whether the Government Profit Formula is relevant to the SPV contractor (this is unlikely);
- what risks the SPV is taking and if these are different to those present when the original PPP/PFI contract was signed (see paragraph 17, below);
- what elements of the price the SPV profit should be applied to. Profit should generally not be applied to sub-contract profit when the SPV and sub-contractor is part of the same group. SPVs may apply profit to sub-contract costs³⁴ when it can be demonstrated that the SPV has provided some added value or taken an additional risk (see paragraph 18 below);
- a risk rate of profit calculated on the basis of the Government Profit Formula for the sub-contractor, plus a percentage for the additional risk or value added by the SPV.

15. As a fundamental principle SPVs should be able to include in their price a cost for the risks they take for implementing changes to PPP/PFI arrangements. There are two major factors that need to be considered when agreeing the risks to be included in the SPV profit. These are:

- the risk may not rest with the SPV but with a sub-contractor.
- the cost associated with a risk may be associated with an element of the price build up (e.g. labour) rather than the SPV profit.

16. An understanding of where the contractor should be including the costs for each type of risk will therefore enable a structured approach to agreement of rates to be applied. To facilitate this understanding attached at Appendix A Part 2 to this PFU guidance is a list of risks with

³⁴ 'Costs', in this context, is taken to mean all a sub-contractor's outgoings in relation to a task, including overheads, handling charges etc but excluding profit.

details of where the cost for these risks are likely to be applied by the SPV. As can be seen most risks are likely to be associated with an element of the price build up rather than the SPV profit. Whilst Appendix A Part 2 may not cover all risks associated with change, it provides a basis for establishing how additional categories of risks may be viewed.

17. Whatever method is employed to determine the rate of profit, care should be taken to ensure that the SPV profit for work sub-contracted to organisations within his own Group reflects the added value or additional risk being taken by the SPV.

Cost of Preparing Quotations

18. Contractors may try and recover the cost of preparing a change quotation. In general, this activity is being carried out as an obligation under the PFI contract. There are, however, some contracts under which the SPV can recover the cost of quotations within the cost of the Change. Commercial staff should ensure that the cost is only recovered directly through the change where this is in accordance with terms and conditions of the contract in question. Many sub-contractors recover the cost of producing quotations through their overhead rates (CAAS should be consulted where this is disputed by individual contractors) and, in these cases, additional payments should not be made. However, where the contractor has to obtain a quotation from a sub-contractor (including a sub-contractor from his own Group) in order to prepare his quotation, then he may have legitimate grounds for passing on to the MOD any charges levied by the sub-contractor, if it can be shown that no provision for these costs were made within the original PFI contract or in overhead charges. In general the MOD does not expect to pay for the cost of providing estimates for changes that do not come to fruition.

Finance Charges

19. Contractors may include the cost of raising finance where a change is to be paid for through an increase in the charging rate. Most PPP/PFI arrangements include a methodology for determining financing costs that the contractor can pass on to the MOD. Where a lump-sum payment is being proposed finance charges should generally not be incurred.

Operating Costs

20. Any quotation that includes an increase to operating costs (e.g. maintenance or utility costs) should be closely scrutinised to ensure that any reduction in the existing costs is taken into consideration. For example, where a new system is introduced that replaces an existing system the maintenance costs associated with the existing system

should be deducted from the price increase. It should be remembered that "maintenance costs" includes the provision of spares and that any savings the contractor makes from not having to provision spares for a system that has been replaced should be reflected in the contractor's quotation.

Capital Costs

21. Where a change renders existing synthetic training equipment redundant the MOD pricing team should consider whether the contractor would be able to resell or reuse that equipment. Where this is likely, the issue should be raised with the contractor with the aim of securing a reduction in the price of the change to take account of benefit the contractor will receive from the sale or reuse.

Residual Value

22. Some Changes may result in a tangible increase in the residual value, which the contractor will be able to recover at the end of the contract term (or when the Change is removed). Where this is the case, the contractor's price should be reduced by a suitable amount. This will often be the Net Present Value of the residual value of the Change. Finance staff should be consulted for further guidance.

Import Duty

23. The facilities underpinning all the services managed by the acquisition team are considered to be Military Equipment and any equipment required to undertake a Change is also classed as Military Equipment. As such, it is exempt from import duty³⁵ providing the correct certificate has been raised. Care should therefore be taken to ensure that the contractor's price does not include any provision for import duty.

³⁵ Import duty is normally payable on goods being imported from outside the European Community.