HM TREASURY

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1 Introduction

Context

1.1 HM Treasury issued draft guidance in January 2011 (Making savings in operational PFI contracts – DRAFT) to assist public sector PFI contract managers to identify and implement savings measures that would reduce costs while maintaining frontline services. The draft guidance drew from engagement with public sector authorities, departmental Private Finance Units (PFUs), private sector financial investors and contractors, as well as from the experience of the Infrastructure UK Operational Taskforce and Local Partnerships and recommendations from National Audit Office (NAO) reports.

1.2 A number of public sector authorities have already been seeking cost savings from their PFI contracts and have followed the recommendations in the January draft guidance.

1.3 Since the draft guidance was issued, four pilot cost savings reviews of operational PFI projects have been carried out, one by HM Treasury with the Cabinet Office and three by the MOD. These pilot reviews have been valuable in enabling the draft guidance and potential savings measures to be tested and further developed through practical application. We are very grateful to the project teams for their participation in these reviews and for the access they have given to their experienced staff and to project information.

1.4 This report draws together the findings of the pilot cost savings reviews and provides updated recommendations for savings measures to be pursued from the portfolio of UK operational PFI projects. Public sector authorities should also factor these recommendations in to future project procurements, and as far as possible to projects in the procurement pipeline.

1.5 The four pilot cost savings reviews were carried out on the following PFI projects:

- Queen's Hospital Romford ("the Queen's Hospital"), part of the Barking Havering and Redbridge NHS Trust ("the BHR Trust");
- MOD Main Building Redevelopment;
- Corsham Development Project; and
- Welbeck Defence Sixth Form College.

Overview of savings opportunities explored during the review

1.6 The pilot reviews have confirmed the draft guidance recommendations for achieving operational savings. These can be summarised as:

- effective management of existing contract terms (including performance regimes and cost/gain share mechanisms, for example in relation to insurance or energy costs);
- optimising the use of asset capacity - and avoiding marginal costs of surplus capacity where possible through mothballing or subletting; and

- **reviewing the specification of soft services** so that the public sector only pays for what it needs, standards are applied consistently across PFI and non PFI facilities, and value testing provisions are used effectively.

1.7 The opportunities for making savings are greater from some elements of PFI unitary charges than others:

- Any construction cost is effectively a sunk cost, and decisions taken at the point of specification of an asset or property drive a proportion of future unitary charges that repay the capital investment over the contract term. There can be scope for savings to be achieved from debt refinancing by the project company (with gain share for the public sector) if market pricing reduces after the project finance was raised. However for long term fixed rate borrowing the base cost of funds element of financing costs is effectively committed for the term of the financing.

- The lifecycle and maintenance costs of the property are bound up with the asset design, construction and management risk transferred to the Project Company at the outset - as such these costs are relatively inflexible without changes to the risk allocation of a project.

- Soft services (to the extent included in the PFI contract) are typically provided under short to medium term sub-contracts, and so are relatively more flexible should changes be desirable. The costs reflect the specification of the services commissioned by the procuring authority, and as such are not driven by the procurement route that has been chosen (ie for the same specification, the costs under PFI or conventional procurement should be similar). The pilots confirmed that is in this area of PFI unitary charges that most opportunity is available to extract operational savings.

- A small element of PFI unitary charges covers project company insurance, risk premia, advisory costs and other fees and can offer savings opportunities covered in this guidance including insurance cost and gain share provisions and the potential to take back change in law risk.

Summary of pilot findings

Queen's Hospital

1.8 The review confirmed that the BHR Trust has identified and acted on a number of opportunities to reduce the costs of the PFI project. There are many examples of good practice in the BHR Trust's contract management that provide useful models for other Trusts and PFI procuring authorities for optimising the management of existing PFI contracts. Examples include:

- Effective management of existing cost/gain share provisions in relation to insurance;

- Seeking to reduce energy consumption, for example through increasing energy use awareness;

- Regular reviews of soft services specification against service requirement;

- Aligning market testing dates between sites with the same soft services provider; and

- Accessing agency energy purchasing discounts (via BuyingSolutions).

1.9 The capacity of the hospital is larger than the BHR Trust's current requirements. The BHR Trust has taken action (through accepted or planned variations to the project) to minimise the marginal costs of surplus capacity, including through subletting a surplus ward to a private healthcare provider, with related usage agreements for clinical and non-clinical services. The BHR Trust is also reviewing opportunities for temporary mothballing of contingent ward space.

1.10 In addition, the BHR Trust has taken or is considering opportunities to extract savings or improve value for money from changes to the project specification, whilst maintaining the operational performance. Examples are standardising the ward housekeeping specification across its PFI and non PFI hospitals and reviewing and adjusting response times and shift patterns for portering and security services. In addition, the Trust has introduced changes to specification of replacement equipment under the medical equipment contract, to reflect the longer lifecycle of some medical equipment, in order to optimise the use of the contract budget.

MOD Pilots

1.11 The details of the MOD's pilot exercises are currently subject to commercially sensitive negotiations with suppliers. Nonetheless, it is clear that the findings identified on the Queens Hospital are broadly aligned with the MOD's findings. In particular, many of the savings identified were found through reviewing soft services specifications and examining asset utilisation. In addition, the MOD examined two other areas:

- Transferring certain services to defence-wide programmes that were not established at PFI contract signature;
- Reviewing opportunities to dispose of surplus land, taking into account the through life requirement and costs before proceeding.

Conclusion

1.12 The four pilot reviews have confirmed the approach recommended in the draft guidance for making savings from operational PFI projects, and have enabled lessons to be learned on the approach to delivering contract reviews and negotiating savings. It is recommended that all Authorities with operational PFI contracts instigate a contract savings review if a comprehensive review has not already been undertaken.

1.13 Subject to the conclusion of ongoing commercial negotiations related to some of the savings identified at the pilot projects, the pilots have confirmed annual savings of around 5% of the annual unitary charges are achievable. In the main these savings come from the effective application of existing contract provisions, optimising the use of contract assets and reviewing the specification of soft services to realign with the service requirement.

1.14 The extent to which a similar level of savings will be available across other operational PFI projects will depend upon the bespoke nature of services under each contract, as well as the degree of active contract management that has applied (and may have already extracted savings from the project), and the extent to which the specification exceeds requirements and can be amended without impairing effective delivery of the necessary services.

1.15 In addition to exploring the scope for savings from the pilot projects, the reviews have looked at the process for accessing those savings, including the management of contract variations and engagement with PFI project companies and service providers. Some important lessons can be drawn:

- Transparency of underlying cost data is extremely valuable to aid the identification of savings opportunities and to inform an authority's commercial negotiation of service specification changes and contract variations. Whilst contractual information sharing provisions should give an authority entitlement to detailed financial information from the Project Company, obtaining the information can be time consuming and difficult. Where contracts do not have SOPC4 levels of transparency obligations, it is recommended that Authorities work to introduce them where possible with the aim of simplifying the process of accessing financial information.

- Contract reviews, the identification of value for money savings and the negotiation of variations will require commercial, legal, financial and technical expertise. It is recommended that public sector network groups established in some sectors are used to provide access to experience and expertise of managing similar PFI contract issues. Where these skills are not available in-house or through other parts of the public sector, then authorities may want to commission external expertise to protect taxpayers interests and mitigate the risk of short term savings being made at the expense of longer term value. The associated costs of advisory fees should be weighed up by an authority in the context of the potential value of savings that could arise (and of commercial and financial risks that could be avoided).
- Value testing of soft services unit costs is a complex area and does not always provide cost reductions. However it many cases it does provide an opportunity to review and make changes to service specification under competitive conditions. Regular reviews of service requirements and specifications in conjunction with scheduled value testing points in soft services agreements is recommended, to ensure that the services provided in PFI projects continue to reflect requirements over the contract term.
- Timing of any review is an important factor. Government departments should establish a clear understanding of the current and future operational requirements of the asset before entering into negotiations with the contractor. This should lead to realistic and achievable outputs. For example, departments should consider reviewing project benchmarking and market testing dates across their PFI portfolio when prioritising projects for review.

1.16 In addition to the above recommendations, local authorities should be aware that, pursuant to the Local Government Act 1999, local authorities should have included "best value" provisions in their contracts, pursuant to which an annual best value review and performance assessment should take place with the contractor every year. This should provide an opportunity to identify improvements and savings which can be made to services and agree these with contractors throughout the term of the contract.

2 Approach to contract savings reviews

Principles to be applied

2.1 PFI projects are complex, long-term arrangements with whole life costing, detailed risk allocation and clearly defined termination provisions. As such, strategies applicable for saving costs in PFI contracts need careful consideration.

2.2 Prior to considering any changes to their PFI contract(s), authorities should ensure that they have a good understanding of the existing contractual terms and are effectively managing the contract. For example, the value of existing provisions such as insurance cost sharing arrangements should be verified before any contractual provisions are changed. If authorities do believe there is a case for changing the contract, they will need to undertake preparatory work before doing so.

2.3 Value for money (VfM) is a cornerstone of PFI and the key rationale for its use. It is therefore crucial that authorities consider cost benefit issues relating to risk transfer and the whole life effects (both cost and quality) of any changes to the project so that they do not undermine essential services and the VfM of how these services are delivered.

2.4 Authorities may need to engage commercial and legal advisors (if the contract is amended) and, where relevant, technical and financial advisors (to assist them with understanding and validating underlying costs, financier concerns and payment mechanism implications). Authorities should choose suitably qualified advisors. In making appointments, authorities should check whether advisers are conflicted by roles advising the private sector on the project and seek to avoid such conflicts.

Recommended contract savings review steps

Box 1: Summary approach to conducting a contract savings review

Steps to be followed:

1. Check that existing contract is being managed effectively
2. Check whether payment mechanism is being used with effective performance monitoring and payment deductions
3. Check insurance cost sharing provisions
4. Consider opportunities to increase energy efficiency
5. Review asset usage and scope to optimise management and use of asset
6. Consider subletting or mothballing spare capacity (if avoidable costs offer VfM)
7. Review whether service specification reflects requirements and that the public sector is only paying for what it needs. Consider potential for efficiencies from standardisation, procuring services outside the PFI contract and/or seeking repricing through value testing
8. Share / benchmark / obtain cost information, comparing information with other comparable projects
9. Consider the costs and benefits of changing the contract
10. If contract changes are likely to be required, agree suitable cost transparency measures and variation protocol
11. Communicate lessons learned with departmental PFUs and other public sector networks

2.5 The approach to conducting a contract savings review has been tested through the pilot projects. The savings opportunities in the box above are discussed in the next chapter of this document in the context of the experience of testing them for the pilot projects. It is recommended that authorities carefully consider the scope for savings in these areas.

2.6 The first stage in any contract savings review is a high level review of the contract, including the contracted services and payment mechanism (including cost and gain sharing provisions), and whether any value testing rights have been exercised. The effectiveness of contract monitoring and the service provider's performance should be reviewed against contracted service levels.

2.7 The authority's actual asset usage levels and current service requirements should be compared with the outputs required under the contract. Opportunities should be explored to increase efficient use of the asset, or to mitigate the marginal costs of surplus capacity. Potential to rescope specified services should be considered, taking into account comparable service standards in other benchmark facilities.

2.8 Whether or not specification changes are likely to be of interest, contract managers should seek available data to inform judgements about the current cost effectiveness of service unit cost pricing compared with suitable benchmarks, and whether to exercise available value testing provisions (in conjunction with any service rescoping, if relevant).

2.9 Where any contract variations may be necessary to deliver savings measures, then this may present an opportunity to introduce more recent standard contract provisions with respect to data transparency and variations protocols. In all cases the VfM of making contract changes will need to be considered, taking account of the likely costs and benefits, as set out in the sections below.

Steps to follow when considering changes to a contract

Box 2: Steps to follow when considering changes to a contract

1. Consider the costs / benefits of implementing changes to the contract
2. Check procurement documentation
3. Ensure sufficiency of cost transparency and suitability of variations protocols
4. Understand what the current charges are for a service relative to what others are paying for similar services
5. Make contact with other authorities, especially those negotiating with the same consortium members and subcontractors.
6. Check current standard provisions in respect of the amendment being considered.

Consider the cost / benefit of implementing changes to the contract

2.10 In addition to considering carefully the impacts of potential savings on services, savings that require contract changes need to be considered carefully in light of the costs of implementing necessary changes to the contract. Implementation costs could include legal, technical and financial advisory fees, survey costs and financial modelling costs for the authority, the PFI provider and/or its lenders and sub contractors. Where there is a concern that savings will be outweighed by implementation costs the Authority could consider deferring the implementation of the change so it is implemented alongside other changes to the contract.

2.11 In addition, authorities should be aware that the consent of senior lenders and/or investors may be required, particularly for more material changes to the contract that may affect risk profiles. Obtaining change consents can be a time consuming process (particularly where bond holder approvals are required for bond financed projects).

Check the procurement documentation

2.12 Most PFI contracts will have been let following a procurement process initiated by a notice in the relevant Official Journal (either OJEU or OJEC notice) and then in accordance with either the negotiated or competitive dialogue procedure under EU procurement law. If an authority is considering varying a contract in any material way, it is advisable to seek legal advice on any risks of challenge that might be presented under the original procurement for the specific changes being considered.

Ensure cost transparency, especially in pre SoPC4 contracts

2.13 All SoPC4[1] contracts and associated financial models have a level of cost transparency (for both PFI provider and subcontractor costs) which enables authorities to understand the costs of individual services under the contract and the mark-ups applied to the base cost of changes[2].

[1] Standardisation of PFI Contracts volume 4 (http://www.hm-treasury.gov.uk/ppp_standardised_contracts.htm)
[2] Required drafting is set out in para 26.2 of SoPC4.

2.14 HM Treasury is engaging with PFI investors, subcontractors and lenders at a national level to seek their agreement to, amongst other things, apply SoPC4 cost transparency to older contracts through a voluntary code of conduct.

2.15 The Queen's Hospital contract pre-dates SoPC4, but nonetheless contains similar entitlements to project information. However, many older contracts do not give this degree of transparency to the authority. Without this information, authorities may find it difficult to determine the VfM of implementing savings measures.

2.16 Experience has shown that where older contract information provisions are not express nor explicit, the authority has to justify each request for information and access may be slow. Whilst amending the project agreement to incorporate SoPC4 cost transparency provisions may not give an authority legal entitlement to any additional information that it is not already entitled to, it may make the process easier. Implementing the SoPC4 cost transparency provisions into project agreements that do not already have them could bring the following benefits:

- clearly establish the authority's rights in terms of what information it can ask for without the need for discussion and justification;
- require the project company and its subcontractors to keep and maintain full records of the costs of performing the services;
- specifically require the project company to furnish to the authority regular reports of all financial information provided to senior lenders in any quarterly period;
- specifically require the project company to furnish to the authority copies of the Financial Model at financial close and further copies any time it is subsequently amended; and
- afford the authority extensive rights of access to project company and sub-contractor records in all areas of design, construction, operation, maintenance and finance.

2.17 Authorities will require legal advice to apply the SoPC4 cost transparency drafting to their existing contracts. If transparency provisions were to be the only amendment to the project agreement then the time, effort and cost of contract amendments may not be justified. But if the project agreement is being amended elsewhere (for example as part of the implementation of cost savings measures) then authorities should seek the incorporation of the SoPC4 best practice provisions simultaneously.

Agree a variations protocol, especially in pre SoPC4 contracts

2.18 Before planning to negotiate variations to a contract, Authorities should first agree a protocol with the PFI provider to outline how the variations will be agreed. Some contracts, particularly those that use SoPC4 terms, will have an existing variations protocol which allows for timely decisions and (as noted above) transparent pricing at different levels in the PFI project structure. However, many older contracts have less efficient change mechanisms, particularly for smaller changes.

2.19 Following publication of SoPC4, the IUK Operational Taskforce produced guidance[3] for pre-SoPC4 contracts to improve management of variations. The guidance includes a sample protocol, similar to the SoPC4 provisions, which can be agreed by the parties and has been designed to be introduced into an existing contract. However, many contracts are yet to implement this protocol.

[3] Taskforce Note 3: Variations Protocol for Operational Projects (http://www.hm-treasury.gov.uk/ppp_operational_taskforce.htm)

2.20 Agreement in principle of applying the Variations Protocol for Operational Projects to older contracts will be an area pursued through the planned industry code of conduct. Authorities will require legal advice to apply the Variations Protocol for Operational Projects to their existing contracts. In considering whether to incur these costs, authorities should consider whether there is a VfM case for changing their contract, as referred above in relation to transparency provisions.

2.21 Each PFI project is unique and, rather than provide a prescriptive variation mechanic, SoPC4 notes a number of key principles to be reflected in contractual change mechanisms. Best practice suggests that change mechanisms should be able to accommodate anticipated changes as well as residual unanticipated changes.

2.22 The majority of unanticipated changes in PFI projects tend to be low value within the context of the project. Small and medium changes need to be specified, agreed and implemented quickly and cost-effectively. Authorities should use catalogues of small works and rate cards where possible. Subject to confidentiality restrictions, these may be obtained from another authority (preferably with a contract in the same sector with similar requirements), or possibly the PFI provider.

2.23 Large value changes warrant the time and cost of proper due diligence. To ensure value for money when assessing the price of large value changes, the public sector should have access to appropriate commercial and technical expertise, and can utilise a number of approaches such as benchmarking or requesting the contractor to undertake competitive tendering by obtaining quotes from at least three suppliers. The public sector should be careful to consider the impact large value changes may have and whether they may give rise to any procurement issues if they are not within the terms of the original OJEU notice.

2.24 At a minimum, a variation protocol should cover the following elements:

- Notification and specification of the variation by either party: the proposing party should provide enough detail on the proposed variation as early as possible. Equally, a contractor should be allowed sufficient time to consider and object (if warranted) to a variation on specific grounds. These grounds of objection should be specific enough to avoid ambiguity and any disputes at the time.

- Allow the contractor the ability to price/estimate the variation: for small value changes, the public sector should agree with the contractor a catalogue of pre-priced works that can be "called-off" as and when required. This catalogue can be refreshed each year coupled with an appropriate inflation index. Where a contractor decides to proceed, it should be afforded a reasonable amount of time (although the timescale should be specified) to provide an estimate to the Authority.

- Give the Authority unfettered rights to approve the variation and consequential change/cost to the project: the Authority should have the final right of approval in determining whether to proceed or discuss further the contractor's estimate/response.

- Provide a process for implementation of such variation: timescales should be prescribed (at least for small value changes) and agreed on a case by case basis for medium to large value changes.

- Outline how such variations will be funded, giving options where appropriate: for Authority variations, the Authority is generally liable for the cost. In cases where the Authority is liable to fund or share the costs for a variation (e.g. resulting from a qualifying change in law), best practice suggests the Authority should only fund capital expenditure upon the achievement of milestones or completion during the construction phase and through the Service Payment during the operations phase. Only in limited and pre-defined circumstances (e.g. large value changes) should the Authority consider alternative forms of financing and place a corresponding obligation on the contractor to use reasonable endeavours to seek additional finance.

- Provide a process for due diligence for large value changes: for small value changes, a catalogue of works should negate the need for extensive due diligence. However, it is reasonable to expect (for large value changes) insurance, legal and technical due diligence to be carried out, in addition to any senior lenders wanting to undertake their own due diligence as a consequence of the variation. Where the Financial Model is to be adjusted, such adjustments should be kept to a minimum with periodic reviews once or twice annually.
- Outline the documentation and monitoring obligations of the contractor: the contractor should be the prime counterparty responsible for documenting and monitoring any variations to avoid any interface risks or confusion as to responsibilities.

2.25 The authority should have an unfettered right to request changes in the operational period but a more restricted ability to do so during the construction period. The contractor's right to object to authority changes should be limited to where the economic fundamentals of the project are imperilled or where such changes would make it impossible for the contractor to fulfil its obligations under the contract. Conversely, the contractor can have the ability to propose changes to the service but the Authority should retain an unfettered right to approve or reject such proposals.

Measures to be considered by departmental PFUs

2.26 The following enabling measures should be considered by departmental PFUs before authorities seek to amend their contracts.

Collect and make available cost data from contracts

2.27 The key to implementing many savings measures is that authorities understand what they are being charged and what others are paying for similar services. Departmental PFUs should consider whether they could facilitate the collection of data on the costs of various services provided under PFI contracts that they have sponsored, including small works catalogue / rate card information. If so, this should be stored in a format that is easy to use by Authorities (e.g. costs per m^2, costs for new or refurbished buildings, unit costs).

2.28 There may be issues of commercial sensitivity which could preclude non-anonymised cost information being provided to PFUs or other authorities. In particular, any such information needs to be compatible with confidentiality provisions in the relevant project agreements.

2.29 Even if there does not appear to be sufficient comparability between contracts for meaningful data to be collated, all PFI contracts should be examined because there may be services within them with sufficient commonality for costs to be collated.

2.30 With respect to PFI hospitals, the Department for Health Private Finance Unit promotes sharing of knowledge between Trusts undertaking market testing / benchmarking exercises (including the headline results of such exercises in terms of cost increase/decrease). Contact with other Trusts and the engagement of in-house or external technical expertise is recommended to collect and use available external benchmarking data effectively.

2.31 The Department for Health runs ERIC – the Estates Return Information Collection, which is mandatory for NHS Trusts, but not all of it is mandatory for NHS Foundation Trusts (http://www.ic.nhs.uk/statistics-and-data-collections/data-collections/information-about-the-nhs-workforce-estates-and-facilities-management-collections/direct-collections/estates-and-facilities-management). Trusts enter data into the system which provides real time performance indicator information varying from on screen indicators to benchmarking charts. Many Trusts use ERIC as a starting point and then speak to other Trusts to get clarification of data.

Facilitate contact between Authorities with similar contracts

2.32 Departmental PFUs should be maintaining an up-to-date list of authority contract managers or contact officers for the projects they fund and this should be made available to each of the contract managers within a sector or where there are common service providers. This will enable contract managers to be aware of any negotiations that have been held with their PFI providers.

2.33 PFI networking groups, such as those which have been facilitated by Local Partnerships, Department for Environment, Food and Rural Affairs and the Department of Health, have been effective for sharing best practice in the past.

Use standard form drafting

2.34 Many sectors have a large number of PFI contracts that have been signed over a period of a number of years. In general, contracts have become clearer with standardised risk positions, payment mechanisms and drafting. This is not just in the context of SoPC4 generic required drafting, but also in sector specific contracts.

2.35 If authorities choose to amend their contracts, they should check early on with departmental PFUs what the current standard provisions are in respect of the amendments being considered. It may be that any changes being contemplated already have suitable drafting in standard form, either within the same sector or in another sector, saving legal costs and negotiating time.

Code of Conduct

2.36 HM Treasury has held preliminary discussions with investors, subcontractors and lenders in relation to the agreement of a voluntary code of conduct on operational savings matters.

2.37 The feedback received from this engagement confirms a willingness to engage in this important initiative, which HM Treasury will now be taking forward, to conclude by end of 2011.

2.38 The code of conduct will include (but not be limited to) the following matters:

- agreeing to engage positively in discussions around operational savings, including suggesting VfM savings proposals to the authority and co-operating with value testing exercises;
- implementing SoPC4 cost transparency provisions to contracts which do not have them;
- implementing the Variations Protocol for Operational Projects to contracts which do not incorporate it or the SoPC4 provisions and addressing cases where unreasonable fees have been sought for variations; and
- enhancing transparency in reporting from providers of risk capital.

3 Savings Opportunities

Effective contract management

3.1 Making changes to contracts can be time consuming and costly, and is subject to legal constraints (in particular procurement legislation) and the need to protect value for money. Before seeking to amend PFI contracts, authorities should first ensure that the existing contract provisions are up to date (reflecting variations that may have arisen) and are being applied effectively to maximise the value and minimise the costs of the project.

3.2 There are two principal measures that can drive savings from effective contract management. Firstly, ensuring that staff are appropriately trained and use best practice processes, and secondly (where appropriate) by sharing contract management responsibilities across different contracts and/or authorities. The Operational Taskforce Transition Guidance[1] provides useful information and checklists for authorities to deliver effective contract management.

Proactive application of contract provisions

3.3 Ipsos-MORI[2] and the NAO[3] have highlighted the importance of contract management in the operations phase of contracts. Whilst feedback on PFI contract performance from managers has generally been positive, there are concerns that contract managers do not fully utilise the provisions of their contracts including the use of the payment mechanism, benchmarking / market testing processes and service level standards.

3.4 In some cases, service failures are not properly logged and appropriate deductions not made. The reasons for this vary, but can result from (or be exacerbated by) insufficient commitment of resource to the task[4] or a shortage of suitable skills and experience in the public sector. Commitment to adequate and suitably skilled contract management resource is essential to realise savings from operational PFI contracts.

3.5 Most projects require PFI providers to provide reports to the Authority. Contract managers should be clear what information they are entitled to and how they can use it to assess performance. While levying deductions may reduce costs, the end goal of the performance management regime is not cost reduction. Rather, it is ensuring the PFI provider performs to the agreed standard – in other words, to ensure that the authority is getting what it is paying for and that the project is delivering the value that was targeted.

3.6 In the case of the Queen's Hospital, the PFI contract management is closely overseen by the Estates Director, with two dedicated contract monitors, for hard and soft services sub contracts, and 0.5 FTE and 0.75 FTE respectively for contract monitoring of energy/waste and the medical equipment service, and approximately 0.5 FTE finance support from a project accountant.

[1] http://www.hm-treasury.gov.uk/d/pfi_projecttransition_210307.pdf
[2] Ipsos MORI, 2008 – "Investigating the Performance of PFI Contracts"
[3] NAO, 3 November 2009 – "Private Finance Projects"
[4] Ipsos MORI found that 66% of sampled PFI contract managers devoted less than half their time to managing the contract.

3.7 The BHR Trust has taken a proactive approach to exploring cost saving opportunities from the PFI contract, including engaging with the project company and its investors to identify potential savings measures.

3.8 Through reviewing each contract's Project Agreement, Financial Model, Schedules and Payment Mechanism the MOD's Private Finance Unit (PFU) produced a number of contracting tools to assist MOD's project teams with their day-to-day business. These tools will assist current project teams, and their applicability will become more valuable in 3-4 years time when a new management team is in place.

Insurance provisions

3.9 Under the vast majority of PFI contracts in England, the risk of damage or failure of the assets during service delivery is transferred to the contractor. Since most contractors are limited recourse special purpose vehicles, they take out required insurances in the market. Their estimates of likely insurance premiums are included in the base case Financial Model that determines the unitary charge.

3.10 The insurance market is cyclical and contractors build in contingencies against adverse movements in the market. Over time, cost sharing mechanisms have been developed and implemented whereby authorities and contractors share the risk of premium fluctuations arising from market movements. These provisions were standardised and mandated in 2006. These provisions, and the non-standard ones that preceded them, attempted to minimise the inclusion of risk contingencies within unitary charges, whilst still incentivising contractors to seek the keenest prices.

3.11 As part of the initiative to review the scope for savings under operational contracts, insurance was highlighted as an area for investigation since

- there were reports of contractors enjoying very significantly reduced premium payments whilst authorities were paying out high amounts (as forecast in the model) as part of the unitary charge;
- there was concern expressed that the market might be mispricing PFI insurances and that PFI's low claims record was not being reflected in lower premiums (effective market failure).

3.12 HM Treasury has accordingly undertaken an exercise to review the market and the various insurance mechanisms within existing contracts, and to work with Departments to review whether existing contract insurance provisions are being implemented correctly (including the extent to which there have been financial rebates to authorities when due).

3.13 This work has confirmed that a large number of existing contracts do not have insurance risk sharing provisions. For these contracts, introducing sharing provisions now would expose authorities to additional costs in future insurance costs (as market rates are predicted to rise from a current low point in the cycle) and is not recommended. Government will continue to explore mechanisms for getting better value from insurance arrangements in these contracts.

3.14 Of the contracts that do have insurance risk sharing provisions, where contracts have applied risk sharing provisions correctly, these have often yielded rebates in insurance costs for the relevant authorities. However there is evidence of reviews of insurance costs not having been undertaken, and of risk sharing provisions having been incorrectly applied. Contract managers should ensure that insurance reviews are undertaken that could give access to additional financial rebates due to public sector authorities.

3.15 It is important that PFI contract managers familiarise themselves with how the contract's insurance cost/gain share provisions work. Each authority should ensure that their PFI provider complies with its reporting obligations in relation to insurance, and applies premium risk sharing provisions correctly.

3.16 Questions have been raised about whether additional insurance savings should be due to the public sector resulting from insurances being bought on a group basis across a portfolio of PFI projects owned by the same investor. To the extent that contracts contain insurance premium risk sharing provisions, then these should already apply to any such reductions in insurance premiums that have been achieved by the project company.

3.17 Alternative approaches to insurance are being considered by Government for future procurements (eg self insurance and pooled insurance), to weigh up potential cost benefits and the additional risks that would be brought back to the public sector. These alternative approaches are unlikely to apply in all cases but may be suited to the risk profile of particular sectors, and further work will be taken forward to consider these options.

Managing contract variations

3.18 A key area requiring skilled contract management is in relation to contract variations. The Queen's Hospital and the MOD pilot projects are typical in having negotiated variations to the original contract, both in construction – for example to extend the asset capacity - and to modify services in the operational phase (which can also impact on asset lifecycle requirements and costs).

3.19 Commercial teams in authorities should prepare thoroughly for commercial negotiations, and have clear objectives for the public sector going into the negotiation. The principle of variations in PFI project agreements is that the Project Company is left in a "no better, no worse" position, and this includes making sure that the public sector is rebated if variations actually improve private sector returns. Authorities can expect that the Project Company will be required by their lenders and equity investors to maintain the financial standing of the Project Company (as measured by financial ratios set at the outset of the contract) following the variation. Authorities should ensure that surplus returns are rebated to them without constraints that would expose them to project risk, such as any conditionality on the Project Company meeting scheduled payments and equity distribution restrictions in existing financing agreements.

Encouraging users to reduce energy consumption

3.20 The Carbon Reduction Commitment Energy Efficiency Scheme process has increased the profile of energy consumption. Energy consumption is influenced by how a building is used on a day to day basis. Authorities should monitor energy consumption and consider ways of encouraging users to reduce energy use. It is widely acknowledged that successful energy management is dependent on a good level of energy awareness throughout the organisation, and this is one of the first key actions which authorities should pursue.

3.21 HM Treasury recently participated in a Whitehall wide energy efficiency competition which raised the profile of energy consumption amongst the building occupants. MOD Main Building PFI posted real-time energy consumption statistics online to increase awareness. At Romford, the BHR Trust has re-formed its Energy Management Committee and is analysing the value for money of numerous investments in energy efficiency. In some PFI schools, energy costs were reduced by using swimming pool covers and switching off PCs outside core hours.

3.22 Costs to implement energy awareness campaigns are minimal; a small amount of funding may be required for the use of branded awareness content, alternatively there are plenty of existing resources available. Resources will also be required to monitor energy consumption and to develop, implement and maintain a programme of energy efficiency measures.

Optimising the use of PFI assets

3.23 Linked to effective contract management is effective asset management. Infrastructure assets typically have a high proportion of fixed costs relative to variable costs. This cost relationship is not unique to PFI, but highlights the need for PFI projects to be considered in the context of the public sector's total asset base. Increases in throughput or occupational density may be the most straightforward route to savings on a per unit basis.

3.24 An example of this approach at the local government level is Total Place[5] which takes a 'whole area' approach to public services with the aim of providing better services at lower cost. This might mean rationalising overall estates and/or subletting space in a PFI project to other public or private sector tenants.

Subletting

3.25 Subletting can occur at a relatively small scale and/or duration. For example, a Local Authority used some excess classrooms in a PFI school to accommodate students temporarily from a neighbouring school that was being built. In another PFI school third party income was generated from the use of facilities on weekends. Authorities should consider the income generation possibilities from assets such as function spaces and swimming pools and understand how any additional income would be treated under the contract[6].

3.26 Subletting can be pursued by either the authority or the PFI provider, depending on the type of contract and whether it is a lease or licence arrangement. Certain types of accommodation may have constraints on use which preclude subletting. Lenders / investors may require comfort that the impact of any subletting has been adequately reflected in the payment mechanism calibration.

3.27 Early in 2010, the BHR Trust entered into a variation to adapt one of the Queen's Hospital wards for use by a private healthcare provider, to provide private cancer care under a 10 year lease. The arrangement includes soft services and use of specialist medical equipment at the site. The capital outlay required for modification of the ward, together with service costs, are recovered through contractual terms agreed with the tenant, which also provide a net contribution towards the fixed cost of the PFI, and a contingent share of future revenues. The arrangements demonstrate that such sublets are i) not cost free and ii) often for relatively small proportions of a project, but can reduce the costs of asset and equipment capacity that is surplus to an authority's requirements.

Increase occupational density

3.28 Changes in technology and working patterns can also create opportunities for better estate management. For example, following a significant IT upgrade HM Treasury is currently working with its PFI provider to increase the occupational density of its building at 1 Horse Guards Road, and by reducing the space occupied by HM Treasury, create a significant amount of empty space that can be used by another public sector occupant, freeing up other space in Whitehall.

3.29 Opportunities to increase occupational density of specialist assets (such as schools and hospitals) are likely to be more limited than for office accommodation properties. Nonetheless, there may also be options to change the use of relatively generic space, such as administration areas. As another example, a schools project modified some spare classrooms to use as office space with only minor modification to door locks. Asset utilisation has formed an important part

[5] http://www.localleadership.gov.uk/totalplace/

[6] In some cases the PFI provider guarantees a certain level of income and in others the Authority takes the risk/reward.

of the MOD's review process and this will continue to be examined across MOD's infrastructure PFI portfolio.

Mothballing

3.30 If there are areas of accommodation that are not required and cannot be efficiently sublet, then it might be possible to mothball them so that full day-to-day service under the contract is not necessary and variable service costs can be avoided. Authorities should consider how long this arrangement will be for[7] and what flexibility may be required to use the space again. A minimum service should be provided to ensure that assets do not deteriorate and lead to non-VfM restoration costs later. As noted above, PFI projects typically have a high proportion of fixed costs relative to variable costs. As such, Authorities should carefully consider the amount of variable costs that could be avoided by mothballing and discuss mothballing proposals early on with departmental PFUs.

3.31 Depending on the type of project and the space that is mothballed, there may be payment mechanism consequences. For example, reducing floor area in less operationally critical spaces may concentrate deduction risk in areas that are more operationally critical. As such, a recalibration of the payment mechanism may be required by senior lenders and/or investors.

3.32 As part of a wider efficiency programme, the Queen's Hospital is considering the potential for mothballing ward space for contingency. Any Trust considering similar estates and services strategies to reflect changes to clinical service requirements need to work with local PCT commissioners.

Review service specification

3.33 If an authority believes that they are buying more than is required to deliver the service or are incurring additional cost as a result of inconsistent application of services standards across PFI and non PFI facilities, then a more appropriate specification could be introduced as a variation. Authorities should consult their departmental PFUs if they believe this to be the case. Measures in this category are project specific but could potentially include:

- less frequent decorating;
- changing to daytime cleaning to reduce lighting costs overnight;
- improving energy efficiency by optimising minimum and maximum temperatures;
- changing the frequency of fault inspections to reflect the history of occurrence and impact;
- longer response times for helpdesk call resolution (appropriate to need and cost);
- more appropriate comparators or standards for services or replaceable equipment (for example where standards are higher than other non PFI assets and higher than needed for the required service).

3.34 In any event, such changes should not harm the core function(s) of the project or contravene safety standards. Authorities should also consider carefully any proposed savings from short term maintenance if this strategy could increase maintenance costs in the longer term (see Annex A). Many PFI contracts deliver services as set out in an output specification, for instance requiring premises to be "secure" rather than requiring security staff to make a certain number of rounds per day. Output based specifications are an important part of PFI risk transfer

[7] If the period is too short, then the costs of mothballing might outweigh the savings, leading to negative VfM.

and any reduction in specification should not lead to PFI provider risks being passed back to the authority without a careful VfM analysis.

3.35 Standards should not be relaxed if there is a concern that the PFI provider is not performing well against the existing requirements of the contract. In this case, the payment mechanism should be used appropriately to ensure that the expected service level is being achieved and deductions made (or performance penalties awarded) if not.

3.36 Wherever possible, authorities should seek to use industry standard performance requirements across both PFI and non PFI assets and customise only where necessary.

3.37 At the Queen's Hospital, an independent technical adviser undertook a qualitative comparison of the scope and content of the main soft services by value (catering, domestic / ward housekeeping and portering) in order to determine whether the services are being provided to a higher or lower set of standards than for comparable projects.

3.38 For each of these soft services, the technical adviser reviewed the standards that the operator is required to comply with, compared with the standards applied in other PFI projects. These standards are a combination of national hospital standards recommended by the Department for Health and applied by the Trust and other operating policies of the Trust. In addition, the adviser reviewed the measurement of the service standards under the contract, by reference to the defined Key Performance Indicators (KPIs). These set out the basic elements of the required service that must be delivered. For example for the catering service these include the service of food at the correct temperature and nutritional content, and hygiene and handling procedures. For the domestic/ward housekeeping service the KPIs include the frequency and adequacy of cleaning and provision of appropriate consumable supplies. For portering the KPIs include timely patient transport and receipt/distribution of materials and waste.

3.39 In each case, the technical adviser found that the specification and standards of the contracted soft services satisfied the basic requirements and standards applying in other comparable projects and were not 'gold plated'. Standard Department for Health specifications are available for use in both PFI and non-PFI schemes, and it is for each individual Trust to decide the level of service that it wants and can afford.

3.40 As part of its preparation for a scheduled five-yearly soft services market testing, the BHR Trust has been engaging with its soft services provider to review the specification for areas that could be provided more efficiently. The factors considered through this specification review are summarised below. Through this process, a discount in the pricing of elements of the soft services is being negotiated, supported by benchmarking of the unit costs of service components using independent technical advice.

- The Queen's Hospital cleaning service features a rapid response time for all spillages, a specification common to many acute hospital PFIs, but a higher service level than the Trust had prior to the PFI. At ward level, spillages are dealt with by staff on or near the clinical area, and in other areas the soft services provider mobilises a rapid response unit in conjunction with the Helpdesk. A relaxation of this response time (by disbanding the rapid response unit and moving to a model where the cleaning activities occur at fixed times) might reduce costs, but also may expose the Trust to other risks by way of infection control and risk of slips on the spillage causing personal injury. Without a detailed risk assessment, it would be unlikely that the Trust would relax the rapid response time requirement.
- Housekeeping services at the Queen's Hospital are at a higher level than being applied in the Trust's non-PFI hospital. A new working system is now being introduced at the Queen's Hospital to standardise the level of housekeeping service across both hospitals,

which will generate efficiency savings for the Trust and enable the delivery of cleaning standards in line with the most recent National Standards of Cleanliness.

- In the case of portering, a number of areas have dedicated porters supported by a small pool of porters undertaking ad-hoc duties, which is a higher standard than the BHR Trust had before the PFI and higher than may be required. A full review of all areas is being undertaken to match resource to activity, which will see some of the dedicated porters removed and a larger pool of porters being made available. The use of touch screen technology is being introduced to improve the efficiency of deployment of dedicated porters.
- In addition, the BHR Trust and its service provider have undertaken a review of the security service input hours at the Queen's Hospital and identified efficiency savings and enhancements to the service from changes to the shift pattern. The security team will be reduced and flexible supplementary resource will be provided across portering and security services (subject to appropriate training and SIA licencing).

3.41 Some other potential soft maintenance savings were reviewed by the BHR Trust and rejected. For example the BHR Trust considered amending the decoration / minor maintenance frequency at the Project but concluded there is not significant value associated with this. Specific factors influencing this judgement include:

- there is a clear split in terms of responsibility between the soft services sub-contractor and the Project Co for superficial items and items relating to the fabric of the building;
- at present, the condition survey is undertaken annually and moving to 5 yearly would save a relatively minor sum;
- amending lifecycle specifications (e.g. changing carpet to vinyl) is likely to increase the flexibility of some spaces but not lead to a significant cost reduction; and
- smaller maintenance items are done on a rolling programme approach and tracking reduced usage levels and maintenance requirements may prove challenging relative to the potential savings.

3.42 The BHR Trust examined its soft services requirements as part of the normal five-yearly market testing process, and amendments to the service requirements referred above reflect the current requirements. There is scope in the existing contractual framework for future service variations, for example should the level of one-off non-routine tasks such as deep cleans need to change. Any review is done in conjunction with a firm commitment to meeting patient, staff and visitor safety, underlying Care Quality Commission requirements and overarching current standards such the National Standards for Cleanliness.

3.43 In terms of the Medical Equipment Supply agreement at the Project and the replacement equipment specification, the BHR Trust regularly checks that medical equipment is specified to the appropriate level. The selection of equipment under the MES agreement is vendor independent, enabling the procurement of the most cost effective solution to deliver the specification.

Rescope or remove services, or agree value testing

3.44 To the extent a review of PFI project services identifies areas where changes to the specification may be appropriate, then it may be efficient for the authority to review standards at a time when they are preparing for a scheduled value test under the contract, so that any changes can be repriced under competitive conditions.

3.45 A key benefit of PFI is linking construction and maintenance obligations for an asset under one contract. This risk allocation incentivises PFI providers to take a whole life cost approach to design, construction and maintenance. Consequently, value testing does not apply to PFI hard facilities management and lifecycle maintenance.

3.46 If value testing of hard facilities management were to be considered, then it should be noted that the division of responsibility for undertaking lifecycle works can vary between the project sponsors and the hard FM subcontractor. This division between sponsors and sub-contractors complicates any benchmarking of costs, and creates risk in the interface between the costs of undertaking works of lifecycle replacement and the costs of undertaking day-to-day maintenance of the various parts of the building structure.

3.47 As a consequence of this division, the hard FM maintenance costs should be considered in the context of the frequency of replacement cycles included within the lifecycle replacement plan. In addition, the specific replacement costs and the frequency of replacement will depend on the original building design. As a result, to review and assess a lifecycle plan comprehensively requires an understanding of the original building design; the obligation to replace "like-with-like" as between the original design and the lifecycle plan; and the adequacy of the maintenance regime to meet the planned lifecycle replacement frequencies.

3.48 As a general rule, changes to contracted lifecycle obligations can risk undermining the long term asset risk transferred to the Project Co and as such it is unlikely to represent VfM to remove hard facilities management services and lifecycle / major maintenance from the contract or introduce value testing thereof. However, as noted earlier, the public sector authority and private sector partners' experience of the short term maintenance requirements of the asset compared with bid assumptions may offer scope for efficiencies, and transparency of the contractor's maintenance costs will be needed to identify relevant savings.

3.49 For some soft and ancillary services, procuring services outside the PFI contract or agreeing value testing provisions may offer better value for the taxpayer. This could be the case if there is an alternative service provider offering better VfM and the contract does not have value testing provisions[8] (provided that the services would be value tested were the contract based on SoPC4). Where the service is no longer required (or fully required) by the authority, then it may be appropriate to remove services from the PFI contract. In such cases recalibration of the payment mechanism will be required, and the transparent sharing of contractor costs should be sought to enable appropriate adjustments to the payment mechanism to be made. For more recent local authority projects the annual best value review offers an opportunity to do this.

3.50 The majority of PFI projects that include soft facilities management contain some form of value testing, being either market testing (where the soft services are re-tendered periodically) and/or benchmarking (where the incumbent provider's costs are adjusted to benchmarks periodically). SoPC4 notes that market testing is the preferred value testing exercise for the public sector as it ultimately allows better value for money assessments to be made with respect to the services being tested. Contract managers should make use of available public sector networks to compare information and best practice on the effective value testing of services in their sectors.

3.51 It should be noted that there are costs associated with market testing, including bid costs (which are recovered through tendered prices) as well as mobilisation / demobilisation and associated operational disruption. The scale of such costs needs to be considered in the context of the scale of the soft services element of the unitary charges and potential for savings, taking into account the expected level of competition and the degree to which the soft services are

[8] Such contracts will typically be older (i.e. pre SoPC3).

market standard or bespoke (where bid costs are likely to be higher for non-standard requirements).

3.52 Cost reductions achieved through value testing will be a combination of any reduction in the service specification and standards, together with any savings achieved from the competitive process. As the nature of a value test is to seek prevailing market pricing for a service, authorities should be mindful that the results could be better or worse than their pre-existing contract pricing.

3.53 Operational Taskforce quidance on undertaking benchmarking and value testing exercises is available on the Treasury website (at http://www.hm-treasury.gov.uk/ppp_operational_taskforce.htm).

Visibility of costs and impact on profits

3.54 Where the contract has an above-market service cost but there is no value testing regime to flow cost reductions through to the Authority, this will enhance equity returns and/or profit at the subcontract level. Conversely, PFI providers have an incentive to de-scope or introduce value testing for services they have underpriced as a means of transferring the risk back to the authority.

3.55 As such, authorities should be watchful of PFI providers steering de-scoping / value testing towards services they have underpriced. If there is evidence that the service is already being provided at or below the market pricing then value testing for the service should not be introduced and de-scoping should be carefully considered[9]. Advice should be sought from authorities with similar contracts, departmental PFUs or technical advisors regarding the current costs of services to determine whether it is likely to be worthwhile.

3.56 When comparing costs across alternative providers (either in-house or outsourced), authorities should take care to ensure that costs are compared on a like-for-like basis (i.e. overheads are treated appropriately). Senior lenders will generally need to consent to a change in service provider, removal of a service from the contract or the introduction of value testing.

3.57 Especially for older contracts, it is quite possible that a market test might lead to an increase in the costs of services as wells as introducing administrative costs for undertaking the market test.

3.58 It can be difficult to determine VfM when de-scoping private sector risks, especially those which are not explicitly costed in the project's Financial Model. For example, if a given risk is costed as part of the required return on risk capital rather than through separately identifiable cashflows, it can be difficult[10] to determine how much the cost of risk capital should come down by if the risk is de-scoped. A similar issue applies to risks that are costed in the cashflows but where the level of detail is insufficient to isolate the cost relating to just the risk being de-scoped.

Interface

3.59 In general, interface risk between the different services provided under the contract is the responsibility of the PFI provider. If a service is taken out of the contract and delivered separately then this interface risk may be increased and, depending on how the service is substituted, it is possible that the potential savings will be offset to some degree.

[9] This can be particularly difficult for risks taken by the private sector but not explicitly costed in the project's financial model. See paragraph 3.58.
[10] Outside of competition.

3.60 The impact of this will vary between sectors. For instance, when services have been removed from PFI hospital contracts there have not been significant increases in PFI provider costs as the hospital is an open environment and there are other services delivered at the hospital which are not provided by the PFI provider. A prison, however, may be an example where using a separate contractor leads to increased security costs or operational concerns.

3.61 If a service is removed from the contract and delivered separately, a clear interface/risk matrix would need to be incorporated into both the PFI contract and the new service provider contract to reduce the scope for confusion, dispute and (potentially) cost duplication.

3.62 If a removed service is no longer required, interface is not an issue but the Authority should be certain that the removed service is not likely to be required for the foreseeable future.

Align timing of value testing exercises

3.63 Value testing exercises, whether benchmarking or market testing, are typically time consuming and expensive for an authority. These exercises are typically undertaken every five years during the operational period of a PFI contract.

3.64 An authority with more than one PFI contract, where the services to be value tested are similar, may save money if the exercises for each contract are undertaken as one. This would require exercises to be brought forward or deferred to align their timetables, for instance with one contract after six years and the other after four years and thereafter reverting to the five year timetable for both contracts. Changing the timing of a value testing exercise may require lender consent if lenders deem this to impact their risk profile.

3.65 It may also be possible for more than one authority to arrange for value testing exercises to be undertaken simultaneously, particularly for projects that have common equity owners.

3.66 If it is anticipated that a value test will lead to a lower unitary charge, then it may be that the extra costs of deferral could outweigh the administrative cost savings and it would be better to bring forward the exercise for the contract signed later rather than defer the exercise for the one signed earlier.

3.67 To the extent that aligning value testing exercises across PFIs increases the total size of the public sector's buying strength, service providers may offer better terms. This can be tested in competition.

3.68 By the same logic, there may also be scope for service providers to bid on opportunities outside of the PFI projects (i.e. for retained estate in hospitals or grounds maintenance at non-PFI schools) if there is a clear VfM benefit. A market test would be a natural time to explore increasing the authority's aggregate buying strength, although maximising buying strength need not be limited to value tested services. The contractual arrangements themselves may need to be outside the PFI[11]. In the case of the BHR Trust, the soft services provider at the Queen's Hospital is also the soft services provider at the Trust's non-PFI hospital (King George's), and the Trust has now aligned the value testing date across both sites to capture competitive savings opportunities, and provide the opportunity to standardise services and generate efficiencies across the estate.

Take back provider's share of change in law risk

3.69 It has been common for authorities to share the risk of capital costs of general changes of law coming into effect during the operational phase of a project (please refer to section 14.7.1

[11] Reasons for this might include procurement issues, senior lenders / risk capital providers being uncomfortable with expanding the scope of the PFI and / or where it is impractical to amend the payment mechanism.

of SoPC4). Generally, a relatively small share[12] of such capital costs is for the account of the PFI provider with the remainder being for the public sector.

3.70 Authorities may wish to re-evaluate the VfM of requiring the PFI provider to share in these costs.

3.71 The financial benefit of the public sector taking back the PFI provider's risk share will differ depending on the project's financial structure. PFI providers have generally managed this risk using either a committed bank facility or a cash reserve. The facility or reserve may be for less than 100% of the PFI provider's exposure under the contract[13].

3.72 Where the project employs a facility, the ongoing commitment fees on the facility could be avoided and would come out of the unitary charge accordingly. Authorities should appreciate that there may be benefit to the lenders of removing these facilities, particularly where the facilities are priced below current market values.

3.73 For projects employing a reserve, authorities should receive[14] the entire balance of funds in the reserve as consideration for taking back the PFI provider's share of the risk. The consent of lenders is likely to be required.

3.74 Authorities should be aware that by taking back change in law risk they are taking back an equity risk, including whether the value of the released reserve is sufficient for the additional risk assumed.

3.75 As a general comment, any related accounting, tax and financial modelling issues (and associated costs) would need to be considered by both the public and private sectors. An authority considering amending these arrangements should contact their departmental PFU.

3.76 The project agreement will need to be amended for the authority to take back the PFI provider's share of change in law risk. The removal of any commitment fees or release of any reserves results from the authority agreeing to take back a risk (subject to VfM). As such, the project agreement amendment will also need to specify that this is excluded from the definition of Refinancing and the full value flows to the authority.

3.77 Authorities can also choose to remove the PFI provider's general change in law risk share of capital costs on projects going forward. Derogation approval from HM Treasury / Infrastructure UK will not be required.

3.78 The potential for change in law risk to be taken back has been considered as part of the Queen's Hospital pilot. Preliminary discussions have been held with the financing parties (the bond trustee, guarantor, EIB and the rating agencies) to get their indicative feedback. Further consideration will now be given to the merits of taking this forward, which will need to take into account the risk that would be taken back by the Trust, relative to the balance of the risk reserve that could be released to the Trust, together with the expected costs of implementation.

Energy purchasing

3.79 In some projects the Authority purchases energy directly or through a public sector buying organisation. Authorities should always consider the use of the public sector buying organisations, such as Buying Solutions (which assumed the functions of the NHS Purchasing and Supply Agency (PASA) in April 2010). By exception an Authority may wish to consider

[12] This share is often based on a sliding scale with total private sector exposure of around 3% of the project's capital cost.

[13] Including cases where certain senior lenders did not require facilities or reserves.

[14] For some projects an alternative may be to use the funds to reduce the ongoing unitary charge by prepaying senior debt. In making the choice, Authorities should consider carefully whether this represents value for money in light of swap break costs / spens, the avoided cost of funds relative to the Green Book discount rate, lending document provisions relating to the application of prepayments and any other relevant considerations.

purchasing its energy via the PFI provider. In these instances, the Authority should ensure that a commercial justification for this has been provided and that full transparency of prices and charging structures is provided in order to benchmark performance and provide options for alternative providers, thereby ensuring smart energy procurement for the life of the PFI contract.

3.80 The drafting related to energy in PFI contracts can be complex and authorities should have a clear understanding of the existing contract before making any changes[15].

3.81 The BHR Trust procures its electricity and gas through Buying Solutions. As a result, the Trust's energy contracts are aligned with a large number of other organisations, thus providing Buying Solutions with significant buying power. This approach provides the buyer with considerable bargaining power when tendering and appointing an energy supply company. Energy supply companies pay particular focus to organisations that are purchasing significant volume, particularly in preference to a single organisation who would have minimal negotiating power.

3.82 Importantly, large buyers such as Buying Solutions have access to good quality energy market information and employ specialist energy market analysts in order to identify the opportunities to purchase tranches of energy throughout the contract period.

3.83 According to the Cabinet Office, Buying Solutions is the single biggest buyer of energy in the UK[16]. As such, their buying power is greater than that of any other procuring body.

3.84 With respect to electricity, ERG independently compared the wholesale prices that Buying Solutions achieved against market prices in the period from April 2009 to February 2011. While monthly performance was variable given market volatility, ERG found that Buying Solutions outperformed the benchmark price from by 18% (for April starts), 3% (for October locked strategy) and 21% (for the variable strategy on average)[17].

3.85 With respect to gas, ERG independently compared the wholesale prices that Buying Solutions achieved against market prices in the period from April 2009 to February 2011. While monthly performance was variable given market volatility, ERG found that Buying Solutions outperformed the benchmark price from by 24% (for April), 11% (for October gas under the locked strategy) and 27% (for the purchase within period (PWP) strategy based on a flat consumption profile).

3.86 Risk management strategies for energy differ. In the main, buying groups offer two strategies, namely purchase in advance (locked) and purchase within period (flexible). In the former, buying occurs before the supply start date and an average locked price is calculated yielding a fixed-term, fixed price deal. In the latter, buying occurs both before the supply start date and during the supply period. An indicative reference price is provided at the start of the contract and price true-ups occur at periodic intervals.

3.87 The BHR Trust has entered into a flexible energy purchase contract, where a buying mechanism allows the purchase of tranches of energy throughout the contract period. Flexible energy purchasing mechanisms are regarded as the preferred method for organisations who want to spread the risk of energy purchasing. Flexible energy purchasing is a complex buying process and is typically available to large energy users or buying consortia (such as Buying Solutions).

[15] Authorities should have a clear understanding of where the contractual incentives lie for investment in energy efficiency retrofits and/or changes to working practices. Where consumption risk is for the private sector, the contract may need to be amended to reflect the benefit of any energy efficiency investments paid for by the Authority (either funded directly or via financed increased borrowing by the PFI provider).

[16] The Buying Solutions supply for central government is 2x bigger than Tesco's and the overall portfolio (incl. health) is 5x bigger.

[17] According to ERG, the significant variation between the April and October locked performance is not typical and was a result of the extreme volatility of prices in 2008 which affected prices for April to September 2009.

3.88 Flexible energy purchasing has been developed as a response to the ever increasing volatility of the energy markets, where the buyer is able to make a number of purchases throughout the contract period, when it is deemed that the market conditions are favourable. This type of arrangement being in contrast and preferable to purchasing a fixed volume at a particular point in the market. It is generally acknowledged that a flexible purchasing mechanism allows the buyer to be responsive to changes in the energy market.

3.89 The terms and conditions of the energy supply contract need to be considered in the context of any significant energy savings. For example, the PASA standard terms and conditions of supply contract for large gas supplies includes a minimum consumption clause, stating that prior written consent is required if the actual consumption is to fall below 80% of the nominated consumption in any contract year. This may influence the willingness of parties to embark on ambitious energy efficiency programmes that would save more than 20%, and may require the sponsorship of Trust senior management and/or Project Co to overcome perceived barriers to energy efficiency.

Seek advice from departmental PFUs regarding other measures

3.90 It may be that an authority is considering a measure that is not covered in this guidance. In this case, advice should be sought from departmental PFUs on the appropriateness of the measure prior to implementation. In particular, earlier projects tend to be more bespoke and may offer greater scope for operational savings.

3.91 Authorities considering a refinancing should understand the relationship between the existing financing terms of the project and those available in the current market. Many projects will have existing terms that are below current market pricing and therefore do not present opportunities for VfM refinancing gains. If authorities are contemplating refinancing, it is requested that they contact their departmental PFU and the Treasury to enable consideration of how the best outcomes can be achieved, taking account of other refinancing opportunities that may be being considered elsewhere.

3.92 Some authorities may be considering the potential to terminate PFI contracts and prepay or buy out the related Project Co debt. The VfM of any such options will need to be considered carefully on a case by case basis. The analysis should take account of:

- contracted costs of voluntary termination, including any market value payments due to investors and the effective sunk cost of any breakage costs due on fixed rate bank borrowing (or Spens payments on capital markets funding);
- any premiums or discounts that may be proposed by the Project Co and its lenders;
- the project risk being transferred back to the authority as a result of the contract termination and/or debt buy out; and
- transaction costs.

3.93 For projects where the borrowing rate being paid by the PFI Contractor is below current market levels (likely to be the case for some pre-credit crisis transactions), then some lenders may be willing to 'sell' the loan asset (i.e. permit the authority to buy out project borrowing) at a discount in order to reallocate capital more profitably (although we believe that some lenders may not have booked the trading loss and would be unwilling to trade out of the asset and force crystallisation of the loss). It is recommended that authorities contemplating debt prepayment or buy-out seek commercial and financial advice to assist with the evaluation of Project Co and lender proposals, including reviewing the Financial Model and contracted termination costs and any discounts that may be proposed, and in each case the affordability and VfM of proposals (calculated on a Treasury Green Book basis) compared with continuing with the contract and leaving Project borrowing arrangements in place.

3.94 Some savings measures that involve changes to the contract or asset financing arrangements without increasing value or risk transfer may effectively represent additional borrowing, and would not be recommended on VfM grounds. Examples could include sale and leasebacks of equipment or property, debt service holidays and concession extensions. Further detail is set out in Annex A.

4 Information and support

4.1 The Government is encouraging authorities to examine the potential for operational savings in PFI projects and this guidance has identified a number of areas in which savings might be possible. Although PFI projects benefit from following a standard contract (versions 1-4), there is still a great deal of variation amongst projects, particularly at the operational level.

4.2 Given the risk of undermining risk transfer within a PFI contract, it is recommended that specialist support is sought before implementing any of these measures unless the Authority is experienced in this area. Failure to do so could potentially result in short term savings at the expense of long term VfM.

4.3 It is also important that authorities consider the costs and benefits of implementing any changes early on and plan any measures to minimise implementation costs. This could include agreeing a range of measures across a number of projects at the same time.

4.4 There are a number of sources of information available to authorities including:

- Operational Taskforce guidance including Benchmarking and Market Testing Guidance, Project Transition Guidance (which includes best practice contract management advice) and the Variations Protocol for Operational Projects[1];
- A projects database which includes information about PPP contracts which can be used for comparison purposes or to establish common circumstances between projects[2]; and
- National Audit Office reports (http://www.nao.org.uk).

4.5 Additionally, advice should be sought from bodies such as:

- Departmental PFUs;
- Local Partnerships (020 7296 6777 or enquiries@localpartnerships.org.uk); and
- IUK's Operational Taskforce (020 7270 5511 or operationaltaskforce@hmtreasury.gsi.gov.uk)

4.6 There are also many sources of support that should be considered such as advisors and providers of contract management training.

[1] http://www.hm-treasury.gov.uk/ppp_operational_taskforce.htm
[2] Projects Database (http://www.partnershipsuk.org.uk/PUK-Projects-Database.aspx)

A Protecting VfM

A.1 In general, measures with one or more of the following characteristics should not be pursued:

- Short term only, at the expense of VfM;
- Harmful to the core function(s) of the project or in contravention of safety standards;
- High implementation costs / fees relative to savings;
- Requiring the Authority to take back unacceptably high levels of risk or risks better managed by the private sector.

A.2 The table below sets out some measures that are generally unlikely to offer VfM and the main reasons why:

Non-Recommended Measure	Primary Rationale for Non-Recommendation
Debt service holiday	Additional borrowing without improving risk transfer
Extension of debt tenor[1] / PFI contract[2]	Additional borrowing without improving risk transfer
Re-profiling unitary charges	Often linked to additional borrowing, inconsistent with paying for a service (see SoPC4 7.2.2)
Authority purchase share in PFI provider company	An investment rather than savings, Authority takes back equity risks
Authority buys / prepays senior debt	Generally poor VfM under Green Book analysis (swap break costs, Authority takes back senior debt risks, low historical debt pricing / market value), risks windfall gain to lender unless purchase price discounted
Take back hard FM or lifecycle timing & pricing risk	Complex and difficult to establish VfM, goes to core of risk transfer, high transaction costs
Reduce handback requirements	Present value of savings likely to be small, goes to core of risk transfer, high transaction costs
Pay unitary charge in advance	Not permitted under SoPC4 7.2.1 (although payment in-month is), may require breaking swap, may end up enhancing equity

A.3 Authorities should not explore these measures unless they are convinced that their particular contract represents an exceptional circumstance. If an Authority believes that a non-recommended measure is appropriate for their contract, it should seek advice from their departmental PFU.

[1] Excluding rescue refinancings, although a VfM analysis in respect of increased termination liabilities is still required in this case. See HM Treasury's Application Note "Value for Money in Refinancing" (http://www.hm-treasury.gov.uk/d/application_note_value_for_money_280205.pdf)
[2] See section 1.6 of HM Treasury's Application Note "Value for Money in Refinancing".

HM Treasury contacts

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