

Value for Money Assessment Guidance

August 2004



HM TREASURY



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BACKGROUND

Introduction **1.1** This guidance sets out a new approach to appraising the value for money of investment proposals to be procured under the Private Finance Initiative (“PFI”) and replaces Treasury Taskforce Technical Note 5 for PFI procurements. It is important that value for money assessments should take place at the earliest practical stage of any decision making process and that departments ensure there is the flexibility to pursue alternative procurement routes if at any stage PFI does not offer the best value for money. To this end, changes to the new appraisal process for PFI, including the reforms to the Public Sector Comparator, are as follows:

- a new test of the potential value for money of procurement options when overall investment decisions are made, to ensure PFI is used only in those sectors where it is appropriate and has a good value for money case, and that departments provide sufficient budget flexibility to accommodate subsequent decisions not to use PFI;
- reforming the Public Sector Comparator into part of an early rigorous economic appraisal of an individual project at the stage an Outline Business Case is produced, prior to the procurement of the project, to allow projects to proceed down alternative procurement routes where they offer better value for money; and
- instituting a final test at the procurement stage of a project that would evaluate the competitive interest in a project and the capacity of the market to deliver it effectively.

1.2 The need for new guidance has arisen due to the significant changes in the Government’s approach to investment appraisal set out in the revised Green Book which became effective for all Government departments in April 2003 (the “Revised Green Book”), and the reforms to investment appraisal for PFI set out in PFI: Meeting the Investment Challenge published by HM Treasury in July 2003 (“MTIC”). It also takes into account the results of the NAO’s reports of previous PFI projects.

Value for Money **1.3** The central proposition should always be that PFI should only be pursued where it delivers value for money (VfM), where VfM is the optimum combination of whole life cost and quality (or fitness for purpose) to meet the user’s requirement, and does not always mean choosing the lowest cost bid. It should not be chosen to secure a particular balance sheet treatment.

Value for Money and Procurement **1.4** In assessing and achieving VfM in procuring a PFI project it is important to ensure, before a procurement is undertaken, that a full assessment is made of the marketability of the project, to ensure a competitive market is available, that the procurement process proposed will keep transaction costs in both public and private sectors to a minimum and that a realistic but expedited procurement timetable is achievable and maintained.

1.5 It is also important to ensure that during the procurement process, there is not an occurrence of a market failure or abuse that jeopardises the VfM of the PFI transaction.

- 1.6** In assessing VfM, consideration should be given in particular to the following:
- good design - design quality is a key part of the appraisal process and should be given due consideration. VfM does not always equate to lowest cost, and full account should be taken in valuing the impact of both design and sustainability on the procurement following the guidance set out in the Green Book, Annex 2, and in Treasury Taskforce Technical Note 7;
 - VfM should not be achieved at the expense of workers' terms and conditions; the position of the workforce within any PFI deal is a vital consideration for appraisers and project teams. Appraisers should consider carefully the impact on the risk allocation and the ensuing benefits and disadvantages of transferring staff when considering whether PFI is appropriate; and
 - factors (non-market) which indirectly affect differentially the VfM of the procurement route, these may include traditional externalities such as the environmental impact but also include factors such as strategic risks that do not directly affect the project.

Protection for Staff 1.7 In undertaking a PFI procurement, Procuring Authorities should take full account of the suite of guidance pertaining to the treatment of staff. This should include the Cabinet Office Statement of Practice issued in 2001, HM Treasury Guidance relating to bulk transfer agreements and, where applicable, the Best Value Code of Practice, NHS guidance on Retention of Employment and the Scottish Protocol on Employment issues. Due care should also be given to the advice set out in PFI: Meeting the Investment Challenge, Workforce Issues. VfM should not be pursued at the expense of staff terms and conditions; this position is embedded in the quantitative spreadsheet used at stages 1 and 2.

Affordability 1.8 Fundamental to any assessment will be a realistic affordability calculation. Affordability in this document refers to what is affordable within the department/ Procuring Authority's spending allocation. For central departments this will be within their Delegated Expenditure Limits ("DEL") and consistent with their investment plans. At all stages projects should not be allowed to proceed unless the Procuring Authority has a high degree of confidence that the project is affordable. Procuring Authorities should undertake a thorough assessment of the envelope and likely project cost. The Authority should consider:

- whether the specifications envisaged take full account of this likely spending envelope; and
- once the settlement for the spending period has been finalised, whether the affordability assumptions still hold and the impact changes may have on priorities and timing;
- how changes to payment of Revenue Support Grant impact upon affordability considerations for local authorities.

1.9 Crucial to establishing affordability will be the inclusion of Optimism Bias (see 1.13) in any calculation of a project's cost, similarly it will be important for the Procuring Authority to take a view on the likely balance sheet treatment of the project and to budget accordingly.

Scope for service provision **I.10** A crucial choice for Procuring Authorities is the extent to which a range of services is included in the scheme. Are these restricted to hard FM or does the scheme also include soft FM? There is no *priori* reason why a PFI scheme has to include soft services where the Authority believes that their transfer is not essential for achieving the overall benefits of improved standards of service delivery specified by the procurer, and where not transferring staff is consistent with delivering the Prime Minister's commitment to flexibility in public services. This should form part of both the quantitative and qualitative analysis.

What is PFI? **I.11** The PFI approach involves the public sector in contracting to purchase quality services, with defined outputs, from the private sector on a long term basis, and including maintaining or constructing the necessary infrastructure so as to take advantage of private sector management skills incentivised by having private finance at risk, and includes projects procured within procurement vehicles such as BSF and LIFT

Box I.1: PPPs and PFIs

In 2000, the Government published "Public Private Partnerships – the Government's Approach" which defined public private partnerships (PPPs) into three categories:

- the introduction of private sector ownership into state-owned businesses, using the full range of possible structures (whether by flotation or the introduction of a strategic partner), with sales of either a majority or a minority stake;
- the Private Finance Initiative (PFI) and other arrangements where the public sector contracts to purchase quality services on a long-term basis so as to take advantage of private sector management skills incentivised by having private finance at risk. This includes concessions and franchises, where a private sector partner takes on the responsibility for providing a public service, including maintaining, enhancing or constructing the necessary infrastructure; and
- selling Government services into wider markets and other partnership arrangements where private sector expertise and finance are used to exploit the commercial potential of Government assets.

I.12 Because PFI is characterised by a long term, whole-of-life commitment by the private sector to deliver and maintain new public infrastructure, it will only be suitable for certain types of investment, naturally limiting its use. This guidance seeks to provide departments with a framework for evaluating the appropriateness of and VfM of PFI, taking account of changes in the Green Book and the policy changes set out in PFI: Meeting the Investment Challenge.

The Revised Green Book **I.13** The Revised Green Book introduced the following changes to investment appraisal generally which also apply to the appraisal of PFI transactions, namely:

- **Discount Rate:** the discount rate to be used in appraisals, which was previously 6% (real) has been unbundled and is now 3.5% (real). It is based solely on an estimate of the rate of social time preference.
- **Optimism Bias:** the demonstrated, systematic tendency for project appraisers to be overly optimistic. To redress this tendency, appraisers should make explicit adjustments for this bias. Adjustments should be

¹ [<http://greenbook.treasury.gov.uk/>]

empirically based (e.g. using data from past projects or similar projects elsewhere) and adjusted for the unique characteristics of the project in hand. Cross-departmental guidance for generic project categories is available, and should be used in the absence of more specific evidence. If departments or agencies have a more robust evidence base for cost overruns and other instances of bias, this evidence should be used in preference. Projects procured by means of both PFI and other forms of procurement are subject to Optimism Bias in different stages of their development, but evidence suggests that Optimism Bias can differ between different procurement options.

- Tax: where a choice of procurement leads to different outcomes in terms of tax receipts, these should be taken into account. This often occurs in PFI transactions. A methodology for taking account of these differences in PFI transactions was set out in the Revised Green Book. Procuring Authorities should refer to the Dear Accounting Office Letter on Tax Planning and Tax Avoidance:
<http://www.hm-treasury.gsi.gov.uk/GFM/accounting/dao/dao0803.doc>
- Benefits: the Revised Green Book encouraged appraisers to quantify all benefits that may accrue from an investment and/or choice of procurement, as well as their costs. In particular, there was renewed emphasis on seeking to quantify those benefits that had previously been only subject to qualitative assessment.

1.14 The Revised Green Book sets out a broad based methodology for implementing these and other changes to all investment appraisals. This guidance builds on these concepts to provide a more detailed methodology and set of tools for applying this general approach to the specifics of PFI transactions.

Meeting the Investment Challenge

1.15 In July 2003, the Government set out its approach to the use of PFI in delivering the investment necessary to modernise public services and the assessment of its VfM, and the way PFI investment programmes should be implemented. Key aspects to this framework are:

- PFI is one of a number of procurement options open to the public sector for modernising infrastructure, with its own characteristics, costs and benefits. As such it is one of a number of ways to involve the private sector in improving public services;
- PFI should only be used where it is appropriate, which is based on the Government's commitment to efficiency, equity and accountability;
- PFI should only be used where it offers VfM;
- there should be no inherent bias in favour of one procurement route over another and Procuring Authorities should ensure that this principle is supported throughout the procurement process.

1.16 In keeping with these aims, procurement decisions need to be based first on the approach to considering which procurement option is most appropriate, given the nature of the capital investment proposed and the public service with which it is associated, and secondly on an unbiased and rigorous assessment of which of the available options is likely to represent the best value for money. This guidance sets out in detail how this should be implemented in evaluating PFI schemes.

When should PFI be considered

1.17 The assessment does not apply to all procurement routes, it should only be applied to programmes where the Procurement Authority believes that the evidence of the benefits which PFI can offer indicate that there is a prima facie case for considering PFI. These include: :

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

Feedback 1.18 No stage should be seen in isolation, information from projects in later procurement stages will be vital to this approach for any programme. Feedback should be shared across teams at the same stage in the procurement process but it is also vital that it is passed to teams at earlier stages allowing them to take more informed decisions.

Headline messages

1.19 Key changes or principles emphasised in this guidance include:

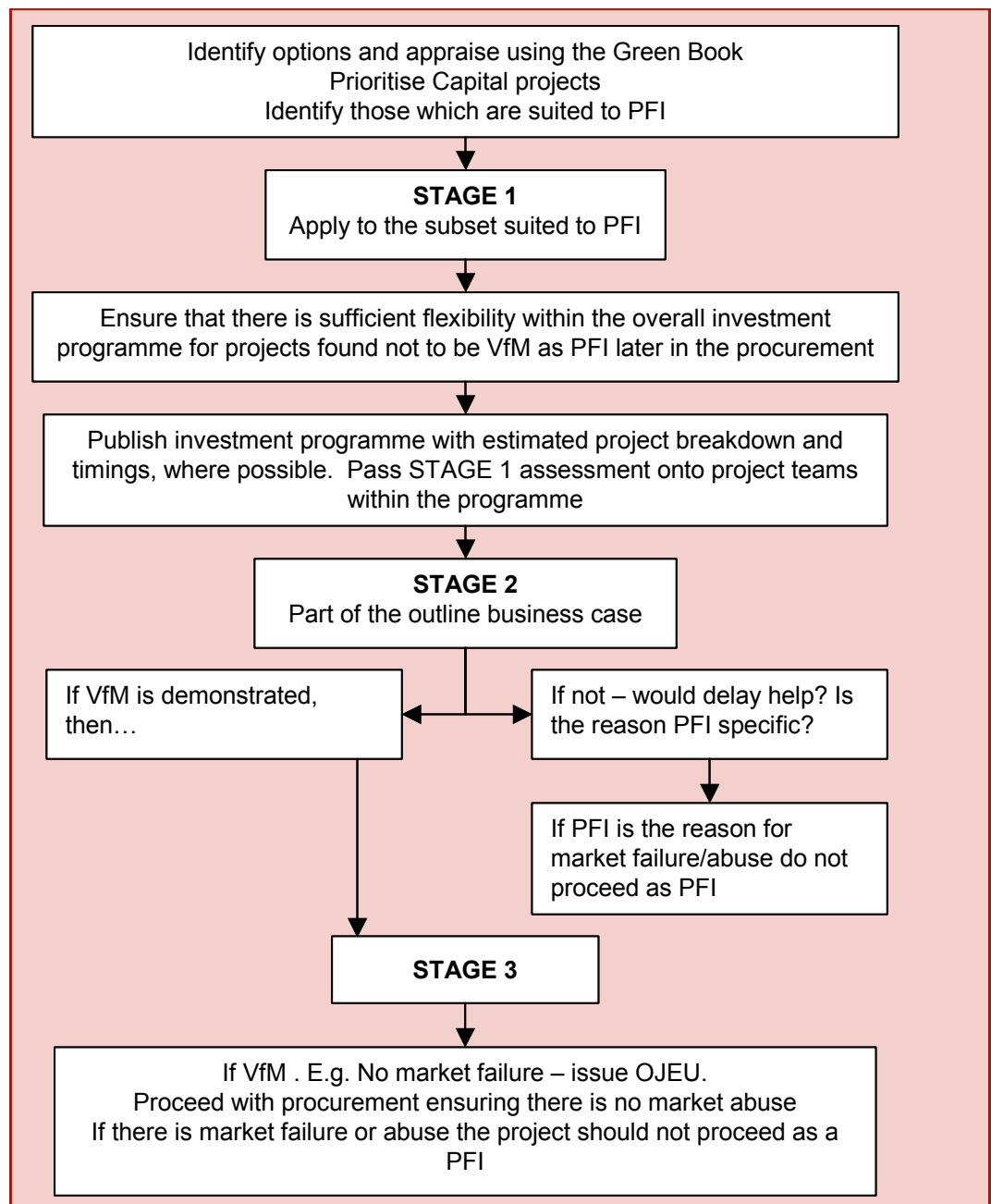
- A final decision based on a hypothetical quantitative assessment will no longer be taken just prior to contract signature (final business case, or the equivalent.) Bid evaluation is a distinct exercise and there will be separate guidance to support this.
- Decisions are made earlier, and prior to the commencement of procurement, to increase the ability of Authorities to build in the flexibility essential to maintaining a real choice.
- VfM should not be achieved at the expense of workers' terms and conditions.
- Quantitative analysis must be made and presented in context, there is no longer a single pass/fail point estimate.
- An evidence based approach is fundamental to good decision making.

- Quantification of socio-economic benefits is an important part of the analysis.
- PFI should not be used for IT/ICT procurements.
- Individually procured projects under £20m are generally unsuitable for PFI.

2

INTRODUCTION

Road Map 2.1 This guidance comprises an overview of the Investment Programme and Project Assessment stages in Sections 3 and 4 with further detailed methodology for the first two stages set out in Section 5. These two stages are further supported by a generic spreadsheet for the quantitative assessment which can be obtained from the sponsoring department's Private Finance Unit and the User Guide which accompanies this document in Annex A. The guidance then goes on to outline the approach to the Procurement stage in Section 6 and to Bid Evaluation Guidance (available separately shortly). All three stages incorporate the principles set out in the Green Book and are intended to ensure that PFI only proceeds where it is VfM. This guidance should be read in conjunction with the guidance published for the spending round.



Status of Guidance **2.2** Stage 1 of this guidance is effective for SR2004 and stages 2 and 3 will be effective for this spending period. Stage 1 may also be revisited in light of the Spending Review outcomes. Treatment of transition projects should be agreed with the relevant spending team or in the case of Local Authorities or agencies with the relevant sponsoring department.

Local Authorities **2.3** Where Authorities are in receipt of central funding, they will be required to adhere to this guidance. Procuring Authorities should agree outputs and the information required with the appropriate sponsoring department, and consider all relevant ODPM guidance. Stage 1 will be completed by sponsoring departments as part of their request for PFI credits which usually takes place as part of the Spending Review process. This finalised programme level analysis should be passed on to the relevant project teams within Local Authorities once an individual project has received an indication that it may draw up an Outline Business Case to take to the Project Review Group (PRG). The Local Authority project team will then become responsible for completing stages 2 and 3 on that individual project. The quantitative assessment should not form the basis for calculating affordability or for the allocation of PFI credits as it contains factors that do not impact directly on the projects cash flow requirements.

Sharing information and building an evidence base **2.4** Collecting information on actual outcomes is key to investment appraisal. This information should be used in appraising all future programmes and projects and should be shared across the public sector. Departments are required to put mechanisms for collating, retaining and sharing information in place (from the start of the spending round). Evidence collected and properly interpreted from past experience is fundamental to the development of a rigorous quantitative and qualitative assessment, it is vital that information from all stages of the procurement process, and information from post-implementation evaluation exercises, be collated and shared. Attempts should also be made to engage the private sector as a source. Although it will be the responsibility of individual departments to assemble and share their own evidence bases, this guidance recognises that information from one sector can often usefully inform others. It is, therefore, important that this evidence be made easily available to other departments, and more widely where appropriate.

2.5 Departments will be required to hold a series of project and programme information, including post evaluation data. This is discussed in more detail in Section 8 (to be added shortly).

2.6 This information may also include:

- a list of any particular difficulties encountered during the appraisal;
- the sources and data used to assess risk;
- what lessons have been learned during the process, identifying what might have been done differently in retrospect, for example were there significant time delays, significant change orders which impacted on the financial envelope and the scope of the project, or significant failures in the performance levels (in this instance were penalty deductions levied);
- any novel ideas or innovations implemented and a note of the respective contributions of the team members;
- description of the evaluation process structure;
- a view of the current market situation;

- outturn figures and actual Optimism Bias; and
- information on the outcome of staff transfers (or lack there of) should also be collated and recorded. Contract managers should update this record at milestones in the contract as set out by the sponsoring department.

2.7 Local Authorities should seek to learn from information maintained and updated by the 4Ps. They should also be prepared to share their own experiences through this forum.

De minimis criteria for application **2.8** There is no *de minimis* level for applying the programme guidance. As stated above, all projects which fall within a PFI programme should be assessed using this guidance, whether singly or collectively under an investment programme as defined in Section 3.3.

Who should do the assessment? **2.9** The accounting officer is responsible for ensuring that programmes are assessed in accordance with this guidance and that the recommended procurement routes are the most likely to obtain VfM for the individual projects under the relevant programme. The accounting officer will need to delegate responsibility for the detailed work accordingly. For the Investment level this should be undertaken by the central PFU in conjunction with the team coordinating the Spending Review submission. At project level the procuring team should update the analysis done at the programme level.

Timing **2.10** The programme level assessment should be applied during the annual budgeting round when any programme of investment is being considered and for which PFI may be a suitable procurement route. These should inform submissions for the Spending Review. The project level appraisal should be undertaken at Outline Business Case before OJEU is issued. Finally, the procurement level appraisal should begin immediately post Outline Business Case and should continue through to commercial close, although the areas it focuses on should be an important consideration from the investment stage onwards.

Audit and review **2.11** The evidence used to perform the assessment should be made available for audit. It will be for departments and the NAO to decide whether or not an external audit would assist decision-making and whether this should take place before decisions are taken on the way forward. Departments should take note of relevant evidence in the large number of NAO reports on PFI projects. These can be accessed at www.nao.org.uk.

Transparency **2.12** The conclusions of the assessment, and the proposed project flow for the spending period should be summarised in existing, publicly available, documents, such as departmental investment strategies. As far as possible, the evidence used to support conclusions drawn should also be made publicly available, for example conclusions from the evidence at stage 1 should be incorporated in the Departmental Investment Strategy, although where there are genuine issues, either of commercial confidentiality or of prejudicing the public sector's negotiating position, departments may decide that the availability of such evidence may need to be circumscribed.

Tailoring departmental guidance **2.13** Departments will need to assess and amend their existing guidance to bring it into line with Treasury policy as set out in this document. This will then need to be agreed with HM Treasury.

Managing Investment Programmes **2.14** Departments will need to consider how best to construct and manage their investment programmes in light of this guidance and as such how they will need to apply this guidance in developing proposals for consideration in Spending Reviews.

Once investment plans are agreed, departments will also need to manage their programmes to genuinely enable alternative procurement routes to be adopted should this be appropriate on VfM grounds.

Unique large projects and pathfinders

2.15 Projects which do not form part of a programme should not be precluded by these reforms. Where a department has a large unique project, stage 1 should be omitted but stage 2 should be applied both at its inception as part of the spending round and again once the Outline Business Case stage is reached. Projects should then proceed as per the guidance, taking account of any extenuating circumstances. Where novel projects are identified the Procuring Authority should engage the HM Treasury spending team and PFI team as early as possible to establish how the VfM assessment should be taken forward. Pathfinders must also be considered in the light of their status.

3

INVESTMENT PROGRAMME LEVEL ASSESSMENT

STAGE 1

Overview **3.1** This guidance should be read in conjunction with the Spending Review guidance. While the appraisal of procurement options at the programme stage will inevitably involve some uncertainty, it does provide Procuring Authorities with a rational framework to consider which procurement route will deliver the best VfM. The aim is to provide a clear strategic direction, whilst allowing reasonable flexibility for the marginal project.

3.2 Where departments do not currently organise planned investment into coherent programmes, they will be required to do so in the future and submit these as part of the Spending Review. These programmes must take account of the fact that a percentage of projects are likely to switch procurement routes at Stage 2, and a very small minority of projects at Stage 3 where there is market abuse or failure. The department must ensure that this is a real option for procurers, where they wish to continue with the project. How this option is delivered should be discussed and agreed with HM Treasury.

What is an ‘investment programme’? **3.3** A programme is ‘a portfolio of projects that have certain common characteristics and which are selected or commissioned, planned and managed in a co-ordinated way and which together achieve a set of defined business objectives’.¹

3.4 Departmental investment programmes vary significantly. For some, a single accommodation project might constitute the major part of its investment programme. Others may have many complex capital programmes and sub-programmes. Departments will therefore need to consider and determine what, for them, constitutes a coherent ‘investment programme’. However, it is expected that, as a minimum, all departmental PFI projects will have been assessed at, programme level, prior to the Procuring Authority embarking on the completion of an Outline Business Case.²

Objectives and outcomes **3.5** The main aims of carrying out the programme level assessment are to:

- provide an early assessment of whether PFI is likely to provide VfM for a programme of investment in public services;
- help predict which procurement routes should apply for individual projects within an overall programme – whether by PFI in whole, in part, or not at all;
- increase transparency and improve deal flow;
- assist departments as a whole in deciding:
 - allocations between capital and revenue budgets;
 - the volume and scale of work programmes to be supported, given the amount of capital and revenue funding available; and

¹ OGC, Gateway Review 0: Strategic Assessment

² Where projects do not fall within a PFI programme but their characteristics lend themselves to a PFI, the project level appraisal should be applied

- the combination of procurement routes that are likely to deliver value for money programmes;
- ensure that investments made using PFI are affordable, e.g. cost estimates are realistic and that due consideration has been given to the likely accounting treatment; and
- ensure departments have in place the necessary framework (both in terms of structure and skills) to implement a PFI programme in a manner which ensures optimal value for money and minimal transaction costs for both the public and private sectors.

3.6 The outcome of the appraisal should be a better understanding of the procurement routes best suited for particular programmes and a closer match between the requirements of each programme and the capability and capacity of Procuring Authorities to complete each programme.

3.7 The programme assessment should clear the path for later stages of the procurement process, enabling Procuring Authorities to concentrate on those value for money issues that are relevant for them at the Outline Business Case stage and during the subsequent procurement and assurance of long term affordability.

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

Scope 3.9 Applying the investment programme assessment assumes that there is already a *prima facie* case for using PFI as a procurement route. It tests that interest against the best available evidence. It does not:

- provide a full analysis of other available procurement options;
- provide guidance on how competing PFI bids should be compared against each other as part of the value for money decision. This is considered in the forthcoming bid evaluation guidance;
- recommend that all projects should be considered for PFI, but it ensures that those that are being considered are assessed against the same criteria.

Overall approach

3.10 The recommended approach is in two parts, qualitative and quantitative. Further detail on these elements is set out in Section 5. The accompanying spreadsheet should be obtained from the sponsoring department's Private Finance Unit and is supported by a user guide (see Annex A) with a worked example. Departments need to look across sectors both within their sphere of responsibility and outside this to assess the impact on the market of their projects

Qualitative assessment 3.11 This part considers the Viability, Desirability and Achievability of PFI when assessed against alternative procurement routes. PFI deals generally should be for large projects that are critical to the delivery of public services. They commit the Procuring Authority to a particular provider for some years ahead. Whether these projects are successful will not just depend on cost. It will also depend on a range of qualitative factors that need to be considered, alongside quantitative factors, in coming to a decision on the most appropriate procurement route.

- Viability involves assessing whether there are any efficiency, accountability or equity issues, which demand that services are provided by Government directly rather than through PFI, and the extent to which service requirements can be adequately captured in a contract-based approach, with a clear specification in output terms.
- Desirability involves assessing the relative benefits of different procurement routes, such as incentives and risk transfer in PFI versus the Government's lower cost of borrowing in conventional procurement, and the relative advantages and disadvantages associated with a long term contractual relationships between the public and private sectors.
- Achievability involves gauging the level of likely market interest and whether the public sector client would have sufficient capability to manage the complex processes involved, as this is key to both the procurement of the services and their ongoing management and performance.

Quantitative assessment 3.12 The quantitative assessment involves estimating values for the capital and operating costs attached to a particular programme and its benefits, and adjusting these for any inherent 'Optimism Bias' and/or specific risks as well as expected transaction costs. It considers how quantifiable costs and benefits of using PFI as the procurement route are likely to compare with conventional procurement. For the PFI option, it calculates the cost of the project if it were to be funded through private finance, adjusting relevant factors accordingly. A generic spreadsheet has been developed by PUK for HM Treasury to capture these values, and to enable sensitivity testing, and must be used as part of any VfM assessment.

3.13 The quantitative assessment at the investment programme stage will inevitably be conducted using only high-level estimates, albeit supported by evidence taken from past procurements. This approach has been adopted in part to discourage overly complex modelling and promote simplicity to reflect the inherent uncertainties at this point in the process. In completing their programme-based assessments, departments should have regard to the level of homogeneity of those projects that are likely to fall within each programme. Where the variety of projects within an investment programme is substantial, departments will need both to ensure that the specific characteristics of each project are tested robustly at stage 2 and that their estimates of the balance between PFI and conventional procurement routes for a particular programme reflect this level of uncertainty. The programme assessment should consider scenarios beyond just the "typical" project, and look at the potential volatility of the programme.

3.14 The quantitative assessment will develop further as more detailed information is known about the programme and the individual projects that it comprises up to the completion of the Outline Business Case. It forms an initial framework for stage 2. All input assumptions must be predicated upon evidence from past experience and projections. The results of the quantitative assessment at both stages should be presented as part of the Business Cases.

Limitations 3.15 There are clearly limitations in the qualitative and quantitative approach, which should be recognised. In particular:

- innovation is difficult to model at the investment programme stage – until the market has proposed innovative solutions, their costs and benefits are unknown. However, this is not designed to prevent departments from procuring large unique projects.
- Where the evidence base is currently limited, or the quality is poor, departments will need to ensure that they conduct and disseminate post-project or post-programme evaluations.
- Pathfinder projects may have difficulties in establishing the depth of evidence available to established programmes, this should not prevent these being taken forward. Additional care should be taken in examining these projects and recognition made of their pathfinder status, the guidance is not intended to reduce pathfinders or inhibit their development.

Outputs and outcomes of the assessment 3.16 Once the qualitative and quantitative assessments have been completed, an overall assessment should be made taking into account the results of both. This should recognise any limitations in the component parts of the assessment, but should provide the overall justification both for the preferred procurement route for the programme as a whole, and for its constituent parts. The outputs from the quantitative assessment should not be considered in isolation, specifically as a stand alone case for, or against, PFI.

3.17 This should provide strategic direction for the programme as a whole, but not act as a straitjacket for individual projects. In determining their overall investment strategies, departments will need to reflect the fact that the specific characteristics of some projects within each programme might justify a procurement route that differs from that applicable generally to the particular programme. See paragraph on Managing Investment Programmes 2.14.

Affordability 3.18 Departments should ensure that programmes are affordable and that they have a realistic assessment of the likely balance sheet treatment, even where projects are novel. Consideration should also be given to affordability in the light of any possible change to the balance sheet treatment of projects within the programme. No programme should proceed without a high degree of confidence that it is affordable.

Communicating the outcome of the assessment 3.19 The results of the assessment should be clearly communicated to individual project managers so that they are aware of the expected procurement route to follow, the basis for this decision, and of the potential for flexibility to choose another route if the detailed assessment at the project level indicates that this is desirable.

Timing 3.20 Stage 1 should be undertaken following the initial investment appraisal analysis for a new programme, usually as part of the spending review.

4

PROJECT LEVEL ASSESSMENT

The Public Sector Comparator has been reformed to ensure that, prior to procurement, there is a rigorous appraisal of a project as part of the Outline Business Case, allowing an alternative route to be chosen at this stage if it offers better value for money

STAGE 2

Overview- Project level assessment - including the reformed Public Sector Comparator

4.1 This stage specifically includes the reform of the existing Public Sector Comparator. This stage is designed to ensure that value for money is achieved by testing the programme level assumption that PFI is the most appropriate procurement route in light of the specific characteristics of individual projects. As with stage 1, it encompasses both a quantitative and qualitative element and is the last point in the VfM decision process where there is a quantitative analysis of the optimum procurement route. The reformed Public Sector Comparator should identify those marginal projects, at Outline Business Case, which will not benefit from programme level decisions. It enables Procuring Authorities to assess why and make adjustments where appropriate and, where necessary, to switch to conventional procurement. The Public Sector Comparator (PSC) should not be referred back to once the Outline Business Case has been approved.

Objectives and Outcomes

4.2 The main aims of carrying out project level assessment are to:

- verify that the initial decision to use PFI, based on an investment programme assessment, is valid;
- where project specific issues suggest that, as it stands, the PFI presumption does not offer value for money, direct the Procuring Authority towards potential solutions including the possibility of switching to conventional procurement;
- feed information back to the programme level to improve the evidence base and potential for market management;
- ensure that Procuring Authorities proceed only if they are confident their project is affordable;
- test whether the PFI solution is marketable;
- ensure an efficient bid process is planned within a realistic timeframe;
- verify whether appropriate risk sharing arrangements are likely to materialise; and
- provide the procuring team with a framework within which they can take difficult decisions if the assessment should suggest that the market conditions are unfavourable.

4.3 The outcome of the appraisal should be a better understanding of the procurement route to be adopted for a specific project forming part of a programme. It

will also provide the Procuring Authority with a better understanding of the capability and capacity available to it to take the project forward.

Scope 4.4 The project stage assessment assumes that a decision has already been taken that, using the best available evidence at programme level, PFI procurement will provide value for money and should be pursued. It seeks to confirm, for an individual project, that the assumptions supporting the decisions are valid. The assessment also seeks to verify that the assumptions upon which the decision was taken to proceed with a PFI procurement route remain supportable in the light of prevailing market conditions prior to going out to OJEU. By doing this, the assessment provides Procuring Authorities with continued assurance that the PFI competition is likely to result in the submission of value for money bids that satisfy stated requirements. However, the assessment does not extend the role of quantitative analysis either in supporting or rejecting the chosen procurement route or in supporting or rejecting the value for money of bids submitted in response to the PFI competition. Departments should not present a quantitative model beyond that drawn up at stage 2 as part of the Final Business Case to justify the procurement route, however there may be a requirement for a reference model for bid evaluation purposes (separate guidance to follow shortly). The spreadsheet applied at stages 1 and 2 will not form the basis of this.

Overall Approach

4.5 At Outline Business Case the project team has the opportunity to verify that the programme level assumptions apply to the project; this includes both the qualitative assumptions, relating to the viability, desirability and achievability criteria, and the quantitative assumptions behind the quantitative inputs, as set out in chapter 5. As for stage 1, this is accompanied by the quantitative evaluation tool and user guide (see Annex A).

Qualitative Assessment 4.6 This section revisits the viability, desirability and achievability of PFI from a project specific perspective. Procuring Authorities should consult the guidance set out in stage 1 and consider whether these assumptions hold in their particular circumstances. If the specific characteristics of a project suggest a different procurement route to the one recommended for the programme as a whole, then this deviation should be explained and documented. Market soundings undertaken throughout the procurement should be based on a well researched, well constructed project once outcomes and objectives have been clarified. It should however be noted that problems can arise if the Procuring Authority uses market soundings to shape its objectives.

4.7 Procuring Authorities must consider the results of the quantitative assessment in the context of the qualitative conclusions. This is discussed in more detail below in Section 5. Procuring Authorities should look forward to criteria for stage 3 and satisfy themselves that these are likely to be achievable as part of their qualitative assessment. Evidence of this should be included in the Outline Business Case. Further more it should be determined prior to going to OJEU that the benefits assumed for the PFI project could not be delivered by the market.

Affordability test 4.8 Procuring Authorities should ensure the project still falls within the affordability envelope, as defined in 1.8. Separate Bid Evaluation Guidance will include a specific test of affordability which the Authority must be confident is met before proceeding with the procurement

4.9 Any problem with affordability that arises late in the procurement process will increase transaction costs and undermine private sector confidence in the procurer and prejudice the procurer's ability to achieve value for money. Ultimately, a major affordability problem could jeopardise the PFI project proceeding, leading to significant waste of both public and private sector resources. It is vital therefore that in drawing up specifications Procuring Authorities are mindful of their affordability envelope.

4.10 There should be a high degree of confidence that the PFI project is affordable, both before going out to the market and during the procurement itself. It is vital therefore that cost assessments submitted at Outline Business Case are realistic and that the likely balance sheet treatment for the PFI transaction is established at the outset of the procurement.

Quantitative Assessment

4.11 As for the qualitative stage, Procuring Authorities should take the opportunity to revisit the quantitative assumptions made at the programme level. At stage 2 the project team will be expected to update the spreadsheet in light of the project's specific characteristics and on the basis of past experience. However, an input should only be changed where there is justifiably better information, e.g. capital expenditure. Teams should not alter the figures estimated; especially for risk factors such as Optimism Bias, without substantial evidence that their project can demonstrate a better performance. This is described in more detail in chapter 5.

Outputs and outcomes of the assessment

4.12 Guidance on how to interpret the results from this analysis is detailed in chapter 5 and the accompanying user guide, however it is worth drawing out here that the outputs from the spreadsheet should not be considered in isolation and specifically should not be considered as a stand-alone case for, or against, PFI. The level of accuracy of the quantitative assessment must be borne in mind, including confidence levels about the inputs and therefore the sensitivity of the outcome. Where the outcome is particularly sensitive to subjective inputs this should be highlighted. Although a degree of work will need to be carried out outside the spreadsheet, this should be done in keeping with the simple approach of the assessment.

4.13 If the result of the qualitative case for proceeding with either PFI or conventional is substantial, the Procuring Authority may decide that this outweighs the quantitative analysis. The qualitative case should inform the confidence placed on the quantitative outcome.

4.14 In order to support this process, it is vital that information gleaned at all stages of the procurement process and information from post-implementation evaluation exercises be fed back to programmes and projects beginning their life cycle. The affordability calculations should be included as part of the Outline Business Case, however it should be noted that the value for money calculations do not drive affordability calculations. If a project is not deemed to be affordable it should not be pursued regardless of the value for money assessment.

4.15 All assumption changes made at this stage should be fully explained and documented by the project owners. Where a project does not look like it will deliver value for money the reasons should be considered carefully as part of the Outline Business Case. If it would be possible to achieve these benefits by delaying the timing of the project, for example if several similar projects have recently gone to the market, then the team should delay. It may be that a re-examination of the approach is required; appropriate changes may mean that value for money can be achieved without alteration of the procurement route. If the cause is more fundamental, the first step for the team should be to examine the project to determine whether there are changes will

still deliver the business requirement and which are value for money. If the issue is PFI specific, and cannot be addressed, the procurement route should be changed, or the project halted.

4.16 Procuring Authorities need to be satisfied that the project will attract sufficient quality bidders before proceeding to OJEU. If the evidence to support such conclusions is inadequate, the Procuring Authority should:

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

4.17 The Procuring Authority should feed back intelligence gained on PFI market conditions to departments so that others examining similar procurement issues are well informed.

Limitations 4.18 There are limitations in the qualitative and quantitative approach that need to be recognised. For example, at such an early stage, only limited account can be taken of innovation. It will also be difficult to assess novel areas where, by definition, there may be little or no substantive evidence available upon which to base decisions. Analysis should take account of this and any mitigation measures that have been taken to address this.

4.19 It should be noted that running the analysis at FBC and comparing the results with Outline Business Case results should not be undertaken as it would be an unfair comparison given the inherent uncertainty at the Outline Business Case stage.

4.20 The Quantitative assessment at Outline Business Case is also not an appropriate benchmark for an in-house bid. In a market testing exercise where an in-house bid is permitted, the public sector team must offer a bid comparable to the private sector bid, including all risks faced by the bidders (e.g. rectification and availability risk).

Timing 4.21 The Stage 2 assessment should be completed as part of the project Outline Business Case Outline Business Case prior to OJEU. It is good practice to consider revisiting this stage should scope changes during development lead to an increase in cost of 25% or more, over and above the original cost, including estimates of Optimism Bias.

5

DETAILED METHODOLOGY STAGES 1 & 2

5.1 This chapter sets out the methodology for implementing the principles set out in the preceding two chapters. It comprises a series of qualitative instructions as to how to approach the quantitative element of the appraisal. Departments will need to secure as much evidence as is practicable and reasonable when determining the procurement route, to substantiate both parts of this analysis.

5.2 Limitations include the fact that Procuring Authorities should be looking for best combination of value for money, and the volume of projects, within capital and revenue budgets. This is a toolkit for PFI, not for all procurement models. OGC provides separate advice on conventional procurement options, which can be found at www.ogc.gov.uk.

QUALITATIVE ASSESSMENT

Introduction

5.3 The qualitative element of the appraisal should seek to answer a series of questions which address the Viability, Desirability and Achievability of the project, which are set out below in Table 5.1. Procuring Authorities should go further however and detail any specific issues that are pertinent but do not fall under any of the table headings. Due consideration should be accorded to the appraisal criteria in the Green Book including distributional and employment considerations as well as indirect factors (non-market) which have a differential impact upon the procurement route's value for money.

Indirect Vfm factors

5.4 Factors that should be considered are those that have a differential impact on PFI versus conventional procurement. These may include (although not in every case) factors such as the quality of the design, environmental considerations or innovations that can be adopted for wider use by the Authority (where there are not intellectual property right issues). These factors can have a significant impact on the quality of service delivery and should not be down played. In addition they may include things that are of value to the Authority, as a result of the project, but which may not directly impact on the project.

Table 5.1:

VIABILITY	
Investment objectives and desired outcomes need to be translatable into outputs that can be contracted for, measured and agreed. Many service areas can be described in contractual terms, but some areas will be inherently 'non-contractible'.	
Issue	Question
Programme level objectives and outputs	Is the Procuring Authority satisfied that operable contracts could be constructed for projects falling in this area? Can these contractual outputs/ requirements be robustly assessed?
	Could the contracts describe service requirements in clear, objective, output-based terms?

	<p>Could they support assessments of whether the service has been delivered to an agreed standard?</p> <p>Is the fit between needs and outcome sufficient to proceed?</p> <p>In the event of staff transfer, can the contracts be drafted to avoid perverse incentives and deliver quality services?</p>
Operational flexibility	<p>Is the Procuring Authority satisfied that operational flexibility is likely to be maintained over the lifetime of the contract, at an acceptable cost?</p> <p>Have the long term tradeoffs between operational flexibility and cost been identified?</p>
Equity, efficiency and accountability	<p>Are there public equity, efficiency or accountability reasons for providing the service directly, rather than through a PFI contract?</p> <p>Are there regulatory or legal restrictions that require services to be provided directly?</p> <p>Have the expected staff terms and conditions at stage 2 been considered and what are the impacts on the contract, equity, efficiency and accountability?</p>
OVERALL VIABILITY	<p>Overall, in deciding to proceed with PFI, is the accounting officer satisfied that an operable contract with built-in flexibility can be constructed, and that strategic and regulatory issues can be overcome?</p>
<p>DESIRABILITY</p> <p>An increasing body of evidence has shown that better risk management in PFI results in a greater proportion of assets being delivered on time and to budget. By integrating the life-cycle and operation costs with the design and construction, PFI can provide better risk management and incentives to develop innovative approaches to output delivery. Consistent high quality services can be achieved through performance and payment mechanisms. However, risk transfer is priced into the contract. The purpose of these questions is to consider whether the benefits of PFI are likely to outweigh this additional cost.</p>	
Risk management	<p>Does the project involve the purchase of a significant capital asset, where the risks of cost and time over-runs are likely to be significant?</p> <p>Does the project involve operational aspects where the risk of cost and time overrun are likely to be significant?</p>
Innovation	<p>Does a preliminary assessment indicate that there is likely to be scope for innovation? To what extent are the project's scope, specification and operation pre-set or open to negotiation with the private sector?</p>

<p>Service provision</p>	<p>Are there good strategic reasons to retain soft service provision in house?</p> <ul style="list-style-type: none"> • What are the implications in the longer term for the organisation in losing these skills- are all the expertise transferring or is there some retention? Eg. skills to manage contracts or let future similar contracts. <p>Is soft service transfer essential for achieving the overall benefits of improved standards of service delivery?</p> <ul style="list-style-type: none"> • What are the relative advantages and disadvantages? • Is there a commitment that the assumed benefits are deliverable without eroding the overall terms and conditions for staff? • Is transfer necessary to achieve the optimal risk allocation? <p>Where soft services are not transferred, is this consistent with the Prime Minister’s commitment to flexibility of public service provision?</p> <ul style="list-style-type: none"> • Are there changes in working practices that are only deliverable through transfer or are there other ways these could be achieved and do they deliver VfM?
<p>Incentive and monitoring</p>	<p>Can the outcomes or outputs of the investment programme be described in contractual terms, which would be unambiguous and measurable?</p> <p>Can the service be assessed against an agreed standard?</p> <p>Would incentives on service levels be enhanced through a PFI payment mechanism?</p>
<p>Lifecycle costs and residual value</p>	<p>Is it possible to integrate the design, build and operation of the project?</p> <p>Is a lengthy contract envisaged? Will a long-term contractual relationship be suitable (or advantageous) for the service?</p> <p>Are there significant ongoing operating costs and maintenance requirement? Are these likely to be sensitive to the type of construction?</p>
<p>OVERALL DESIRABILITY</p>	<p>Overall, is the accounting officer satisfied that PFI would bring sufficient benefits that would outweigh the expected higher cost of capital?</p>
<p>ACHIEVABILITY</p> <p>While PFI may allow a more efficient and effective combination of public and private sector skills, determining the rules that will govern the relationship between the two sectors does involve significant transaction costs. In particular, the procurement process can be complex and significant resources, including senior management time, may be required for project development and the</p>	

<p>ongoing monitoring of service delivery. Client capability will have direct consequences for procurement times. Perceptions of this capability will also affect the level and quality of market interest. PFI and other contract-based approaches should maximise the benefits of a competitive process - but the structure of proposals and the choice of procurement route should be informed by an assessment of the likely market appetite.</p>	
<p>Transaction costs and client capacity</p>	<p>Is there sufficient client-side capability to manage the procurement process and appraise ongoing performance against agreed outputs?</p> <p>Can appropriately skilled procurement teams be assembled in good time?</p>
<p>Competition</p>	<p>Is there evidence that the private sector is capable of delivering the required outcome (see Section 7)?</p> <p>Is there likely to be sufficient market appetite for the project?</p> <p>How is it expected that the market will receive the proposed risk profile?</p> <ul style="list-style-type: none"> • E.g. what has been the market reaction to similar deals with and without staff inclusion? Or what has been the reaction to the allocation of demand risk?
<p>OVERALL ACHIEVABILITY</p>	<p>Overall, is the accounting officer satisfied that a PFI procurement programme is achievable, given client side capability and the attractiveness of the proposals to the market?</p>

Using results from other stages of the assessment and post project evaluations

5.5 It is vital that post-project evaluations are carried out on past and existing projects and that this evidence is used in the assessment of future projects. Similarly, information from projects further down the procurement line should be used to inform decisions and as such should be made available to the departmental PFU.

Capital and resource constraints

5.6 In carrying out the assessment at the programme level, budgetary capital constraints will need to be considered. Consideration should also be made for supply-side constraints, the broader fiscal position, and the resource implications of either PFI (unitary charges) or conventional procurement both in the long and short term (depreciation and cost of capital charge; maintenance stream into the future).

PRE OJEU (FOR STAGE 2 ONLY)

5.7 When looking at finalising the Outline Business Case, the Procuring Authority should begin their assessment of the likely market conditions and plan and assess their procurement accordingly. The likely quality of the competition will be key to these decisions. No project should proceed to market prior to receiving approval for Outline Business Case.

Quality of competition

5.8 Sponsoring departments should:

- maintain regular dialogue with key PFI players in their sector and put in place mechanisms by which Procuring Authorities can be kept informed of the latest market developments;
- be aware of any actual or emerging market capacity constraints within their sector or related sectors through dialogue with other departments where necessary¹;
- be aware of the range and number of projects vying for market interest;
- assess formally the level of market interest in particular projects in the light of both particular project circumstances and competing demand from other projects likely to approach the market at around the same time;
- consider the case for managing the release of projects to the market, thereby creating a transparent pipeline of projects and avoiding clusters of projects reaching market at the same time; and
- seek to actively promote a dynamic market by, for example, ensuring that barriers to entry remain low.

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

Market-soundings

5.10 Some form of market sounding is generally good practice - please see separate bid evaluation guidance, to follow shortly. The public benchmarking service may also be a useful reference point [<http://www.benchmarking.gov.uk/default1.asp>]. This would involve determining the potential level of market interest and the current and future capacity by talking directly to potential players, perhaps through issuance of a PIN (Prior Information Notice), although this may be initiated later in the process. Procuring Authorities should however take care not to use the market to establish their requirements or to place an undue cost burden on the market at this stage. It will be important for the Procuring Authority to establish some assessment of how the proposed risk profile will be received by the market, including financiers and potential shareholders. Where projects are not of a standard, recurring nature, the Procuring Authority will be required to enter into market soundings

5.11 Procuring Authorities should undergo a final analysis of their affordability envelope, likely balance sheet treatment and ensure that their specifications are deliverable within this prior to proceeding to OJEU.

QUANTITATIVE ASSESSMENT**Introduction**

5.12 The quantitative assessment takes full account of the key Green Book themes, including the differentials resulting from the procurement route in tax, Optimism Bias

¹ The central PFU may act as a co-ordinating entity for such information flows within a department.

and valuing benefits, both to the project and the Government more widely. This should be applied at stages 1 and 2 of the assessment. It is also designed to complement and not to replace the Green Book guidance. The use of the spreadsheet developed by HM Treasury for this assessment is a requirement for approval of the Outline Business Case.

5.13 The quantitative assessment relies upon a sound evidence base, wherever possible built up from past procurement experience in relation both to PFI and conventional procurement routes. This evidence base needs to be continually refreshed by the incorporation of new information from projects at all stages of procurement and operation, particularly where there is a differential due to the procurement method. If the current evidence base is inadequate, then other information should be sought to justify the inputs into the model and steps taken to remedy this gap for future procurements. The user guide addresses possible ways this can be achieved.

5.14 It is important to note that there are inherent uncertainties in estimating long-term costs. Where the values for the two procurement routes are similar, it should be noted that there is little to choose between them on a quantitative basis.

Affordability 5.15 In addition to the model, formal consideration should also be given of the overall affordability of the project. This must be included in the Outline Business Case. No project should proceed without a high degree of confidence that it can be delivered within this envelope.

Objectives 5.16 The main aims/objectives are to:

- allow the quantitative element to be assessed in an objective and timely fashion;
- enable projects to make appropriate use of private capital, to justify explicit additional costs against the benefits achieved as a result of risk sharing;
- inform the qualitative judgement of officials involved in allocating capital between programmes, and of Procuring Authorities at project level in determining value for money;
- increase the evidence available to departments to support future procurements; and
- allow departments to defend, through an audit trail, decisions taken in the context of government policy and sound evidence.

The Quantitative Evaluation Tool 5.17 The analysis is intended to contribute to an assessment of whether the price under the PFI option represents value for money. At stage 1, departments will be required to run the analysis for whole programmes. If, for example, a department prioritises a service, which requires substantial investment, then the best procurement route in support of this investment will need to be determined. This might be achieved by using evidence from programmes that are currently delivering broadly similar services. The spreadsheet should be run for several scenarios to reflect variations within the programme. Inputs are designed to reflect the principles set out in the Green Book and, where appropriate, the department should establish defaults for particular inputs. The model, rather than focusing on a single point estimate, allows sensitivity analysis to be conducted, (discussed further below).

5.18 Procuring Authorities should ensure that as part of the quantitative assessment they have taken full account of the differential non-market impacts associated with the procurement. This should be entered as an indirect VfM factor in the spreadsheet.

5.19 At stage 2 the analysis should be run for the specific project characteristics as set out above in Section 4.6, in line with the user guide.

Sensitivity analysis **5.20** The estimated net present value of the overall cost of a project following a particular procurement process will be based on a number of assumptions and the Procuring Authority should therefore avoid relying on overly elaborate estimates. Sensitivity analysis should be undertaken to compute the effect of different assumptions on the relative value for money of the procurement routes. This type of analysis can identify the points at which changes in the assumptions are sufficiently significant as to change the conclusions drawn from the quantitative assessment and require the project team to revisit the specifications and their underlying assumptions. Where practical, the analysis should be used to identify the changes in assumptions which would influence conclusions. The results include a set of graphs illustrating the percentage change required in the value of individual inputs to erode to zero the net present value difference between the public and PFI estimates, and therefore make the procurer indifferent between the two procurement options. It is important to note that the analysis assesses the change to one or other of the options but not both at the same time. Consideration should also be given to which inputs are likely to be subject to movement and where the uncertainty lies. They should also consider what the implications, and likelihood, of these changes would be.

5.21 Sensitivity analysis on costs allows the department to explore the effect of assuming different - but plausible - values of important variables which may be beyond its control. Such analysis helps improve the Procuring Authority's understanding of the inherent uncertainty involved in long-term projects. For further guidance on sensitivity analysis, you should refer to HM Treasury's Green Book and the User Guide accompanying this guidance, in Annex A.

Interpreting results **5.22** It is important that the quantitative results are considered in light of the qualitative assessment. It is important to recognise the part that judgement necessarily plays in any decision and that this cannot always be reflected in a single figure. The accompanying User Guide details the care with which outputs from the model should be interpreted. A positive "crude" value for money figure should not be seen as sufficient justification for proceeding with a PFI procurement route, particularly if it is close to the tolerance levels for the project. Similarly a small negative is not sufficient evidence against.

5.23 Where results for the public option and the PFI option are marginal or where there is uncertainty surrounding the inputs, and hence the margins within which the outputs should be considered are large, then it will be vital to accord proper weight to the qualitative assessment. The decision to proceed with a PFI procurement route cannot be based upon the estimated cost in the absence of a qualitative assessment.

Documentation Check list**Stage 1** (1-5 should be included in Spending review submissions or equivalent)

1. Viability, Desirability and Achievability questions answered and the overall position signed off for each heading.
2. A table listing the assumptions behind each of the spreadsheet inputs. Where there is a lack of supporting evidence this should be stated and the method used to approximate the input detailed.
3. A plan and timetable to address any gaps in the information collected.
4. A table setting out the key scenarios run for the programme spreadsheet and the reasoning behind these.
5. The final programme documentation should include:
 - an assurance that there is sufficient flexibility within the overall capital programme to allow some projects to switch to a conventional procurement route if they are not VfM as a PFI, and they are considered a priority within the overall capital investment programme (no project should proceed as a PFI if it is not VfM);
 - a commitment to pass on the programme analysis to the appropriate project teams;
 - an assurance that the Procuring Authority has/will have the skills and resources to deliver the programme; and
 - an affordability calculation and the commitment that the specification falls within this envelope.
6. A table setting out the programme and the estimated project breakdown with timetables where possible for publication with the Departmental Investment Strategy (or equivalent). See PES guidance.

Stage 2 (for inclusion in the Outline Business Case)

7. Viability, Desirability and Achievability questions answered and the overall position signed off for each heading.
8. A table listing the assumptions behind each of the spreadsheet inputs. Where there is a lack of supporting evidence this should be stated and the method used to approximate the input detailed.
9. A table setting out the key scenarios run for the programme spreadsheet and the reasoning behind these.
10. Analysis of the quantitative spreadsheet outputs and conclusions.
11. A table setting out the reasoning behind changes made from the programme analysis.
12. An updated affordability calculation and an assurance that the project specification falls within this.
13. An undertaking that sign off was given pre OJEU and that all standard documentation has been followed (and explanations for any exceptional deviations).

6

PROCUREMENT LEVEL ASSESSMENT

Key points

Before proceeding to OJEU, Procuring Authorities must have established their affordability envelope and be confident that the project can be delivered within it.

Procuring Authorities must assess whether their specifications align with their affordability envelope.

All procurements should follow SoPC3 and the approach to Standardised Contracts set out in the relevant implementation letters issued by HM Treasury, and VfM judgements be made in this context.

No further adjustments can be made to the quantitative assessment from stage 2 once this point is reached. The Stage 2 quantitative spreadsheet and conclusions should not be referred back to, nor should bids be assessed against it.

STAGE 3

Introduction

6.1 This stage follows on immediately from stage 2 (undertaken as part of the Outline Business Case) but is more iterative in nature. The emphasis is on identifying market problems early in the process. This stage will apply throughout the procurement period, from the issuance of the OJEU notice through to Commercial Close of the scheme. Procuring Authorities will need to consider and agree key project milestones in line with this approach, on a sectoral basis, recognising the inherent differences in procurements where they arise.

Optimism Bias 6.2 If cost estimates at Outline Business Case differ significantly from the price at financial close, questions should be asked as to whether there are legitimate external reasons which could not be foreseen and, if not, why this escalation was not captured by the Optimism Bias estimates. This analysis should then be incorporated into future Optimism Bias estimates for forthcoming projects. This is not however a reason at this stage to halt or revisit the procurement decision. This information should be used to inform future procurements.

Objectives of the Procurement Assessment Stage

Objectives and Outcomes 6.3 The main aims are to:

- feed back market intelligence to projects in earlier stages of planning and procurement;
- determine if there is a market failure or abuse;
- ensure the proposed risk sharing is deliverable;
- dovetail with bid evaluation.

6.4 This assessment should provide Procuring Authorities with a better understanding of the benefits that are likely to arise from pursuing a particular procurement route at a particular point in time.

Transaction Costs 6.5 A PFI transaction is one of the most complex commercial and financial arrangements which a procurer is likely to face. It involves negotiations with a range of commercial practitioners and financial institutions, all of whom are likely to have their own legal and financial advisers. Consequently, procurement timetables and transaction costs can be significantly in excess of those normally incurred with other procurement options.

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

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

Viability 6.8 An important part of the assessment at this point is the consideration of the financial viability and capability of the potential, and later the actual, bidders. This is key to assessing whether the procurement should proceed, and the manner in which it does so.

Risk sharing 6.9 Appropriate sharing of risks is key to ensuring value for money benefits in PFI projects are realised. The benefits described above flow from ensuring that the many different types of risks inherent in a major investment programme, for example construction risk or the risk associated with the design of the building and its appropriateness for providing the required service, are borne by the party who is best placed to manage them in line with SoPC3. The Government's approach to risk in PFI projects does not seek to transfer risks to the private sector as an end in itself. Where risks are transferred, it is to create the correct disciplines and incentives on the private sector to achieve a better outcome.

SoPC3 6.10 All procurements should follow the approach set out in SoPC 3 and the relevant implementation letters issued by HM Treasury on Standardisation of Contracts. The overall aim of this approach is to establish the use of SoPC3 and sector specific contracts in order to frame a risk profile for the PFI procurement which provides proper incentives for the private sector to perform efficiently. VfM judgements should be made on the basis that the risk allocation is of a given in this context. It is not appropriate to use VfM arguments to alter the risk sharing arrangements set out in SoPC 3.

Overall Approach

6.11 Following successful completion of the project assessment stage, both Procuring Authorities and sponsoring departments (where applicable) will need to be fully appraised of market conditions before embarking on the procurement process. The detailed methodology is set out in Section 7.

Market failure 6.12 At any stage, if the procurement team identifies market failure, e.g. lack of competition as a result of a single bidder or perhaps two bidders where only one is credible, then it is unlikely that the project will deliver value for money and should not proceed as a PFI. The reason for the market failure should be examined closely as it is possible that it may, in some circumstances, equally affect a conventional procurement. It should be noted that is not always the number of bidders which is of concern in this regard, quality of bidders will be a vital factor. It is possible to have an extremely effective competition with just two players if both are very credible and want to close the contract. In other circumstances three may be insufficient, if only one constitutes a serious contender.

Market Abuse 6.13 If, once the project has selected its preferred bidder, it identifies market abuse then the value for money of the project again comes into question and it should not proceed as a PFI. Market abuse can be defined as a situation where the bid offered is out of the market, that is to say above the PFI market price for similar projects or where the risk profile has been substantially eroded relative to other similar recent PFI projects at this price. If there is market failure or abuse this is likely to lead to a bad value for money transaction and should therefore be halted and either procured conventionally or cancelled.

6.14 Bidders should be aware that in the absence of real competition this is a real possibility. Bidders should also be aware that projects may be withdrawn for reasons other than value for money.

Limitations 6.15 Procuring Authorities should be clear that a bid evaluation process can inform this work but would not constitute justification for a procurement route decision. The approach to Bid Evaluation [separate guidance to follow shortly] should be borne in mind throughout the process. Equally the quantitative analysis updated at stage 2 should not form the basis of bid evaluation and does not play any part in this stage 3 assessment.

Outputs and Outcomes 6.16 The assessment of the procurement process should be detailed as part of the Final Business Case or equivalent prior to contract signature, in line with the Documentation Checklist in Chapter 7.

Timing 6.17 From Outline Business Case through to financial close.

Bid Evaluation 6.18 Separate guidance detailing the approach to bid evaluation and supporting tools will follow, work is currently underway and HM Treasury would welcome all input into what support would be welcomed as well as indications of problem areas.

7

DETAILED METHODOLOGY STAGE 3

Introduction 7.1 Once into the formal procurement stage (following issue of OJEU notice), stage 3 involves a series of ongoing ‘checks’ on value for money. There are three main value for money drivers:

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

7.2 Procuring Authorities should also keep in mind the affordability envelope throughout the procurement.

Quality of Competition 7.3 The procurement period can be divided into clear and distinct stages, as set out by the department, and Procuring Authorities should take the opportunity to assess the quality of competition at each of these different stages. If market interest drops below a competitive level, Procuring Authorities may need to reconsider their approach. The qualitative assumptions made against the viability, desirability and achievability criteria should be reassessed at each stage.

7.4 Table 7.1 below sets out points which should be considered by Procuring Authorities and should reflect the nature of the sector. Analysis should reflect the nature of the competition, for example where there are multiple bidders but only one can credibly deliver, this should be considered akin to a single bidder situation. This is likely to vary for unique projects, but could be consistent for established programmes where the projects are similar.

7.5 Should the Procuring Authority find itself in a single bidder scenario, the procurement is unlikely to deliver VfM and should be halted unless exceptional circumstances can be demonstrated.

Table 7.1 Key stages and Indicators Post

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

KEY STAGE	INDICATOR	ACTION
Response to OJEU notice	A strong competition ideally requires a number of well-qualified bidders. If the response indicates that this is not the case then, prima facie, optimal competitive conditions may be absent.	Authorities should reconsider the planned procurement at this time. There may be a case for revisiting the first stage of stage 3. If the problem is simply one of timing, a delay and relaunch may be appropriate. If the problem is more fundamental, the approach may need to be reconsidered, see outcomes above. A very low response, or only one credible bidder, should be regarded as a warning sign.
Pre-qualification	The Procuring Authority would ideally want to see a number of strong bidders pre-qualifying and will want to be satisfied that a sufficient number of these will submit bids.	If not, the Authority will need to reconsider the planned procurement. As above, there may be a case for revisiting the first part of stage 3. If timing is an issue, the Authority should consider the case for delay and relaunch. If the issue is more fundamental, the approach should be reconsidered, see outcomes section above. The Authority should only proceed with the minimum number of bidders that they are comfortable with, except in exceptional circumstances, and after consultation with sponsoring department (if applicable). If there is only one bidder, there will be a need to reconsider the approach, see outcomes section in stage 1.
ITN	As above.	With a low number of bids or a proportion who are not credible, the Authority will need to reconsider and, where applicable, consult with the sponsoring department.

KEY STAGE	INDICATOR	ACTION
Post ITN	Any loss of a bidder, which is not a decision of the Procuring Authority, is a warning signal. If the competition is reduced to a single bidder through loss of bidder(s) (and not decision of Procuring Authority) the procurement will need to be reconsidered.	Need to reconsider approach.

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

Risk Sharing 7.8 A range of standard guidance is available to Procuring Authorities that sets out the commercial and contractual positions that should be secured if value for money in PFI procurement is to be achieved. The three main sources of guidance are:

- ¹Standardisation of PFI Contracts (SoPC). Version 3 published April 2004 (use of which is now a mandatory requirement);
- Standard Payment Mechanism (if available);
- Standard Output Specification (if available).

7.9 Procuring Authorities should use the risk profile as set out in SoPC, as experience has shown that this is likely to offer the optimal value for money. It is government policy to use SoPC in all circumstances and Procuring Authorities should avoid alterations as this is likely to impact transaction costs. Procuring Authorities should also heed the Dear Accounting Officer letter on tax planning and tax avoidance.

7.10 SoPC: contracts issued with a Procuring Authority’s ITN should follow SoPC or, where appropriate, the sector-specific version. Compliance of the bids should be tested at certain key stages including:

- initial receipt of bids;
- BAFO (if applicable);
- selection of preferred bidder;
- periodically following preferred bidder; and
- immediately before contract signature (FBC).

¹ Letter 29 April 2004 - Geoffrey Spence

7.11 If available, the sector-specific Standard Payment Mechanism should be used. Departures should not be accepted. Compliance of bids with the standard required would again be tested at key stages:

- initial receipt of bids;
- BAFO (if applicable);
- selection of preferred bidder; and
- before contract signature (FBC).

7.12 If available, the sector specific Standard Output Specifications should be used. Departures should not be accepted. Compliance of bids would again be tested at key stages:

- initial receipt of bids;
- BAFO (if applicable);
- selection of preferred bidder; and
- before contract signature (FBC).

Controlling contract costs

7.13 Once a preferred bidder has been selected it will be important for the Authority to ensure that VfM is maintained in the absence of competition tension. The Authority should be mindful of the possibility of market abuse, as set out in 6.13. The Procuring Authority can carry out a high level check of underlying costs against an appropriate range of benchmarks, but this must not involve any reference or return to the quantitative assessment conducted as part of Stage 2. The impact of changes at preferred bidder stage on the risk profile should be of particular interest, as should their potential impact on affordability. It is important that the commercial position is considered in the round.

7.14 It is important however that individual costs are considered within the overall cost envelope and the Procuring Authorities do not seek to “cherry-pick” items at the expense of overall VfM.

Funding competitions

7.15 Where there is doubt over the ability of the bidders to achieve a competitive rate for funding the PFI project, the Procuring Authority may wish to consider running a funding competition. If it is likely that an Authority will wish to exercise this option, the provision should be stated in the OJEU notice. This will not be appropriate in every case and thought must be given to the trade off between the transaction costs associated with this versus the potential gains.

7.16 Procuring Authorities should be mindful that they too impact on procurement costs of both the public and private sectors and should seek to minimise this. Changes in the scope of the project or the Procuring Authority’s requirements following the selection of the preferred bidder should be avoided wherever possible as at this stage the disciplines of open competition have been diluted. Similarly, the Procuring Authorities should be clear about their own responsibilities under the contract and document the internal resource used for the procurement process.

Efficient timetables

7.17 As highlighted in Section 6, a realistic timetable for the procurement should be set out in the Outline Business Case, and Procuring Authorities should monitor progress against key milestone dates. Significant slippage in the procurement timetable might indicate potential problems in achieving value for money. In particular, Procuring

Authorities should monitor the time taken between the selection of preferred bidder and Financial Close. If this period has gone beyond the planned period then the impact on value for money must be explicitly considered, as should the drivers behind this slippage. [Requirement to report to sponsoring department where applicable]. If the period extends significantly, a further report should be required based on the checklists above. Consideration of possible appropriate steps that might be taken to assure value for money under these circumstances should be made, these may include running a funding competition, market testing sub-contracts or consideration as to whether the PFI procurement route is suitable.

Post project evaluation **7.18** Procuring Authorities should periodically, post construction, undertake operational evaluations to ensure the project is performing and to populate the evidence base for future procurements.

Documentation

Stage 3

- 14. An undertaking that the Procuring Authority believes that there was no abuse before contract signature.
- 15. A detailed estimate of the in-house procurement costs.
- 16. Any derogations from SoPC and the underlying justification, and accompanying approvals from HM Treasury.