The Smith Institute

The Smith Institute is an independent think tank that has been set up to look at issues which flow from the changing relationship between social values and economic imperatives.

If you would like to know more about the Smith Institute please write to:

The Director
The Smith Institute
3rd Floor
52 Grosvenor Gardens
London
SW1W 0AW

Telephone +44 (0)20 7823 4240
Fax +44 (0)20 7823 4823
Email info@smith-institute.org.uk
Website www.smith-institute.org.uk

Designed and produced by Owen & Owen

public sector procurement and the public interest **2005**

public sector procurement and the public interest

Edited by Denise Chevin

RBC Capital Markets

THE SMITH INSTITUTE

THE SMITH INSTITUTE

public sector procurement and the public interest

Edited by Denise Chevin

Published by the Smith Institute

ISBN 1 902488 98 9

Contents

Preface
Wilf Stevenson, Director, Smith Institute

The Smith Institute is an independent think tank, which has been set up to undertake research and education in issues that flow from the changing relationship between social values and economic imperatives. In recent years, the institute has centred its work on the policy implications arising from the interactions of equality, enterprise and equity.

As the government considers the next steps in its public service reform agenda, a key question is how to rethink the approach to public-private partnerships and the relationship between procurement and the public interest. Although many recent reports have looked at private finance initiatives and public-private partnerships, including those produced by the Audit Commission, the National Audit Office and Sir Peter Gershon, very few have addressed the issue of how to make the public sector a better partner in the procurement of buildings and services.

The Smith Institute is pleased to be publishing this collection of essays by leaders in the field, expertly edited for us by Denise Chevin, the editor of *Building* magazine. We hope that, taken together, the essays in this collection give a useful account of those measures that can be taken by public agencies to ensure that contracts are drawn up and carried through in a manner that delivers value for money, flexibility and foresight in service specification, and high-quality design, and which extract the full value of the expertise that private-sector partners bring to the table.

The Smith Institute gratefully acknowledges the support of Royal Bank of Canada Europe Limited towards this publication and the associated seminar series.

Introduction
Denise Chevin, Editor of *Building* magazine

Over the past decade and more, the private finance initiative has played an increasingly crucial role in government expenditure plans. Since 1992, 670 PFI contracts have been awarded with an aggregate value in excess of £42 billion. Of the 68 hospitals completed since 1997, 64 are PFI projects.

Both Tory and Labour governments have come to rely on this programme as they have struggled to deliver roads, hospitals and other public amenities within conventional budgetary constraints – so much so, that according to a recent report from the Royal Institution of Chartered Surveyors, PFI now accounts for over 30% of all public investment.

Yet despite its centrality, there is a growing realisation that PFI needs closer examination if it is to work more effectively. The purpose of this series of papers is to consider what precisely these faults and malfunctions are, and what needs to be done to correct them if the government is to deliver its promised massive upgrading of schools, hospitals and infrastructure.

Whereas much of the debate about PFI to date has been bogged down in ideology and political dogma, the aim here is to take a rational and analytical look at the process and, in particular, examine how the public sector can become a better partner in the procurement process.

As Peter Dixon, chairman of the University College London Hospitals NHS Trust remarks in his chapter: "Are the procurement and running costs higher than they should be? Why do we need 35-year agreements? How do we incorporate change and flexibility? These are the sort of questions which we should be asking, not to rubbish PFI but to move it on and make it fitter for purpose, and indeed, to see if there may be alternatives."

The PFI is not about borrowing money from the private sector. It is supposed to be about creating a structure in which improved value for money is achieved through private-sector innovation and management skills delivering significant improvements and energy savings. The premise is that the transfer of risk to the private sector, coupled with the efficiencies derived from its management skills, will outweigh the costs of private funding, thus resulting in greater value for money to the taxpayers.

PFI projects have generally been delivered on time and to budget. And where there have been cost overruns, these have been borne by the private sector. The involvement of building companies in operation and maintenance should also ensure that no shortcuts are taken on materials and equipment, as it is in the interests of the private operators to reduce whole-life costs.

However, a broad consensus is forming that the PFI process is breaking down, and the very benefits that it was meant to deliver – greater competition and innovation – are increasingly being undermined. In transferring the risk to the private sector, is it simply transferring deficiencies in public procurement that are ultimately pushing up the costs, which the taxpayer pays somewhere down the line?

In particular, there is a strong agreement in these pages, based on the experience of the past 10 years, that public and private sector need to collaborate far more constructively than has been the case to date.

Another recurring theme is that the rising costs of bidding for schemes are making it increasingly unattractive for the private sector to bear the risks. According to a report by the Major Contractors Group, the average bid cost for a PFI hospital has now reached £11.5 million; for school projects, this cost is £2.4 million.

The bidding process, which demands detailed designs from a number of consortia before whittling the list down to a preferred bidder, is blamed for pushing up costs. This is coupled with the lack of expertise in the public sector, which in some cases sees clients demanding more than they can afford, forcing them to abandon the scheme and start again. As PFI increasingly becomes the model used abroad, where bid costs can be lower, there is a growing threat that companies will eschew the UK.

While there is shared view on many of the difficulties with PFI, the solutions put forward by the experts assembled here are diverse – although the need to bolster the skills of the public sector in some way is a widespread plea. Other recommendations would entail a bolder approach to public service reform.

But certainly, if PFI is to be the well-tuned machine it needs to be to deliver 21st century public services, doing nothing is not an option. The ideas presented in this monograph provide a platform for research, debate and action.

Chapter 1

Getting the finance right

Adrian Bell, Chairman of Royal Bank of Canada Europe Limited

Despite the successes of the private finance initiative so far, contracts are still too expensive, too time-consuming and insufficiently contested. The root causes are identified as public-sector resource constraints, poor time management and insufficient attention to financing. While the Treasury is experimenting with new funding approaches, and the public-sector partner must become involved in financing decisions at an earlier stage, it is perhaps also time for banks to reassess the creditworthiness of PFI projects.

Getting the finance right
Adrian Bell

Since its launch in 1992, the private finance initiative has revolutionised the purchase of services and capital assets by the public sector. While it has had many vocal detractors – criticising what they perceive as a flawed and expensive initiative – the PFI has had a significant influence on public-sector procurement and has done much to accelerate capital investment in public infrastructure.

PFI's overriding success has been its ability to deliver a substantial part of the government's investment programme on time and to budget. A wide-ranging National Audit Office report[1] on construction performance stated that nearly 80% of PFI projects had been delivered on time and to budget, and where this was not the case the private sector, not the public sector, had suffered the consequences.

Compare this to conventional public-sector procurement and the benefits of PFI become apparent: only 30% of conventionally procured public projects are completed on time and a similar number suffer cost overruns – in these instances, of course, the public sector picked up the tab.

And there have been other benefits arising from public-private partnership. The competitive process involved in bidding for contracts has served to accelerate changes in service provision. PFI has also encouraged the private sector to take a whole-life cost approach to a project, ensuring that it has an incentive to integrate design and facilities management elements into the construction process, leaving the public sector to focus on its core competencies.

However, while any shortcomings are clearly outweighed by benefits, some PFI projects:

- are still taking too long to close;
- are costing too much to bid on; and
- do not attract sufficient contractor interest.

This monograph attempts to identify the root causes of these inefficiencies and suggests ways to reduce them.

1 *PFI Construction Performance* (5 February 2003).

Internal resource

A major capital project can require the time and expertise of an army of professionals, however it is procured, before the first builder moves on site. This is undoubtedly exacerbated in the initial stages of a PFI project, owing to the competitive process and the wide-ranging and long-term nature of the obligations. In most cases, the private sector commits far greater human resources to a bid than does the public sector.

The latter, therefore, can be massively resource-constrained, particularly during the bidding process, when there may be three complex bids in competition. A heavy burden is put on the public-sector negotiators, who are frequently the executive management of the procuring authority and have to fit the PFI project around their day job.

There may also be a general tendency during the planning stage for the procuring authority to underestimate the resources needed to see the project through to completion, with more attention paid to the costs of the delivered project than the opportunity cost of the bidding process and reaching close.

To address this, we believe that as part of the PFI approval process the government needs to ensure that the procuring authority has sufficient experienced support from both internal and external sources. The creation of a team of individuals with experience of the nitty-gritty of closing PFI transactions, which can be parachuted in to support the bid team, may be worthy of consideration. We will not speculate here where such a team should reside or to whom it should ultimately report.

Use of external resources

Given some of the headline figures quoted for the bill for the public sector's use of consultants and advisers, this is a well-trodden path. We do not advocate greater use or higher fees for these firms, but better use, with a more focused brief.

One of the larger public-sector advisory bills in relation to a PPP is for the financial adviser. At present, this role will include assisting its client to put together a business case to present to the relevant spending department and the Treasury, negotiating with bidders, assisting in the selection process and then overseeing the deal until it is closed. This means outsourcing such process and project management skills as modelling, co-ordinating bid documentation, maintaining a detailed audit trail to support its decision making, and management of the bidders.

We suggest that this brief needs to be changed, so that the financial adviser becomes more like a corporate financier appointed by a private-sector company to run a competitive process. The specification should become output-based, and the firm act as a strategic adviser tasked to optimise the final outcome: creating value by stimulating interest in the project among prospective bidders, harnessing appropriate market forces and encouraging innovation.

This type of role may require a different basis of remuneration – a blend of retainer and success fee, which recognises the on-going expertise being offered but equally motivates the adviser to get the best deal for the client.

Clearly, it means some thinking about how to define success, and will require discipline from both client and adviser.

Time management

The resource constraints described above are intimately connected with time management, just as time management is directly related to cost.

In most PFI projects the timetable leading to the selection and appointment of a preferred bidder, though long, is actually met. This is not surprising, as at this stage the procuring authority secures funding for its project. Yet one of the continuing frustrations in PFI is the apparent inability of both the private and the public sectors to close deals on time – invariably a delay occurs between the appointment of the preferred bidder and financial close. This has numerous detrimental consequences including:

- a lack of budget discipline – no one knows when the project will close;
- a lack of continuity among the project team – people move on;
- a tendency to let the project "drift" and to "park" issues rather than agree on them;
- an increase in bid and development costs; and
- a reduction in the number of bidders.

A major reason for delay is often that the procuring authority redefines the scope of the preferred bidder position – this can occur for a multitude of reasons, be it the need to address affordability or simply to address the changing needs of the service delivery.

Such issues cannot be ignored, but it does raise the question as to why such material amendments are being addressed after selection of the preferred bidder, given that they can have serious pricing implications that in some cases even cause the project to be cancelled. Defence and information technology projects, in particular, have been victims of re-scoping and delay.

Trying to identify who is causing delay is a hopeless task – both public and private sector are responsible for this lack of discipline. Time appears to be valued differently on each side: the private sector values it in money terms, the procuring authority – particularly those that deal directly with the public – in terms of accountability for delivery. Once a preferred bidder is selected, the pressure is reduced as both sides become highly confident that the project will go ahead.

There is no need for a new, complex system of incentives and penalties – they are already there. However, the threat that the project will be cancelled if commercial and financial close is not met by a given date must be a real one. In British Columbia, the public sector requires the preferred bidder to put up a surety bond binding it to the terms of its bid and to a financial close date.

The incentive on the private sector in the UK is probably sufficient without this additional spur. For the procuring authority, the threat has to be that their project will be cancelled and relegated to the back of the queue. It is hard to imagine senior executive officers not being motivated by the consequences of such a failure for themselves and their communities.

Financing

One of the questions often asked of PFI is the extent to which the financing provides good value to the public sector, and whether there is sufficient financial efficiency within the PFI procurement process. It is a reasonable question, and an important one to address in an environment where one of the more robust arguments against PFI is the additional cost of raising private finance in comparison with funding public infrastructure and services through the national debt.

Setting aside the politics, at initial financing of a project, the taxpayer is taking the interest rate and structural risks inherent in the funding package that is negotiated between the private sector and its bankers – risks that are magnified under typical PFI contracts, given their length.

Less attention has been paid to procuring finance, because savings on debt interest are a small benefit in comparison with negotiating a better building or services contract. And from the private sector's point of view, it has become commonplace to say that the funding package never wins or loses a PFI bid.

Funding is now coming under closer scrutiny from both the private and the public sectors, each of which is seeking to demonstrate that financing is procured on a competitive basis. But the approach is still less sophisticated than would, for example, be seen in major corporations, let alone supranational agencies.

One of the dangers for PFI is that deliverability is being valued more than cost efficiency, and innovation and transparency are being sacrificed for standardisation.

The private sector is quite capable of delivering greater efficiency – but it often needs encouragement to do so. The public sector needs to find ways to exploit both the commodity end of the funding market and the private sector's ability to innovate and find the best solutions.

The status quo

At present, under the terms of a typical PFI project, the private-sector partner is responsible for sourcing the debt and equity in the project. The cost of this will depend first on how much risk the public sector has transferred under the contract, and second how that risk is shared between the subcontractors, debt providers, insurers and shareholders, and their ability to bear them.

As outcomes become increasingly uncertain over time, generally the longer the term of the funding, the more costly it will be – as effectively more and more risk is transferred to funders.

The sponsors are likely to put in their own equity, possibly with some other specialist PFI equity investors. However, they have to look elsewhere for the bulk of the funding – to the markets that offer senior debt. At present, the sponsors of a project may select one or two funding packages (perhaps one from the bank market and another from the bond market) during the bidding process.

The decision as to which of these funding structures to adopt is usually made by the public sector, on the basis of lowest cost at assumed interest rates, after selection of a preferred bidder but still some time ahead of financial close.

The funding packages proposed by bidders will include not only the proportion of risk-bearing equity to loans, but also the structure of the loans and the identity of the lenders, despite the fact that the market for senior PFI lending is one in which numerous large banks are active. And after closing the deal, limitations on refinancing and the costs of unwinding the original long-term funding restrict the opportunity to exploit changes in the funding environment.

Such a process tends to prolong the status quo; and as the funding solution may be selected some time in advance of close, the private-sector partner will propose structures that have been used before, because it is keenly aware that deliverability of financing forms a part of the public sector's evaluation of bids.

Cost of debt and equity

Equity is the most expensive form of capital in PPP projects – because it bears the greatest risk. On the other hand, it also carries control, and brings the rewards of successful delivery. The conventional wisdom for senior debt financiers of PFI projects is that a layer of equity is required, both to absorb the financial impact of risks and also provide an incentive to management, in terms of a variable return dependent on their performance. However, whether for political or efficiency reasons, there has been much discussion on reducing the amount of equity in these schemes.

But risk cannot be magicked away. Someone is bearing it, even if it is not a shareholder, the consumer or the taxpayer; and without this layer of risk absorption, it is difficult to find lenders prepared to commit to the schemes. If the funding markets are happy to lend to PFI projects with less or no equity, either some party is taking those risks in an unconventional manner, or they view the PFI market as less risky than the market had previously believed.

If those risks still exist, then efficiency is dependent on their analysis, allocation, pricing and long-term management. The public sector, at local and central level, is experimenting with new models that redistribute risk, with the aim of achieving a more efficient funding package.

At one extreme, HM Treasury has initiated two pathfinder projects to use a new funding arrangement (credit guarantee finance) where risks normally borne by funders as part of their lending package are separately allocated. Project and credit risks are taken by those specialist institutions most experienced at managing and pricing them, while the actual cash – now risk-free – is provided by the Exchequer. This model, however, has not obviated the need for traditional equity.

Another radical model is attempting to do this: a grouped schools project in Argyll & Bute, Scotland, is the first project without shareholder equity (a structure known as NPDO, standing for "non-profit distributing organisation"). If this model can demonstrate that a project can be run as efficiently and robustly under a management contract as it can when shareholders have a cash investment at risk, it may be possible to reduce the cost of funding on many projects – not because there is less risk, just that risk is being priced in a different way.

In an NPDO, some risk-bearing capacity can be provided by subordinated debt, which senior lenders will, to all intents and purposes, treat as equity. Small amounts of subordinated government debt might also materially reduce funding cost.

There are other ways of producing a "cushion" to protect lenders – for example, by varying the length of the concession or contract. The companies that built the Queen Elizabeth II Bridge across the Thames and the Severn River Crossing, two PPPs signed before the formal launch of the PFI in the early 1990s, were granted variable-length concessions to collect tolls.

The concessions terminate (as has happened in respect of the QEII Bridge) as soon as the senior and subordinated lenders have earned a fixed rate of return and all debt is paid off; the toll revenue then returns to the public purse. However, the concession has a legal end date, which is long enough to provide a "tail" of revenues, allowing lenders to continue to collect tolls to pay off their debt after the expected redemption date if the revenues failed to live up to expectations.

True equity in PFI projects is already a small part of the funding package, and the cost is getting lower. The secondary market for PFI equity is bidding for shares at prices that suggest they are being seen as utility or bond-type securities. And primary equity (that injected into the project at financial close) is similarly falling in cost.

It is certainly valuable to experiment with new forms of risk structure to increase capital efficiency; but as the database of PFI projects grows, showing that the overwhelming majority of lenders suffer no loss, it is now time to reassess whether the credit ratings of these deals are not better than previously thought.

The cost of long-term funding

A company with a large portfolio of debt will try to optimise its overall cost through a variety of means, balancing cost with risk. In particular, it will be sensitive to the fact that if it aims to remove all financial risk (by perfectly matching its liabilities to its assets and cash flows) it may be sacrificing considerable upside opportunities.

The problem for any project financing is that it rarely has the opportunity to do this – it has a single source of cash flow, which is likely to be highly geared, leaving no room for mistakes.

A project needs to match as many features of its financial liabilities as possible to the nature of its cash flow. In PFI, this generally means very long-term, fixed or index-linked bank loans or bonds, leaving it unable to exploit improving credit risk and general changes in interest rates over the life of the project.

No stakeholder can be criticised for what is an understandable approach. However, perhaps we need to challenge these tenets, as the need to enter into long-term funding reduces the flexibility to benefit from favourable conditions in the financial markets, should they arise.

Long-term funding is inherently expensive, as the variance in potential outcomes for a project – that is, risk – increases over time. In addition, long-term loans are expensive to raise: in the bank market, because interest rate risk (the risk of rates changing during the term of the project) has to be insured against through a derivative product; and in the bond market, because bonds are fully drawn at issue (rather when required through construction), and it can be expensive to repay a bond early.

Perhaps greater efficiency could be achieved through an unbundling of risk – in particular, construction risk and long-term operating risk may be priced very differently by funders. The public sector continues to look at ways to create incentives for the private sector to exploit improvements in the funding market by sharing any refinancing gains. The private sector will continue to look for ways to maximise the value of its investments without sharing it – generally through gearing up its investment in the project, rather than refinancing.

A more radical change would be for the public sector to separately fund construction and operation. Selective use of design, build, finance and transfer contracts – whereby the public-sector purchases completed assets once commissioned and can then retender a long-term operating contract – may be one alternative. However, this cuts across one of the basic tenets of PFI: to encourage the private sector to take a whole-life cost approach to the assets it is proposing to build and maintain.

In other areas, the operating risk is more problematic than construction. The sector where innovation is being seen worldwide is privately financed toll roads. Demand risk is particularly difficult to assess in the UK, as we do not have a (recent) history of user-pay toll roads, and price elasticity is untested.

With the ability to divert to alternative roads or modes of transport, it may be difficult to achieve the real potential from this sector until we have a clearer view from the public sector on nationwide road pricing, and whether privatising roads is about raising revenue or reducing road use.

If the public sector wishes to capture more of this upside, it needs to encourage a more innovative approach to financing than has been seen to date, and in some cases (particularly transport) it needs to be clearer about its aims.

Timing of the finance decision

At present, the public sector bears interest rate risk on the preferred bidder's selected funding package up until financial close. This has meant the public sector has borne not only the risk of changes in interest rates but also other risks that could affect the margin. The political uncertainties surrounding the project to upgrade the London Underground, being carried out by two consortia under PFI contracts, meant that funders priced in uncertainty when setting their funding rates. These uncertainties had been largely removed by financial close, but the margin stayed the same.

At times, the market offering best value when preferred bidder is selected is no longer the optimal route at financial close. In extremis, these changes in market conditions could render a project unaffordable between appointment of a consortium as preferred bidder and close, requiring a reduction of the services provided. The public sector has mitigated this risk by requiring the preferred bidder to defer the choice of funding market until much nearer to financial close.

However, this ties up unnecessary resources and can compromise the amount of due diligence the funders are prepared to undertake. Given that the funding market for PFI is now so well developed, it should be possible to oblige the sponsors to structure a project that is competitively fundable, but relieve them of the obligation to provide committed funding too early in the bidding process.

Funding can then be competed on transparently close to financial close. At the time of writing, the public sector is expected to issue guidance requiring funding competitions to be run after preferred bidder selection on all PFI projects, unless a reasonable case can be put demonstrating that a rigorous and transparent funding competition has been held as part of the bid process. The onus of proof will be on the private sector to show that the most competitive terms have been achieved.

Audit trail versus value for money

Wherever public funding or public services are involved, the audit hurdle will justifiably be set high. However, as PPPs appear formulaic, the audit trail is in danger of following the formula, and missing where value is really being gained or lost.

Funding is unfortunately one of the areas where this is happening, and is at the heart of the difficulties of achieving the best pricing on even standardised financial product. Easily auditable variables such as banking margins and fees are being competed on, while ignoring the underlying interest rate assumptions.

This is a simple issue to rectify and requires a more sophisticated understanding of the financial markets by the public sector and its advisers. It can quickly show returns on traditional PFI funding packages, and will be essential if the public sector is to benefit from new developments.

Revisiting the role of the public sector

A leitmotif of this section has been a suggestion that is superficially contradictory – to obtain greater involvement by the public sector in project funding, at the same time as freeing up the private sector to innovate. The public sector can have a role in stimulating competition at the commodity end of the market, ensuring that the last few basis points are squeezed from the model.

And it has an even more important role to play in allowing the private sector freedom to create new solutions for larger and more complex programmes, such as Building Schools for the Future, road development, regeneration and defence schemes.

This may involve activity that appears to be at opposite ends of the spectrum: at the intrusive end, the public-sector partner may wish to consider the creation of a dedicated agency to act as its window on the market, and advise on all aspects of treasury and risk management in relation to the individual and portfolio risks assumed through PPP.

In terms of deregulation, less involvement in the actual fine print and details of a particular funding package, a willingness to negotiate contracts that allow for innovation and a more aggressive harnessing of competitive market forces may ultimately deliver better solutions.

Conclusion

Public-private partnership has arguably achieved what it set out to deliver – increased spending on public infrastructure, on a basis that provides predictable costs to the public purse and transfers major risks – such as delivery on time, to specification and on budget – to the private sector.

However, given these successes, it is a tragedy that the procurement itself is a sub-optimal process. Some relatively small changes to these practices could free up substantial additional resources for delivering services, while encouraging more contractors to compete for projects.

Chapter 2

Sustaining the benefits of change

James Stewart, Chief Executive of Partnerships UK

Partnerships UK research shows that the private finance initiative has been overwhelmingly successful in meeting the needs of the public sector. The challenge now is to ensure that PFI projects deliver long-term value – in particular, through on-going support for managers, benchmarking and the adjustment of contracts to accommodate necessary variations.

Sustaining the benefits of change
James Stewart

As the private finance initiative matures, the boundaries of where it can demonstrate value for money have become well defined. Over 700 PFI contracts have now been signed, with 500 operational facilities having been delivered through this mechanism. PFI delivers operational assets on time and on budget more effectively than conventional procurement.

Meeting the Investment Challenge, published by HM Treasury, set out a commitment by government not to pursue PFI for small deals or information technology projects. The policy has been followed through and has proved the point that PFI can be successfully applied to certain types of capital procurement, but not to all types.

The government's as well as the market's focus is now moving to how PFI projects are performing in operation, as well as in procurement and construction. We have conducted research that paints a positive picture about PFI in practice.

Users and contract managers are satisfied with the services being provided under PFI contracts. The benefits of a long-term commitment to our underlying public infrastructure assets are being realised. Pupils, patients and all types of public servants are benefiting from the £43 billion investment in public services under PFI.

The challenges in sustaining the benefits of PFI are twofold:

- continuing to improve the procurement of PFI to reduce procurement timescales and bid costs, and improve the ability of PFI to deliver value for money; and
- continuing to ensure that PFI delivers user expectation and services throughout the life of the contract. Unlike previous experience, the challenge we face now is operational.

PFI is delivering in operation
With over 500 projects now operational, our focus is rightly shifting from the procurement phase, and we need to understand whether PFI is delivering user requirements and expectations in practice. We and others have now undertaken extensive research into the operational performance of PFI contracts.

Along with the study we conducted for the Department for Education & Skills, *Post-Contract Signature PFI Schools*, which was published in October, we have conducted a wider survey across all PFI sectors for the Treasury.

The headline message from both pieces of research is that PFI is working, in terms of user expectations and the views of public-sector contract managers. That is good news and should be welcomed by all those interested in delivering high-quality public services.

Users are satisfied

Investment in public-sector infrastructure must be focused on the end-users – be they teachers and children in a school, patients and doctors in a hospital, or road users. Unlike previous procurement procedures, PFI has built-in reviews to ask whether users are satisfied with the services that are being provided.

In 79% of the projects that we surveyed, users believed service standards were being delivered "always" or "almost always". However, we must continue to strive to do better and understand where we are falling down on user expectations.

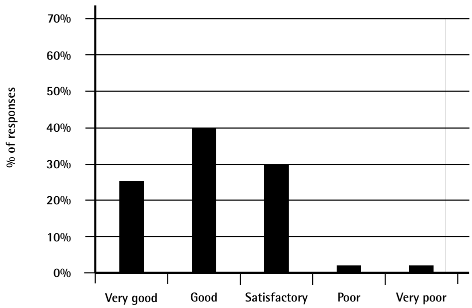
Unsurprisingly, some comments made by users focused on the most visible aspects of PFI – the provision of soft services like cleaning and catering. Responses from users and contract managers presented challenges for PFI in the future that are set out below.

Public-sector managers are also satisfied

As well as users, we surveyed public-sector contract managers. This is because these managers are more aware of the direct obligations on private-sector contractors than are users. They are the ones responsible for managing the delivery of services to users and integrating PFI contracts into wider public services.

A similar picture to that presented by users appeared when we asked public-sector managers about their perceptions of the contracts that they manage. Our research shows that 66% of public-sector contract managers rated their project performance as either "very good" or "good" against the PFI contract, with a further 30% being "satisfactory".

Figure 1: How survey respondents rate the project's overall performance in terms of delivering the services stated in the PFI contract



The incentives and risk transfer in PFI contracts are working

One of the key benefits of PFI is that the private sector is accountable for the service it provides and is given incentives to deliver that service. Our research demonstrates that when the private sector did not meet the required service levels, one of two things happened:

- operational problems were resolved in the time allowed in the contract in over 80% of cases; and
- payment deductions were levied on the private-sector partner for failures in performance. Where payment deductions were levied, the private sector raised its game and improved performance.

The public sector is developing effective partnerships with the private sector

Our survey results confirmed what we already knew: that successful performance is based on a strong partnership between the public and private sectors.

Our study found strong evidence that the relationships between the public and private parties in PFI are good, with both sides recognising the advantages in developing a long-term partnership.

Figure 2: How survey respondents rate the day-to-day operational relationship between public- and private-sector contract management teams

The key aspects of developing a good relationship involve working together in the spirit of partnership rather than continually referring to the letter of the contract. However, this does not mean that public-sector managers are not enforcing the contract in key areas such as payment and performance mechanisms.

Challenges for operational PFI contracts

Learning the lessons from public-sector managers

While the overall messages from users and public-sector managers were positive, a number of themes were also raised in feedback. These included:

- the level of central support for public-sector managers;
- the issues raised by forthcoming benchmarking reviews; and
- the ability to undertake minor variations efficiently.

Given the age of the projects reviewed, many of the older PFI contracts – which informed later thinking on "what works" – cannot benefit from the process of standardising the PFI contract that the government has undertaken. Many of the issues raised by public-sector managers have been resolved under later versions of the standardised contract, in particular clarity over benchmarking reviews and the change mechanism.

Increasing the level of central support for contract managers

A consistent message from public-sector contract managers was that, while significant central support was provided during procurement, this support was typically reduced once the projects became operational. While the PFI contractor integrates service delivery and undertakes long-term maintenance, just as under conventional procurement, the public-sector manager still needs to be able to test long-term value for money through benchmarking and to make variations to meet changing needs.

The support to public-sector contract managers should start during procurement, with these managers being sufficiently trained and participating in procurement, so that they are able to understand the project they are managing and shape the procurement to ensure that it will work better on the ground.

Securing long-term value for money through benchmarking

Long-term value for money in PFI contracts is secured through benchmarking and market testing and the on-going management of services. Research showed some uncertainty about how a benchmarking review should be resourced and undertaken.

This should be a key issue for government, given the number of contracts that will go through benchmarking over the next few years. We need to ensure that the public sector is adequately resourced and managed to respond to these challenges. In fact, we are experiencing a much greater emphasis on operational issues from projects now being delivered as well as from projects still at the procurement stage.

Improving the day-to-day flexibility of PFI contracts

When the Partnerships UK survey asked public-sector contract managers what they felt to be the key challenges for the future, the most consistently raised issue was the need to manage change. Specifically this was raised in the context of dealing with changes in public-sector requirements and, by implication, the need for resources and experience to negotiate these changes with the service provider.

The evidence gathered shows that most changes that have occurred within PFI projects so far have been relatively small and have had little impact on the overall unitary charge (the rent paid to the PFI consortium).

Given the age of the underlying assets in many of these projects, this is not surprising. Estimates of the number of variations completed within operational projects to date vary enormously, from 0 to over 500 (typically 0-10 variations).

Applying the lessons from the Refinancing Task Force

The Refinancing Task Force demonstrates the benefits that can come from co-ordinating the relationship between the public and private sectors. The voluntary code of conduct agreed between the public and private sectors in 2003 set out an agreement on refinancings for contracts where the relevant clauses were often different, in many cases unclear, and in some cases not present at all.

Both the private and public sectors need to focus on handling the operational issues maturely, to ensure that the on-going benefits of PFI are not undermined. Both sides have proved they can do this, through the refinancing code of conduct.

This will benefit the private sector as well as the public sector, as greater certainty can be provided over how the public sector will respond to these points in the operational life of projects.

Improving the standardised contract

Over recent years the government has committed to put in place a standard PFI contract across all PFI projects. This guidance contains standard terms and conditions across contracts that are being signed today. The lessons from the public and private sector we have received will need to be reflected in future contracts and versions of standardised contracts.

Sustaining the benefits for the long term

PFI has a strong track record on delivering public-sector infrastructure assets on time and on budget. Increasingly, it has delivered the high levels of service demanded by the public sector and users directly.

Our research has demonstrated some of the challenges that need to be addressed in order to improve the operational effectiveness of PFI projects now being delivered and of those still at the procurement stage. These are the challenges we must step up to if we are to sustain the benefits of PFI for the long term.

Chapter 3

Improving the contracting process

Jonathan Inman, Partner at Linklaters

Most criticism of the private finance initiative from the private sector has focused on the length and cost of the bidding process, and the complicated nature of the contracts created. Much of this difficulty can be ascribed to the lack of expertise and resources in the public sector, and the constraints placed on contracting authorities' ability to negotiate by centrally determined prescriptions. Limiting the shortlist to three bidders and practising true partnership would help the awarding authority to better manage the bid process.

Improving the contracting process
Jonathan Inman

Since the inception of the private finance initiative in the early 1990s, more than 670 PFI/public-private partnership contracts[2] have been awarded, with an aggregate value of more than £42 billion.[3] Such projects are being implemented in a wide variety of sectors, including accommodation (hospitals, schools and prisons), transport (roads, bridges, light and heavy rail and the London Underground), defence, waste and other local projects.

Although the number and value of contracts awarded indicates a general measure of success in implementing the PFI/PPP structure, a number of criticisms have been levelled at the contracting process. These criticisms have principally focused on:

- the length of the bidding process – this can take years from the date of the initial announcement in the *Official Journal of the European Communities* to contract award. Even the average time from announcement of preferred bidder to contract award is at least 12 months;[4]
- the cost of bidding – sponsors have criticised the level of bid costs they have had to carry with no guarantee of success. The prohibitive level of such costs has, in some cases, restricted competition as sponsors have declined to participate; and
- the lengthy and complicated nature of the legal contracts, requiring a high level of legal and other specialist input.

Further criticisms from the public sector have been that the complexity of PFI projects leaves the public sector vulnerable in negotiations, as the private sector is perceived to have greater resources to devote to the process, and that this tendering and negotiating process has distracted the public sector from identifying its principal requirements.

In addition, public-sector discretion in determining the bidding process has been tempered by compliance with the body of procurement law, which has been developed following a series of European directives enshrined by national legislation.

During the development of the PFI process over the past 10 years, the government has sought to address the principal criticisms in a number of ways:

2 HM Treasury website.
3 Ibid.
4 Ibid.

- improving each public-sector body's approach to and understanding of PFI/PPP projects, through training procurement teams and establishing dedicated private finance units in the relevant departments;
- improving the standard of advice given to the public sector (for instance, through the establishment of Partnerships UK and HM Treasury's initiative to accredit external advisers[5]); and
- standardising the contract terms, now embodied in HM Treasury's *Standardisation of PFI Contracts version 3* (SoPC3), and related standard terms.

The government has also sought to defend the right of the awarding authority to use the "negotiated procedure" under existing procurement legislation, as this procedure has generally been considered – compared with other available contracting procedures – to provide the flexibility needed in forming what are, generally, lengthy and complex agreements.

These measures have not, however, resolved the principal issue of protracted bid times and associated costs. Indeed, bid times have not been significantly reduced, and the risk to potential bidders remains as the public sector has, other than in very limited circumstances, steadfastly refused to underwrite bid costs.

Shortage of expertise in the public sector

Although training, experience gained over the years and dedicated private finance units have undoubtedly improved the public sector's ability to co-ordinate its strategic objectives, deliver better contract documentation and negotiate contracts, as a general rule it still lacks private finance expertise.

This is particularly acute where the authority may award only a single, long-term PFI contract, and there is therefore limited scope for the team to develop and hone their skills on successive projects (unlike their counterparts in the private sector).

Partnerships UK has provided additional resources for the public sector to draw on, particularly in policing the government's initiative to standardise PFI contract terms. However, neither the dedicated private finance units nor Partnerships UK have sufficient resources to engage in the day-to-day bid management needed.

5 HM Treasury *PFI: Meeting the Investment Challenge* (July 2003).

The standardisation of PFI contract terms has met with some success, and SoPC3 terms are being increasingly applied. Derogations and project-specific distinctions are managed and policed by the dedicated private finance units and Partnerships UK. However, contracts still involve lengthy negotiations between the public and private sectors, despite the high element of standardisation. Why is this?

In short, the standard contractual terms do not deal with project specifics, particularly the technical schedules detailing the specifications for the facilities and operating regime. This requires a draft contract (which includes technical schedules) to be drawn up before release to tender. If this is not done, considerable time will be spent after selecting a preferred bidder to document the technical solution.

Even if this is done beforehand, bidders may offer variant technical solutions that will require documentation. The technical solution may well therefore require a combination of bespoke documentation and adaptation of the standard terms.

In addition, bidders can propose alternative or variant allocations of risk. Generally, the public sector has not been able to respond flexibly, efficiently and with the requisite speed to accommodate these proposals/requirements.

This is partly due to underfunded and under-resourced public-sector bid teams; the demands of ensuring value for money do not usually permit the allocation of sufficient resources to the bid process. In addition, the public-sector bid management team's ability to accept changes is clearly constrained both by the consequent effects on the market and by fears of a critical National Audit Office review after the close of the deal.

More resources needed

Some projects have also suffered from an inability of the public sector sufficiently to identify and prescribe its principal requirements – partly because some requirements do not lend themselves to the PFI structure of prescribing outputs, but also because of limitations of resource and expertise.

Indeed, the government has recognised that not all public-sector infrastructure requirements lend themselves to the PFI structure; information technology projects, for instance, are now not generally considered appropriate for PFI.[6] In addition, recognising the cost

6 Ibid.

involved in developing and negotiating PFI projects, the government has suggested that PFI projects should have a capital value in excess of £20 million.[7]

Clearly, the public sector needs to continue to improve its general level of expertise and know-how in developing the initial invitation to bid. Its output specification, scope for design innovation and project parameters (including available site and existing infrastructure) need to be precisely set out.

This may necessitate additional commitment of up-front resource and expertise, and we suggest that expertise developed on PFI projects in the same sector should be made available to the relevant awarding authority for successive projects; for instance, transfer of expertise between NHS trusts. Too often, project developers remain within the relevant authority to implement a project following contract award; public-sector developers should, rather, transfer their skills set to the next PFI contract to be awarded.

In addition, and subject to any proprietary rights, authorities should assess the merits of utilising design solutions developed in conjunction with the private sector as a part of future bid specifications. This may create opportunities for government to use its buying power to bulk buy specialist fixtures, fittings and equipment in the relevant sectors (for example, specialist medical equipment), just as major private-sector players have bulk purchased lifts, escalators and so on.

Allowing more independence

Another key issue is the negotiating latitude allowed to awarding authorities. Too often the process is frustrated by constraints on the authority from guidance and so on. Perhaps, prior to preferred bidder selection, the authority should agree with the relevant bodies the extent of latitude it may have to accept amendments set out in the tenders.

Alternatively, the use of the new European Union "open dialogue" procurement processes will enable many issues to be negotiated and agreed prior to preferred bidder selection, while competitive tension remains (which assists the public sector's negotiating strength).

In addition, we would suggest that the public sector invest in further training for its project development teams; this could, in part, be achieved by the encouragement of open workshops with interested private-sector parties, with an exchange of mutually beneficial

7 Ibid.

expertise and knowledge – although care would need to be taken that this is not seen simply as exploiting a competitive tendering process, as has sometimes been the perception where "convergence" phases have been introduced prior to issue of an invitation to negotiate.

On this latter point, convergence phases should be viewed as a genuine attempt to develop project specifications in a manner that recognises the technical scope of interested bidders – it should not be seen as a means to negotiate risk allocation, which should be the prerogative of the development team and its external advisers.

Regarding external advisers, too often the temptation has been to take the nearest and cheapest. The public sector has not always had access to the best advisers and, in addition, has not generally found it easy to maintain objectivity in reviewing and evaluating the quality of advice that it has actually received. We suggest that feedback on the performance of advisers is sought after contract award from, among others, the private sector; this could be a contributing factor in HM Treasury's proposal for the evaluation of external advisers.

Managing the bidding

In terms of best managing the resource available to the awarding authority, we suggest that at the prequalification questionnaire stage the authority should select no more than three bid consortia. While maintaining competition, this would improve the ability of the public sector to manage and evaluate each bid and would facilitate decision making.

Equally, it will facilitate each bidder's assessment of its prospects and the extent to which it is prepared to invest in bidding for a particular project.

In evaluating bids, a common complaint from the public sector is the difficulty of comparing differing bid proposals. We suggest that bidders be required to provide a full mark-up (including all required drafting changes, fully supported by the potential lenders) of the relevant project agreement.

This is already a requirement for certain developed sectors (for example, accommodation projects), but can be widened in application to the extent that the public sector is able to improve its specification and output requirements.

Another area that gives rise to considerable delays and costs for bidders, and where government could consider sponsoring a streamlining of the process, is the time spent negotiating the subcontract documentation for the construction, operation and maintenance of the project.

This is normally a process that takes place between the construction and operation/maintenance contractors and the financiers in the lead-up to financial close, and focuses on major issues of liability and risk allocation. All too often sponsors and their contractors, working with limited resources in the bid phase, are unable to give these key issues priority until late in the process, causing inevitable disruption to the lenders' due diligence review of the documents.

Procuring authorities could accelerate this process by adding a requirement for bid submissions to include detailed term sheets, setting out the full liability package for sub-contractors. Confirmation of acceptance of these terms by the sponsors, the respective subcontractors and, importantly, the financiers would also be a condition of the bid.

Honouring partnership principles

Finally, we would like to see more serious consideration given within the public sector to the concepts of alliancing and partnering, which are much debated in theory but rarely implemented in practice (not least because of the constraints imposed by the procurement rules).

This would require a radical rethinking of some aspects, such as willingness to compensate bidders for bid preparation costs and risk allocation generally, but may well be a much more workable solution in areas such as information technology, where the conventional PFI structure has proved unsuccessful – largely due to the inability of the public sector to develop specifications and scope descriptions to a sufficient level of detail.

One further option in attempting to align the interests of private and public sectors, and one which has worked with some considerable success in other countries, is the taking of an equity stake by government in the project entity (extending the structure proposed for the Building Schools for the Future programme to other sectors).

This provides authorities with much greater visibility of the entire process, and provides reassurance to the private sector that the authority will not behave in a way that would prejudice its interests as a project shareholder.

It has also been demonstrated that this can be done using financing structures that do not place undue additional burdens on government, and also maintain the full risk transfer of matters such as construction risk to the private sector.

Chapter 4

Overcoming problems with risk and bidding cost

Pascal Minault, Managing Director of Bouygues UK

The UK public-private partnership system has significant benefits, including: the measurement of cost over the whole life cycle, rather than by construction only; risk transfer to the private sector; fiercer competition from better-quality, better-focused bidders, as companies tend to specialise; and transparency. However, there are areas where improvement is still possible, including the exorbitant costs of bidding, the procurement timetable, and the inequities of the present risk transfer system. Framework contracts and the removal of the private funding element are proposed as partial solutions.

Overcoming problems with risk and bidding cost
Pascal Minault

The UK has developed, with the private finance initiative, a new and efficient procurement of public infrastructure, which has delivered on its promises. It is being widely replicated in other parts of the world, with local adjustments, and often under public budget deficit pressure.

This chapter highlights some of the greatest benefits of PFI, seen from a construction and services point of view, as well as some areas where the process could be improved for greater efficiency – without compromising the competitive tension, risk transfer and whole-life optimisation principles that have made it a success.

Bouygues UK is the UK subsidiary of French construction group Bouygues Construction. Bouygues Construction together with its sister company Colas (which specialises in roadworks) is one of Europe's top three construction groups, turning over more than £10 billion. Bouygues UK, together with its facilities management sister company Ecovert FM, has been involved in PFI projects since 1998. We have won 10 PFI/public-private partnership projects, including five hospitals, four education projects, and the Home Office's new central London headquarters. Other subsidiaries of the Bouygues Group are also involved in PFI schemes, for example in road maintenance in Portsmouth (Colas UK) or street lighting in Lambeth (DWL).

The views expressed in this chapter are those of a company that considers its UK PFI experience as very positive, having created new construction and facilities management businesses, developed competences and references that are being exported back to France and beyond, and, most importantly, having delivered projects and services to the satisfaction of its clients.

Benefits of PFI
For Bouygues UK, the most striking benefits of the PFI procurement process, especially when compared with traditional construction procurement in France, are the following.

Construction/facilities management optimisation
In PFI, the price of construction is no longer the sole criteria for affordability: it is the unitary payment (whether nominal or calculated as its cumulated net present value) that the client will have to pay over the period of concession. The impact of the construction

cost on the unitary payment, on a typical 30-year hospital contract, varies between 70% for a new-build, hard facilities management only contract down to as little as 30-40% for a contract encompassing retained estate and soft facilities management.

To win contracts, one has to propose the most cost-effective combination of construction, maintenance and life-cycle costs, while enabling efficient delivery of soft services. This requires that alongside the end-user's requirements, the designers and contractor take into consideration the activities (and their related costs) to be carried out to service the facility.

Working with Ecovert FM, we have developed the following tools:

- a joint design and construction interface process, explaining the role of each party at all stage of a project, from early concept design to post-completion;
- software that, based on initial facilities management specifications, provides the designer with initial estimates of the different facilities management areas needed;
- a design guide for hospitals, incorporating all the lessons learned from our experience of designing, building and operating our hospitals; and
- a set of specifications that we consider optimal from a whole-life cost point of view.

To establish this last document, we have considered each component of a building (doors, heating systems, floor coverings and so on) and have estimated for each one the whole-life cost of the different solutions available in the market. The whole-life cost is the computation of the initial installation cost, maintenance cost, removal, disposal and replacement ("life cycle") cost for the estimated lifespan. We have then selected the technical solution that presented the most economical whole-life cost.

A few comments: this assessment generally leads us to adopt technical solutions that have a higher initial construction cost, but a longer lifespan. For the client, this means a higher perceived quality of the building, and over time, less frequent disruptions for maintenance or replacement.

In doing this assessment, we held numerous interviews with hospital estate managers, product manufacturers and consultants; we found that data on product lifespan and maintenance costs was scarce and unreliable. We are monitoring these data in our PFI projects, and will adapt our assumptions if needed.

As a result of this analysis, we have decreased the expected life-cycle cost by more than a third, with an increase in construction cost that represents only a fraction of that saving. The difference has all been passed to our clients, who will also enjoy a better building environment.

This new approach has also had an unexpected positive impact on the approach of all our design, procurement and production staff at Bouygues UK, who now regard their duty as extending far beyond the handover date, to the full length of the concession.

Other examples of the benefits of this joint approach are:

- Engineering services are designed and installed with clear identification and easy access, making maintenance safer and more efficient.
- Facilities management areas have the appropriate size and are well located for efficient distribution of services, with minimal impact on users.
- The contractor has sole responsibility for design, construction and maintenance, sparing the client the trouble of identifying the causes and responsibilities in case of non-performance of the building.
- The overall cost of provision of some "soft" services, like security, waste treatment or transport, can be optimised by use of innovative technology.

Risk transfer/risk management

The risks inherent in construction are overwhelmingly transferred to the PFI contractor. As a result, and to safeguard its profitability, the contractor will take advantage of the tender, and thereafter of the development period before financial close, to research, identify and plan for those risks ahead of the actual start of works on site. It will carry out detailed site surveys, develop the design, and establish detailed programmes for design, procurement and site works.

Having identified residual risks, the contractor will establish contingency plans, build buffers into its delivery programme, and be ready in case problems happen. As a result of this preparation, the incidents that too often derail construction projects will for the most part be avoided; when they do occur, they are dealt with more efficiently by the contractor, without the delays of contractual argument with the client, and within the client's budget and programme.

An example of significant transferred risk that materialised on the new Home Office building was the demolition of underground bunkers. We knew of their existence, and had brought in from Japan a concrete "muncher" supposedly capable of demolishing the three-metre thick walls. It did not succeed, and eventually we had to use three tonnes of dynamite to finish them off. The demolition works were delayed by nearly six months.

We then had to fully rephase and accelerate the construction works to take account of this major delay, and significantly alter the design of the foundations to minimise the extent of demolition needed. We clearly spent more than we expected because of this problem, but it cost nothing to the client.

More importantly, it cost us much less to solve this problem than it would have cost to the client and ourselves combined, had this issue been managed under a traditional construction contract. And this fantastic new building (the project has to date received seven awards) would never have been completed on time.

Competition and commitment

It takes a lot of money (a finite resource) and good people (an even scarcer resource) to prepare bids for a PFI project, such is the complexity and comprehensiveness of the proposals. (A recent survey by MCG indicates a bid cost of over £10 million for large hospitals.)

For a sustainable presence in PFI, contractors have to win a minimum proportion of tenders (one out of three), otherwise they cannot recover their lost bid costs. To win tenders, they have to be good in all departments, and better than their competitors in a few.

We have observed in recent years that our competitors have progressively specialised by sector (as we have in hospitals and schools), developing product expertise and client knowledge. They are more focused on fewer projects, and have developed a better understanding of the client, its environment, expectations and constraints. They learn the lessons, improve and innovate, project after project. The result is fiercer competition, and better-quality projects, all to the benefit of the clients.

We also trade on our reputation, and it is essential – in particular for a non-British company like ours – to ensure that our clients speak positively about us. There is a virtuous circle that motivates us to perform and keep our clients satisfied, and it is also very rewarding for a client to see its partnership working well.

We are committed to keeping each of our clients satisfied if we simply want to carry on trading in a particular sector. We have to be flexible and adapt to our clients' constraints and changes, even if the contract structure does not specifically allow for it.

There is also a strong commitment from the public client, which spends a lot of its money and of its own staff's time to prepare the tender and to drive the tender process and, subsequently, the development process. As a result of this mutual commitment, the projects consistently end up as contracts (with a few exceptions, but probably more systematically than with private clients), and there is a lot of buy-in from all stakeholders in their project.

Note on transparency and integrity

A remarkable feature of the PFI process is its transparency and integrity: the rules are clear up-front, confidentiality is well observed despite the high number of participants, evaluations are undisputed, intellectual property is respected, and Chinese walls work well.

Suggestions for improvements

However, we also feel that there are areas for improvement in the PFI process, if the huge benefits mentioned above are to be entirely captured by the client.

Bid costs

Bid cost is a contentious subject, with two opposing perspectives. On the one hand, no one is obliged to enter a tender (although it is sometimes difficult to find two bidders), and paying bid costs to the losers could be seen as subsidising the lowest-performing in the market. On the other hand, bid costs are significant, and value has been created for the client during the tender in one way or another.

We once, unfortunately, lost a tender for a very large hospital; it wiped out more than a year's profit. Who can afford that? Bidders today are limiting the amount of money they are willing to risk on tenders, and some projects are prejudiced because they fail to attract a sufficient number of bidders (three would be a good target to ensure diversity and competition).

There are suggestions that the bidding process should be "lighter", or alternatively that the design should be undertaken separately by the client. We do not see either of these solutions as beneficial to clients: under competitive tension, a lighter process may not provide the level of commitment and certainty that the present process delivers at preferred bidder stage; and a client-led design would wipe out most of the benefits mentioned above, in terms of risk transfer and whole-life optimisation.

We suggest that it should be left open to each authority launching a tender to decide to reimburse a fixed amount to the losing bidders, provided that they submit a decent proposal. They would decide to propose such indemnity after sounding the market interest for their project. We would suggest an indemnity of 0.5-1% of the construction cost, well under the actual bid costs. Just to reassure the proponents of the competition theory, we bid to win projects, not to receive indemnities.

Control of procurement process and timetable

We have, unfortunately, seen projects where the procurement process has experienced delays, in particular after selection of a preferred bidder. This has been in some cases owing to the relative inexperience of clients who are facing for the first time a very complex situation and process. They are generally not familiar with design and construction, not to mention the legal and project finance complexities of PFI.

We suggest that those one-time PFI clients be assisted from the centre in the selection of their advisers and of the key project team members, to ensure that relevant PFI experience is represented. We would also encourage the centre to propose significant PFI training sessions to decision makers (for instance, trust chief executives and/or finance directors) to help them better understand the process, and their role in it. Such training could be jointly organised by Partnerships UK and PPP Forum.

We have also seen situations where concern for public accountability and traceability of decisions have led to delays by the client in taking key decisions (clients asking for more information, analyses, option appraisals, checks and so on, where a straightforward decision could have been taken faster), resulting in higher costs for the bidder and eventually for the client. There should be a clearer understanding of the cost of time spent, an incentive to close deals rapidly, and a possibility for client teams to call on central expertise for help in taking some key decisions.

Lastly, there is a debate on whether the authority should divulge affordability at the start of the tender, or whether it should be kept secret. We think that by being open on affordability, the client would benefit from the best that the bidders can propose for what it can afford (they would compete to maximise the value), rather than leaving the bidders to guess and later receiving bids that are either unaffordable or sub-optimal.

A more balanced risk transfer

We have over the years witnessed the public sector progressively transferring more risks to the private sector, at the beginning with good reasons to do so (the private partner being better placed to manage it), but lately sometimes more for the sake of it, for achieving new milestones.

We think that this is not right. If we are asked to take on risks over which we have little or no influence, we are not efficient at managing them; we shall then price them just as an insurer would do, except that we have neither the skills nor the assets of insurers. There is a high probability that we will either overprice it, and fail to provide value for money, or underprice it, and put ourselves at risk. This is a threat that should not be ignored. The public sector has to retain those risks that cannot be efficiently managed by the private partner, and that cannot be insured in the market.

We suggest that instead of continuing to impose more risky standard contracts, the public sector should commission a review of the transferred risks in the latest standard documentation, with the public side explaining their objectives in seeking risk transfer, and the private side explaining how they would manage and price those risks.

Comments for the future

Benefits of framework contracts

The government has launched several initiatives aiming at establishing framework contracts (local improvement finance trusts and Building Schools for the Future, among others) intended to bring economies of scales and cut procurement times and costs. Bouygues has in France obtained spectacular results on such types of contracts, achieving economies of more than 20% on repeat projects.

Key factors in achieving these economies are standardisation and continuity or predictability of workflow. It will therefore be critical that these conditions are met, if the public sector wants to reap all the benefits of these procedures: otherwise, there is a genuine risk that it will end up with an exclusive partner that will simply design and price one-off projects, with little references to the original schemes, and with no particular competitive pressure when pricing.

Do we need private finance?

Private funding of public infrastructure is a key part of the PFI.

- Funders provide the funds for investments that government budgets may not afford.
- They take a few risks on the project, the main risk being that of having to replace a failing subcontractor.
- They also take a few general risks at the level of special purpose vehicles.
- They impose on the whole process their discipline, which can sometimes be seen as an element of rigidity.

We have since 1997 had a contract with King's College London for the design, construction and maintenance of two of their buildings. It features most if not all of the characteristics and benefits of a PFI (including risk transfer and optimised construction/facilities management) apart from the finance element, the college having paid for construction out of its own funds. It is probably more flexible than a PFI, due to the absence of a third party in all negotiations between Bouygues and the college regarding future changes to the contract.

Chapter 5

Towards an outcome-based partnership model

Paul Morrell, Partner at Davis Langdon LLP; with contributions from Sir Stuart Lipton, Chairman of Stanhope plc, and Peter Rogers, Director of Stanhope plc

Public-private partnership needs to be greatly improved in order to deliver the better outcomes of which it is capable, driving efficient provision of public works and ensuring best value over the whole life of a project. Focusing on outcomes rather than outputs, conducting careful evaluations, reconsidering risk transfer, giving due care to the questions of market conditions and project affordability, and, vitally, improving the public sector's capability as a client, will all improve the effectiveness of PPP procurement.

Towards an outcome-based partnership model
Paul Morrell, Sir Stuart Lipton and Peter Rogers

All new ideas draw flak. This may be because they threaten vested interests, or challenge political ideology, or simply because people don't like change. Or, of course, it may be because the new idea isn't a good one.

Time will always tell, and in due measure new ideas will either have gone the way of mere fashion, or will have matured into an orthodoxy of their own (embedding a new family of vested interests in the process, so discouraging the next level of debate).

So where, in this range of possibilities, does the concept of public-private partnerships now stand – and can we do better than to take a reactive position based on prejudice, separating those consequences of PPP that are structural from those that are the natural attendants of an immature market?

Of course we make mistakes when we try something new, but then we begin the long crawl up the learning curve, and this is a time to resist the tendency to throw things out and start again with something else that is new and untested.

It is clear, however, that PPP in its present form is in need of a step change in improvement. Government must become a more sophisticated and knowledgeable client; this will enable the process to provide better outcomes, as we will discuss later in this paper.

What is the point of PPP?
The starting point for a more considered response to the state of PPP should be to step back and reflect upon the objective of the whole exercise, and upon what it takes to make a good project, for here at least there should be common ground.

One objective is the efficient provision of public works, and the removal of many of the inefficiencies that have dogged public procurement since time immemorial – for even those with a powerful aversion to the new have to concede that the previous situation in construction is virtually impossible to defend.

In a 1999 survey, 73% of all projects in the public sector ran over budget, and 73% finished late.[8] By comparison, just 22% of the first tranche of private finance initiative

8 National Audit Office *Modernising Construction*, report by the Comptroller and Auditor General (2001).

projects ran over budget, and 24% finished late.[9]

To focus on this is, however, to make the mistake of thinking that PPP is just one more way of procuring construction work. Rather, it is about the efficient provision of public services, and this distinction needs to be preserved in any future development of PPP if its benefits are also to be preserved.

There is a real structural distinction in this bundling of requirements, for it does address some of the weaknesses inherent in previous ways of doing things.

Like design and build, PPP responds to one of the principal problems with the traditional method of procurement: the separation of design and construction, leading to a lack of accountability and obstructing the creation of integrated supply chains.

However, it also seeks to redress one of the principal risks of design and build – the potential compromise of long-term ease, efficiency and economy of operation in the interests of short-term ease, efficiency and economy of construction. It does this by making the providers of the building responsible for the running cost as well – making them providers of services.

The problem of whole-life assessment

So far, so good – and it is good, but only so far. Over the typical life of a building designed to house a service operation, the proportion of initial capital cost to the capitalised value of annual running cost will rarely be more than 1:2. Indeed, even in PPP accommodation projects, construction will typically account for only 25-30% of transaction value.

However, factor in the cost of operating the service, principally the salaries of those working in the facility, and the ratio becomes 1:2:20. Real value therefore lies not in the cost of the building work itself, nor in the cost of running the building, but rather in putting the facility to work for its intended purpose – in short, value lies in the outcome.

Now, although much is said about buying by “best value”, this is rarely what it is taken to mean, partly because we lack the data, and partly because whole-life appraisal is difficult. There seems to be something in the way the human brain is wired that makes it easy to understand a pound, something static you can hold and put in your pocket, but difficult to comprehend a pound per annum, a slippery thing that changes over time.

9 National Audit Office *PFI: Construction Performance*, report by the Comptroller and Auditor General (2003).

And the comprehension of value becomes even more difficult when the outcome itself is complex, or even abstract, and when tough choices need to be made in evaluating priorities.

So the problem with making service providers take responsibility for running costs, and regarding this as the end of the chain, is that this is neither the most important cost nor does it go to the real objective. Yet the government has developed a touching faith in the private sector, and seems to believe that through the magic of "innovation" it will produce new solutions to old problems.

What can be expected of the private sector (and the only thing that can reliably be expected) is that it will answer the question that is asked of it, in a way that secures value for its shareholders. But there is nothing unavoidably incompatible between this and the provision of public services.

Writing about prison reform in the late 18th century, Jeremy Bentham suggested that well-written and properly enforced contracts could allow government to join duty with self-interest, to harness the self-interest of the private sector to serve public ends.[10]

Outcome, not output

The critical thing, though, is the question that is asked, and in PPP arrangements this generally relates not to the real *purpose* of the project commissioned, but rather to the *availability* of a facility. Compare this to the distinction between the desired outcome of a public facility (producing well-educated children, say, or making sick people better) and its *output* (the provision of hospital beds, or school desks, together with a degree of facilities management – heating, cleaning and the like).

Moving the focus from output to outcome therefore has to be a key objective in any future development of PPP. Of course, one way of doing this would be to extend the question asked of the service provider to embrace the provision of the core service as well. However, this is in effect to put decisions of policy into the hands of the private sector, and few would be comfortable with that.

The alternative is to ask more intelligent questions, leading to an answer that is focused on outcome. This does not require all that is good about PPP to be set aside, and a lurch

10 Bowring, J (ed) *The Works of Jeremy Bentham*, quoted in Semple, Janet *Bentham's Prison* (Oxford Clarendon Press, 1993).

to yet another repackaging of public procurement policy. It does, however, call for a review of what makes for a successful project, and a realistic appraisal of whether the preconditions for success are embedded in the PPP process.

Foremost among these criteria for success is a need for those commissioning projects to know what their objective is, the real purpose of the undertaking. This goes to the root of policy. For example, if the policy decision about prisons is that their primary purpose is to punish, or perhaps just to contain, then that will lead to one set of design prescriptions. If, on the other hand, the primary purpose were to reduce recidivism, then design would be centred on those things shown to have that effect.

Taken to an extreme, the private sector might be rewarded as much for keeping people out of prison as for keeping them in. It should not, however, be for the private sector to decide what the policy itself should be. This is a function of government, and should be subject to electoral accountability.

Having identified the overarching objective, the next need is to know what will work – what will serve the purpose of that objective. To continue the example, the things shown to have worked in reducing recidivism are education and training, detoxification, addressing offending behaviour, and keeping prisoners connected to their family and community.

But how are these desiderata translated into standards of design? This calls for a knowledgeable client, which researches what has the desired effect and builds that learning into a set of standards – which are in turn passed on to all who might benefit.

The value of evaluation

The reality, however, is in stark contrast to this. Although the gateway process of the Office of Government Commerce includes a standing requirement for post-occupancy evaluation – the most fertile source of information as to what works and what doesn't – this is honoured more in the breach than in the observance. Skipping this cost looks like an easy "saving" to make, and the lessons will often be of more value to those who follow than to those who pay for them.

Post-occupancy evaluation, conducted in a consistent way and building to a body of transferable knowledge, must therefore become a routine requirement of public projects, the omission of which is treated as seriously as a budget overrun – for the waste of resources will be just as great, or greater.

Coupled with this there needs to be an equally consistent approach to the application of design standards, once set; and yet the approach from government department to department appears inconsistent to the point of being random, with each seeming to reserve the right to demonstrate its independence by taking its own turn to repeat the mistakes of others. There is consequently very little shared learning and expertise, and each project operates in a vacuum.

In place of this, there is a call for a core centre of expertise in each sector, not just to capture experience but also, critically, to look forward to possible future use of the buildings, so that design is not always based on the past.

There also needs to be a mechanism for ensuring that lessons, once learned, can be incorporated into the specifications put out to the marketplace. There are two difficulties with this. The first is that the structure of the public sector is such that it is not always possible for the payer of the piper to call the tune.

In education, for example, the Department for Education & Skills – for all its experience – has only limited means to require a local education authority to apply that experience in its own programme.

The second obstacle to the application of learning arises out of a point of dogma, and it is a point that perhaps we can now outgrow. Two of the guiding principles of engaging the private sector in the provision of public services were that risk should be transferred from public to private, and that advantage should be taken of the perceived ability of the private sector to innovate under the stimulus of competition.

This led to the primacy of the output specification – a statement of requirements expressed in terms of resources provided (so many hospital beds or school desks) rather than resources consumed (so many bricks and so much mortar).

In principle buying by output, by the thing desired, is a good thing; but to the extent that output and outcome are not aligned, that the former may even be inimical to the latter, then the public good is not well served by failing to specify in clear terms some *thing* that is necessary to achieve the desired outcome.

For example, to concentrate on the provision of that hospital bed or school desk, with its due measure of environmental control, without contemplating whether the environment created is conducive to healing or learning, is rather to miss the point.

Yet the dogma, rehearsed at department level to a degree that may even surprise the Treasury (whose dogma it presumably was originally), has been that any measure of prescription in a specification, such as the desirable width of corridor in a school, or even the amount of natural light in a classroom, amounts to an input, and is therefore a bad thing.

So notwithstanding the fact that research may show that academic results improve in classrooms enjoying optimal levels of natural light, there has developed a reluctance to specify requirements in such prescriptive terms, for fear that this may compromise risk transfer or stifle innovation.

The risk argument

The first argument runs that telling a service provider *how* to deliver that service, as opposed to just specifying what service is to be provided, leads to the risk that criticism of the service will be countered with the allegation that any shortcoming is attributable to that element that was specified by the users.

But whether risk is transferred or not is surely a matter of legal construction; and given that there is no longer any need to keep up the pretence that PPP projects are "off balance sheet" (indeed, it is the assertion of the Treasury that this was never a priority, and that less than half of all PFI/PPP projects, by value, have been accounted for off balance sheet), then there should be no need to be dogmatic about maximum risk transfer.

This, coupled with the reality that the public sector can never shift the fundamental risk of having to provide the service, makes room for a more intelligent and appropriate approach to PPP procurement – for there is surely no risk greater than the risk of being handed accommodation that does not fit its purpose absolutely as well as it can.

Indeed, there are signs that seeking to achieve maximum risk transfer may operate against the public interest in some circumstances. This would be the result of transferring risk that is either unquantifiable, or unmanageable to a degree that deters competitive interest in the project, or leads to the shouldering of risk being overpriced.

In those circumstances, the public interest would be better served by more of the risk being carried by the public-sector client. Again, though, this calls for a skilled client – a client with the skills of analysing risk, gauging its potential impact, and managing it through the process.

The second argument is that any lead on how to meet the service need will constrain the private sector's freedom to find new ways of doing so. Here too, though, there is a link to risk, particularly in the greater tendency of risk aversion to discourage innovation in the interests of keeping the proposition bankable (bankers as a breed tending to regard the words "risk" and "new" as interchangeable).

So, once again, a reappraisal of the appropriate degree of risk transfer may well pay back in the form of more creative solutions to the challenges of an ever growing demand for public services of ever higher quality.

In the meantime, innovation remains patchy and less than profound – and it should be no surprise that such innovation as there is generally concentrates on those aspects of the service that are included in the unitary charge (the rent paid to the PFI consortium). That is how markets work.

All are not equal

This also raises the importance of treating different sectors in different ways, rather than trying to apply a "one size fits all" approach. For in some sectors, the public need is easily defined.

In roads, for example, the need does not go far beyond the availability of a usable road surface, and it will be in the interests of the appointed surface provider to build in the quality that keeps the road available. Questions of policy and priority are limited, and public and private interests are generally aligned.

There is no real difference between output (available road surface) and outcome (journeys). In these circumstances one of the aspirations of PPP adherents – that it would lead to the development of companies operating in sectoral markets, to an extent that would amount to a specialist industry – is still a realistic prospect.

In education and health, however, although the generality of the need is easily stated (to be educated or healed), the priorities are many and difficult, and the details of need and the ways it might be met are far more complex, affected by demographics, local policy and choice, the availability of skills, and much more.

These factors principally affect outcome rather than output, and it follows that the underlying purpose of the accommodation is not served by asking for a market-driven response to a question that concentrates on output alone. Still less will that question stimulate innovation where is it most valuable: in the provision of the core service. Once again, therefore, this remains an obligation and a skill that has to be retained by the public sector.

Establishing affordability

Having established a body of knowledge that informs the question to be asked of the supply side, the next challenge for any client is to gauge affordability. The aid to this is a cost database drawn from past projects to provide a baseline for benchmarking. For PPP programmes, this needs to extend to benchmarking the price paid for changes, as these are negotiated without the benefit of competitive tension, and the only test of value for money will be comparison with similar changes on similar projects.

While there is a huge amount of information available, benchmarking in this area does not exist – indicating a seemingly assiduous desire either not to use it, or to avoid the process. Since benchmarking would provide minimum quality standards, efforts must be made to overcome this avoidance.

Added to this, though, there needs to be realism in expecting more service for the same money, or the same for less. In fact, there seems to be a blind hope that "innovation" or the force of competition will come to the rescue, and produce unspecified "efficiency savings" that will indeed produce more for less.

A current example is the new acoustic standard in schools – a good thing in that, in precisely the way envisaged above, it has been shown to improve academic performance; but against an estimated cost premium of about 5%, funding has been increased by just 1%.

Unless blind hope is indeed rewarded, the result will be worse schools, not better, as the money necessary to pay for the improved acoustic standard is stripped from other elements of the building.

Better clients, better contracts

All of this – knowing what works, specifying it properly, being realistic about its cost, managing risk, knowing how to put the proposition to the market, revisiting the completed facility to test that it has delivered on its promise, and feeding back ideas for continuous improvement – contributes to the definition of a good client.

The truism that a good project demands a good client remains as valid as it ever was, and the newly appointed sponsor for a public project could do worse than to hark back to the recommendations contained in Sir Peter Levene's 1995 report for the Efficiency Unit as to the skills and practices of a good client.

However, there is a changed emphasis in a world in which projects are procured inclusive of services. That changed emphasis is that the skills of central and local government departments need to move from the *provision* of public services to the specification and *procurement* of those services on behalf of the public.

This is not a call for everything to be privatised, or for all or most public service employees to transfer to the private sector. Rather, it is a suggestion that the scope of service to be procured through a PPP arrangement might be determined by principle rather than ideology, where the guiding principles should be the efficient provision of services (a function of the public sector) and the efficient allocation of resources (a function of the market).

This also entails an honest recognition of the limitations of markets, and the boundaries set by matters of public policy, beyond which decisions must rest with public servants – who must in turn have the skills necessary to make and implement those decisions.

Instead, what is happening is a general deskilling of public service departments as staff complements are reduced. This is perhaps through a belief that the problem has now been passed to the private sector, or is in pursuit of more of those elusive and unspecified efficiency savings. Either way, there is massive risk of a loss of institutional learning about what works, which will not be replaced in the private sector, because it is not being asked a question that depends upon that knowledge.

As far as procurement is concerned, this deficiency could be made good by the availability of centralised intelligent advice within government which all departments could – or indeed *must* - follow. This might be an independent agency, staffed by people of the best calibre in the National Audit Office, that could assess projects at the appropriate Office of Government Commerce gateways to make sure that sensible procurement decisions are made.

Consider market conditions and specific needs

At the same time, the market should be evaluated at procurement stage to test its capacity and its appetite for a project, and to agree criteria for value for money and the prospects of them being satisfied.

It is also to be hoped that this would create the confidence to avoid forcing all public projects into an excessively restricted list of procurement options – noting that Office of Government Commerce guidance seems to be based on an assumption that the public sector will always be an immature client and that maximum risk transfer is necessary to protect the public purse.

This has led to projects following a plainly inappropriate procurement route, such as design and build utilised on complex refurbishments with demanding and unusual user requirements, creating more problems than are shed.

Choosing a suitable procurement route is, however, just one of the tasks that fall to a client, and there will always be others that call for a real depth of sector-specific knowledge. This is because, no matter how much data is collected from previous projects, and no matter how good the lessons learned from exemplars, it will never be possible to reduce all design briefs to a formula.

Taking schools as an example again, the right design will be conditioned by differences of curriculum, of local demographics, of the degree to which the school wants to extend into the community, of civic context, and so forth; and to impose a standardised design that is insensitive to these differences will almost certainly be to destroy value.

Even in this example, however, there are elements of buildings that can be standardised – for instance, applying minimum classroom standards of natural light and size, and guides to appropriate materials, would be entirely reasonable. Such a minimum-standard approach could open up the possibility of buying factory-made lifts and other standard elements, which would benefit from mass customisation both in quality and in price.

Returning to the problem of differences in needs, another opportunity here would be to have a book of exemplars, illustrating these minimum standards. The client would then have the chance to deviate from these exemplars if an improvement in outcomes and whole-life costing could be shown.

How much design, how early?

This leads into perhaps the hottest topic of debate in public procurement today: the extent to which design should be developed by the project sponsor in advance of going to the market. Both extremes are espoused, from those (generally architects, who have an understandable faith in the value of project-specific design) who would carry design to something close to the traditional model before seeking bids; to those (generally contractors, still hoping for the client who tells them what he wants and then leaves them to it) who regard *any* design work as unduly restrictive.

Working back from the second of these extremes, there are real problems arising from leaving all design work to bidders. The first is that the process by which designs develop, in dialogue between users and designers, is where real value is created, and even skilled clients feel their way towards a design proposal that works for them through a series of iterations.

Through such a dialogue they can also explore possible future developments, to ensure that necessary flexibility is built into the specification, rather than trusting in the random chance that this may come from innovation by bidders.

This process can be replicated through multiple bids, but only at the cost of considerable waste – with user groups having to meet with each bidder, giving each equal access and attention in the interests of parity, and with each team then producing its own design.

At a time when designers with design skills specific to each sector are in short supply, it offends against good sense to put them to work producing designs of which three-quarters will be thrown away. This is a major contributor to the high cost of bidding, which, although it is not the primary issue of public interest, still represents waste.

It also represents a barrier to entry that – though it might once have been welcomed by major contractors, which previously had little protection against new entrants to the market – is fast becoming a damaging obstacle to the creation of the competitive market that was a base assumption for the cost-effective PPP concept. The barrier needs to be lowered.

One way of doing this would be to go to the opposite extreme, and produce a full design, but this is to create waste of a different kind – a waste of opportunity. For although the amount varies from sector to sector, innovation is being demonstrated in PPP bids, and the scope for this is removed altogether if the design is so prescriptive that all that remains is to build and operate it.

So it is a question of balance, and where that balance is to be found will vary from sector to sector, and from project to project, and even from one part of a project to another.

Essential to specify criteria for success

The one rule, as in design and build, is therefore that whatever the client regards as critical to a successful outcome should be specified. If this can be achieved by specifying outputs, so be it. But likewise, if it can only be achieved by progressing the design directly under the control of the end-users, and before the question is put to the market, then that should be done.

This development of a reference scheme would also make the best use of the limited pool of specialist design talent available in each sector (who could be prequalified and covered by a framework agreement, to curtail the process of selection through the *Official Journal of the European Communities*, and the waste sometimes associated with that).

In addition, it addresses one of the most frequent irritations expressed by the private sector: that clients come to the market with a lack of prior preparation, and consequently with an imperfect understanding of just what it is that they want. Time spent in preparation is rarely wasted.

It may also be that, to get the best from the marketplace, project sponsors should take the risk of anything they specify prescriptively being fit for purpose. In other words, the ultimate client in effect says that no challenge about the suitability of a design will be mounted where it offers back design developed and specified by the client itself.

It would be possible, at least on paper, to ask the service provider to confirm that the reference design and any inputs included in the specification will meet the requirements of the users, but it will not always be sensible to do so – particularly where the user has more knowledge and expertise about what is required (the specification of an operating theatre, for example).

The production of a reference design can also deal with one of the most difficult specification challenges of all: establishing a definition of design quality that can serve as a benchmark against which bidders' proposals can be evaluated.

Each project will have a different schedule

It is consequently not appropriate to say that a project should be put out to tender at, say, RIBA Stage C, or D. It should be put to the market when its key requirements have been specified, and that will be different from element to element.

Even then, there should be scope for alternatives to be offered; and this also serves as a check on the amount of design work that is being included in tender documents. If bidders repeatedly throw away that design work and yet still produce an otherwise compliant bid that is acceptable to the project sponsor, then that is waste as well, and the amount of design work needs to be wound back.

This too is something that gets worked out as a market matures, as long as it is given a chance to do so.

It follows that the team that produced the design for the project sponsor should not be novated without bidders being given the option to assemble their own integrated team. This would otherwise restrict the bidders' ability to produce different solutions within the constraints set by the specification; and it would also inhibit the assembly of settled integrated design and construction teams specialising in particular market sectors. This is every bit as important for the accumulation of learning and the avoidance of wasted effort.

Conclusion
In summary, there is nothing incurably wrong with the PPP baby, but there is a need to change the bathwater. The biggest change relates to the recognition of the distinction between output and the far more important issue of outcome, and for the protection of the latter to remain the highest duty of those charged with the delivery of public services.

This in turn points to a new set of client skills in the public sector. These start with the obligation to create and develop a body of knowledge about what works best in securing those outcomes, including striving for the avoidance of waste and for constant improvement in the product and its value – for example in exploring opportunities for standardisation and economies of scale.

They continue through the skills possessed by any knowledgeable client who knows what it takes to deliver a successful project: a clear sense of purpose; a full definition of need; the assembly of a suitably skilled and experienced team; project management and leadership; risk and value management; and the creation of a culture of commitment, accountability and co-operation.

And they conclude with an understanding of how to procure what is needed from the private sector through the well-drafted and properly enforced contracts envisaged more than two centuries ago by Jeremy Bentham.

No regular private-sector client would venture into the marketplace without the resources and skills necessary to guide it through the complexities of the design and procurement process. No more should those entrusted with the public investment programme attempt to do so.

There is yet more that can be done to exploit fully the opportunities offered by PPP. Thus far, little innovation has actually been shown, considering the annual spend and the opportunity available. If government does not invest as the largest single spender in innovation, who will? If we know that 30% of a building is waste, and that government pays little heed to energy conservation, there is a huge opportunity.

It must be possible to invite bids with a stated benchmark cost figure, and ask that innovation be separately identified. The constant theme in construction that buildings always increase in cost takes us out of the real world.

The whole process of innovation needs support from government. If commercial companies can do it, so can the public sector. The financial benefits are obviously huge, not only on the built form, but on the outcomes where the spend rate is vast.

There is an opportunity to create a sea change in construction procurement. Government has made the first step of controlling cost and time, but now needs to make the much more important step of outcomes partnered by a return to civic quality, without which we will see a steady degradation in our towns and cities.

So PPP must change. Those engaged in design development must become smarter, more thoughtful, more caring, more conscious of innovation, and the process must deliver better outcomes. There is no option but to change.

Chapter 6

Measures to make the public sector a better partner

Bob White, Chairman of Mace Ltd and Chief Executive of Constructing Excellence

A major concern over public-private partnership is the public sector's inadequacies as a contract partner – inadequacies stemming from lack of expertise, especially technical and commercial skills, lack of learning, and lack of partnering protocol. The use of good project managers, appropriate advisers, strong guidance from central government and proper relationship management would help to overcome these problems.

Measures to make the public sector a better partner
Bob White

Over the past decade, central and local government have become increasingly aware of their potential to leverage better performance from the construction industry, in their role as major client. Two such opportunities are private finance initiatives and public-private partnerships, which were principally intended to facilitate the use of private-sector finance in public-sector reform initiatives.

There is still an opportunity for this programme and the construction industry's own reform programme to progress in parallel, understanding the cross-serving benefits of the combined agenda, with resultant successes for both sectors. Examples of innovations that could still be successfully evolved together are integrated teamwork, and the development of data for, and competence in the use of, whole-life costing for projects.

The fact that this ideal mutual improvement programme has not yet come to pass invites several interpretations; but a recurring concern from the private sector is that the public sector does not possess the appropriate skills to be a good partner in a PPP environment – particularly the technical and commercial skills. This chapter is intended to offer some insight into this opinion, and indicate where changes in approach might rectify some of these perceived or actual shortcomings, without which the present approaches to improving the overall process might fail.

This concern over the lack of "appropriate" skills does not deny that there are good skills in the public sector. It is also fair to say that public-sector staff frequently receive poor support from professional advisers, and the use of consultants in the PFI process demands overhauling. But PFI procurement is a relatively complex activity – certainly compared with the sequential lowest-price tender activity that has prevailed for many years in the public sector.

As a result of this convention, the public sector wishes to make quantitative, not qualitative judgments. Yet the private sector is being increasingly encouraged to deliver a qualitatively inspired solution – "Tell us what we need!" This is an example of where central government dogma has not been clearly communicated, or understood, at local level.

The lack of, say, a clear partnering protocol can result in die-hard public-sector representatives working to find fault, rather than working to improve what can be delivered. They have not been inducted into the concept of best value, and of procuring by value rather than by lowest cost.

This is, I accept, no simple matter. Even those professionally involved in building economics far better understand the determinants of project cost than they understand project value, about which the views in the industry are neither consistent nor mature.

Strong leadership can drive success

Detailed knowledge of a selection of PFI projects indicates that the use of good project managers – in some cases totally independent, with significant project experience – has overcome the perceived skills void of other interested parties. In other words, a surrogate leader has been commissioned to work across a whole project team.

It is not difficult to envisage how a senior figure, adding authority and gravitas, but particularly with total familiarity with project processes, can play an important role in the PFI process, particularly during the procurement stage. In cases where such individuals are absent, there have been some disastrous reported results in terms of programme slippage and eventually increased costs, where the resultant teams have unfortunately had no clear understanding of project process, roles and responsibilities.

Sometimes, of course, it is neither lack of skills nor lack of knowledge that is the barrier; there are those who are just resistant to the philosophy of private-sector involvement in the public sector, and demonstrate that in their "not invented here" approach.

There must be an honest appraisal of project management capabilities at the outset. What is required in procurement teams is frequently, it seems, hopelessly underestimated – sometimes in terms of numbers as well as skills – and this seems to be a product of a poor start-up process, into which in-house resource has been drip-fed.

There is a tendency to limit the initial estimate of a project, in order to keep accountability to the lowest possible level. This appears to be endemic in certain sectors, such as schools. The practice leads to poor start-up, procurement delay (stop-start), poor expectation management at a local level, and massive affordability issues during the later stages of procurement.

Skills gaps can be overcome by good advisers, but there seems to be some confusion about the competencies required, especially in technical and commercial roles. These roles are frequently filled by engineers or lawyers, who often do not have sufficient relevant experience, and inevitably neither professional is that accustomed to making difficult commercial judgments. Lawyers, in particular, should not lead commercial teams – they will inevitably revert to type and ask you what you want to do!

By comparison, the private-sector partners can often field a very strong team, particularly when they are representatives of a consortium or organisation that has founded a business upon PFI contracts, and as a result, some of their team have become very practised in the format.

It is often very difficult to man-mark the private-sector team, either in skills or numbers. It is rare for a local authority to build a dedicated PFI team with repeat project experience; every time a public-sector organisation enters into such a project, the team is often doing so for the first time!

It is quite evident that if the public-sector team does not have a knowledgeable leader, not only can they lose their way very quickly, but also the private-sector partner is quickly frustrated. This can lead rapidly to the breakdown of any growing trust or relationship on which the success of the project could have been founded.

More guidance needed

There is a strong case for more guidance from others to be available, and in this case the obvious place to turn to is central government. It has taken a long time to develop standard documents for PFI, but this is one of many areas where the sharing of knowledge – both within and across sectors – must add significant benefits.

Certainly, where such agencies exist – such as Partnerships for Schools – there is evidence that good knowledge exchange has occurred. Valuable support and guidance has been given to local authority organisations involved in the Building Schools for the Future programme. There is no room for complacency here, however, as the key performance indicators for delivering the educational attainment potential can, in my view, only be enhanced by more central intervention.

Could central government do more? There are various opinions about the success or otherwise of Partnerships UK, and it would be interesting to study how similar organisations have performed in specific sectors such as health. The general consensus, however, seems to be that these agencies are big on policy (aspirational) but hand down the responsibility for delivery, and all its associated problems, to lower bodies.

Despite the activities of organisations like Partnerships UK, the government has still not created a knowledge collection and sharing environment harnessed specifically to inform the public sector. As a result, public organisations are still unable accurately to define their requirements before going out to tender, preferring to ask competing consortia to feed back to them what they, the private sector, think the client needs.

Far more effort therefore needs to be focused into helping the public sector at local levels in a practical way – particularly when they are being asked to absorb new policies on a frequent basis during the course of procuring a project.

Important skills in change and risk management are in short supply in private enterprise, let alone the public sector. If central government insists on allowing policy change to affect contracts under way, it must be prepared to make recompense for the consequences. Otherwise, it risks recklessly throwing the process into chaos, knowing that the private sector will almost certainly respond with increased costs and/or time penalties.

A better alternative is to freeze change, at least at ITN (invitation to negotiate) stage, and accept retrospective change. Again, it is about respecting the ethos of the partnership – it is quite evidently not sufficient to say that bidders are responsible for the impact of policy or legislation change during the bid process.

Central government's approach to risk is equally heavy-handed, insisting, as it does, that it is all picked up by the private sector. Far too much time, effort and, of course, cost is expended by both sides trying to wriggle out of risk. If bidders are asked to accept standard documents plus a heavy risk burden, there is only one way the price will go.

If, at the local level, organisations do not have the skills to manage the risk – which invariably they will not have – then they need better direction from central government. Government needs to engage with the private sector and work through a generic risk agenda, based on the assumed benefits of partnership, rather than on the likely outcome of an adversarial contract.

Recommendations

The vagaries in performance of public-sector participants in the PFI process have implications for the ways in which central government staff and local representatives are managed, trained and work together. It is evident that the development of new skills and capabilities, to manage systematically the new relationships and contracts arising from new procurement policies, is required.

Relationship management is relatively well developed in the private sector because of private companies' primary need to collaborate, the frequency of alliances and consortia, and their experience, albeit variable, of supply chain management. But while relationship management can be fragile in the private sector, it is virtually nonexistent in the public sector.

For example, even if two or more public-sector organisations attempt to organise themselves into a single unit, it is quickly evident that they are working to different agendas, and such arrangements frequently collapse.

There is a long-term tendency to revert to traditional legalistic contracting, driven by the public-sector client, which can become highly adversarial unless corrective action is taken. This sort of behaviour can be perceived to be supported at central level, unless appropriate organisations are seen to set examples and provide guidance, with a mandate from the centre.

As a result, it would appear that contracts of the DBFO type – design, build, finance and operate – are more suited to private-public partnering than design, build and operate contracts, and will continue to be so while public-sector staff behave inconsistently. It is quite possible that the City Academies programme has a better chance of success than Building Schools for the Future, because all aspects of the project, including the educational enhancement outputs, are placed in the hands of the private sector.

Any contractual solution that demands significant public-sector input can be considered by this measure to be increasing risk. In particular, a transaction that requires embedded relationship management skills, such as partnering, will be more successful in the private sector, because of the higher trust levels within these organisations; that is, there is greater potential to resolve issues through relationships. It may be no small coincidence that PFI has enjoyed greatest success in full design, build, finance and operate service offers, for prisons and highways.

The role of central government is highlighted here. Government departments have developed processes to guide the implementation of PPP/PFI projects, and have given some direction as to how these contracts might be implemented through the experience of others. They have failed, however, to support this with any guidance on behaviour to support the importance of relationships from the client side, and have overlooked the need to invest in management principles generally to ensure the consistent implementation of policy.

Government departments need to convey to local level a clearer understanding of policy aims, and what the implications are for implementation. They also need to provide tactical support, combined with management principles such as relationship management.

Where PFI succeeds

It is not true, as Ken Warpole recently claimed,[11] that PFI has succeeded in transferring risk for projects only at the expense of "asset stripping and deskilling local authorities in their historic role as architects, planners and publicly accountable asset-holders". This deskilling of the public sector started long before PFI was born.

But it is true that for PFI/PPPs to work well in future – indeed for any form of public procurement to succeed – it is necessary to invest in reskilling those in the public sector responsible for these projects. The alternative is to transfer much more responsibility (but not risk) to the private sector.

Ultimately, this may be more the result of political rather than of operational drivers. If, as is speculated in some quarters, local government eventually moves totally away from providing services, to become a strategic planning organisation (responsible for commissioning services only, setting standards and judging performance), increasingly the private sector will be responsible for holistic service delivery and, not least, clearly defining need in local environments. By that time, the tables will have turned and it will be the private-sector organisations that will need new skills!

There are ways in which PFI/PPP can lead to an increase in public-sector skills. The transfer of public-sector project managers between local authorities is one example, with a body of knowledge and skills sets emerging and available for more forward-thinking public bodies. The role of contract monitoring/liaison officers could be used to develop partnering skills.

11 Quoted by Elliott, Larry in *The Guardian* (29 August 2005)

Unfortunately, this is often used as a mechanism for "jobs for the boys", to avoid transferring or losing existing staff, rather than as a dynamic role to further and strengthen partnering after financial close. Worse, many public bodies use consultants (in particular accountants) to support a large part of the relationship role during the operational life of a PFI contract.

They team up with local authority officers who are in awe of the reputation carried by the support organisation, and as a result are happy to be led into counting the pennies rather than developing relationships. Inevitably, this leads to falling back upon the contract at every juncture, rather than advancing partnering skills or getting the best from the deal. The ethos must be focused on a willingness to develop a partnership, not on running a contract.

There is significant evidence from private-sector partnering that the move from contractually based relationships to trusting relationships is not easy. The important issues are who leads, and how can it be made to happen. It requires constant management effort across the spectrum of the organisations to earn trust, much as in strategic alliances between independent organisations.

Trust is very fragile – easily damaged and any damage long remembered – and quickly undermined if not consistent. Private-sector organisations regularly invest in building relationships, both within companies and between companies in supply chains. The public sector, wary of accusations of impropriety and inappropriate actions, finds it more difficult to put aside contracts and cost-based decision making.

Ultimately, it is this challenge – the need fully to embrace decisions based upon value rather than cost – that will finally define the public sector's ability to become a partner of choice rather than necessity.

Chapter 7

How times change!

Phil Swann, Director of the Tavistock Institute

From being almost a dirty word, procurement has become an increasingly important function of public policy, and the tone of the conversation has changed accordingly. But hangovers from an earlier attitude persist; in particular, the relationship between the parties involved has been less than a true partnership. This is changing as new priorities demand more emphasis on collaboration and improved understanding of the differences in local needs. Both councils and businesses must change in accordance with these demands.

How times change!
Phil Swann

In the early 1990s, a prominent and progressive senior Labour councillor struck out the word "procurement" from a paper I had written on inner-city policy for the then Association of Metropolitan Authorities. The word, he felt, had seedy overtones.

Today no white paper, strategy document or think piece is complete without several references to it. My former political boss has even made a speech or two about it himself.

This is not to suggest that procurement has simply become flavour of the month. It is an increasingly important function, and as a word and a description of a strand of policy, it encapsulates a set of crucially important relationship between public bodies and the private and voluntary sectors.

The question to be explored in this chapter is the nature of the relationship between the focus on smarter procurement and other significant policy developments. Just how much synergy is there?

The start of the conversation

It is important initially, however, to reflect on the nature of the discussion about procurement. The tone was set, apparently irretrievably, by Prime Minister Tony Blair's first-term claim that he had scars on his back as a result of his dealings with public-sector organisations.

The notion that there is a battle to be fought has been pervasive. Take, for example, the way in which Sir Peter Gershon conducted his review. The early stages were highly secretive. Whitehall departments had precious little involvement, let alone major spending bodies such as local councils or health trusts. The process was eventually opened up, but by then the tone of "being done to" had been set.

The relationship between an organisation such as a council and the people who provide services on its behalf, whether in-house or not, is crucially important. But that relationship will mature only if the key actor is treated as a grown-up. Too often the dialogue around procurement resembles that between a frustrated parent and a stroppy teenager. It also suffers from the limited vocabulary with which it is conducted.

This summer, millions of people witnessed at first hand the product of some of the most successful public-private partnerships ever. They were not the passengers on the London Underground (the beneficiaries of another model of partnership). They were the holiday makers who flew from Britain's regional airports.

Almost all those airports exist because of municipal enterprise supported by many private-sector skills. In many cases, councils became shareholders; in a few they have clung on to that role in the face of ministerial antagonism or indifference. The same was the case with many local bus companies.

There are undoubtedly lessons to be gleaned from the experience of councils in this shareholder role. Yet the debate is structured in a way that makes it difficult for those lessons to be understood. They do not easily fit within the contemporary lexicon.

Now let us return to the central theme of this chapter: the implications for partnerships of the changing policy agenda, and in particular policy in relation to the delivery of public services at a local level.

The goals of the procurement programme

What is that changing policy agenda seeking to address? The best starting point is the agenda that was set for Labour's third term by the five-year strategies published in the run-up to this year's general election – much of which was reflected in Labour's manifesto and has been developed further in subsequent green and white papers.

It adds up to a set of profoundly challenging public policy issues. They range from the need to tackle the environmental and economic implications of our dependency on car use, to the high incidence of child obesity; from the pervasive long tail of educational underperformance, to the growing – literally! – waste management challenge; from the continuing high levels of truancy, to the impact on communities of prolific offenders.

These challenges have a number of features in common. None of them are amenable to off-the-shelf solutions. They require action by more than one traditional public service body, and by both national and local bodies. They also all require action by individuals and communities, as well as by and on behalf of the state. They are difficult issues, which require complex interventions by a range of bodies.

In response to this agenda, the case for more collaboration between agencies at a local level has become stronger and stronger, as has the need for a more collaborative relationship between central government and local bodies.

The pace of change has been and still is rapid. Initiatives such as the pilot New Commitment to Regeneration Partnerships, promoted by the Local Government Association in 1997, informed the subsequent development of local strategic partnerships. There is now growing support to move this up a gear and introduce a mechanism by which all the key players in a locality can agree a single strategy for that area, aligning their business plans and budgetary processes to the delivery of that strategy.

At the same time, the relationship between the centre and localities is changing with the introduction of local area agreements. Now being piloted across a large part of England, these agreements – between central government and local councils working with their local partnerships – provide a way of focusing attention and resources on locally agreed priorities.

This is all part and parcel of the partnership agenda. But the broad direction of policy outlined raises some significant challenges for public-private partnerships. Smart procurement is a noble goal; the present direction of policy will demand smarter procurement yet.

The business agenda

Business, quite understandably, seeks a clearly defined client with a coherent brief. Those demands are easier to meet in the context of silo-based traditional service delivery, but those days are over. In the increasingly complex and sophisticated world of local governance and local service delivery, where joined-up government and multiple interventions are becoming a reality, that clarity will be harder to achieve.

Those of us who have helped to demolish a silo or two (and still have a number of targets in sight) will not connive in their reconstruction, never mind how strong our belief in the contribution the private sector can and should make.

Business leaders are demanding in their calls for policy makers and practitioners to understand commercial realities better. And quite right, too. But it is legitimate to ask that those leaders should develop their understanding of the changing shape of local governance, and reflect on the implications of it for the procurement and commissioning processes.

Much of the focus of the Gershon review has been on local government, and the sector has moved convincingly to develop its procurement capacity. But here too there is an urgent need to ensure that two significant policy agendas do not collide, or simply pass in the night.

There are serious and welcome moves to strengthen the quality of local political leadership. This is important in its own right, to enhance the quality of local government. But it is also significant in terms of the revival of interest and participation in politics generally.

Two factors are important here, both encapsulated by the word “difference”. First, as the quality of political leadership increases it is likely that the nature of local councils will change. They should be different to work with from other organisations. That difference should be celebrated – it is called local democracy. This is not a justification for bad practice, but rather a call for different practice.

Second, if local politics is revitalised, not only will Birmingham be different from Bolton, but a Labour-controlled Birmingham will feel dramatically different from a Conservative-controlled Birmingham. Again, that difference should be celebrated; again, this is not a defence of bad practice.

Business should feel that difference. It needs to understand that there will be more commonality between the ways in which different health trusts work, compared with how different councils work, simply because the latter are subject to local democratic accountability and the former are not. For me, the gains for society as a whole to be gleaned from better-functioning local politics are worth the possibility that business will face some additional costs as a result of that difference.

How councils must change

Business is right to press for councils to be better clients and partners. Many individual councils still have work to do in improving their practices and enhancing their capacity. The sector as a whole is working on that, through organisations it has set up such as the Improvement & Development Agency and 4ps.

The key to a step change in performance, however, does not lie in uniformity, but in autonomy. Councils need the space to develop relationships with their private-sector partners in ways that match their local needs, their political culture and the capacity and ambition of their partners.

Central government has an important part to play in this – in helping to create an environment in which councils move from dependency to autonomy, and in engendering a more honest and open dialogue.

Education Secretary Ruth Kelly is talking about a new role for local councils in education. Not a role in running schools or in telling head teachers what to do; rather, she is painting a new role for councils as the commissioners of local education provision.

It is potentially exciting, and if delivered could provide a powerful local engine for improvement in education. Yet, at the same time, she has picked up the baton from her predecessors in the race progressively to shrink the discretion councils have over education expenditure.

A commissioner with no cash! Smart procurement, or what?

Chapter 8

A centralised resource for better value

John Oughton, Chief Executive of the Office of Government Commerce

Following the Gershon review of public-sector spending efficiency, the Office of Government Commerce set up the procurement efficiency workstream to help local authorities achieve gains as targeted by the 2004 spending review. In a landscape of highly fragmented procurement, with enormous differences in prices paid for the same services, there are obviously enormous efficiency gains to be made. This will be done by promoting intelligent aggregation, as well as by building a knowledge base of successful approaches, implementing electronic procurement systems and making use of procurement experts.

A centralised resource for better value
John Oughton

Getting better value for the taxpayer is at the core of the Office of Government Commerce's procurement efficiency workstream. Every pound that we help the public sector save is a pound that can be ploughed straight back into front-line services. That is what makes our work both exciting and rewarding.

Gone are the days when simply increasing expenditure was seen as a way to improve delivery of public services. Increasingly, citizens are demanding, quite rightly, that their taxes are spent wisely. Mistakes do not go unnoticed, and the media is quick to point out when public-sector procurement falls below the mark, although perhaps less quick to comment when we do it well. However, we can and we should do better.

To understand where improvements to public-sector efficiency could be made, Sir Peter Gershon was commissioned to undertake an independent review of public-sector efficiency, the results of which were published in July 2004. This set out the scope for further efficiencies that he identified within the public sector's back-office, procurement, transaction-service and policy-making functions.

Sir Peter also identified opportunities for increasing the productive time of professionals working in schools, hospitals and other front-line public services, and made a series of cross-cutting recommendations to further embed efficiency across the public sector. The 2004 spending review is the government's response to these challenges.

The spending review essentially tasks HM Treasury's efficiency team with helping the public sector deliver £21.5 billion in efficiency savings by 2008. Within this challenging target, procurement forms the biggest single chunk. The Office of Government Commerce's procurement workstream team was established to work with central government departments and wider public-sector organisations, to help them achieve procurement efficiency gains to contribute to this overall target.

As important as delivering real efficiency gains is the procurement workstream brief to embed a culture of continual improvement in procurement architecture and practices, to support procurement efficiencies to 2008 and beyond. These are not slash-and-burn cuts; they are about embedding a sustained culture of efficiency right across the public sector. Organisations that make efficiency savings get to keep the resources and choose how to use them. That means more doctors and teachers, and better schools and hospitals for everyone.

The procurement landscape

Before the workstream was formed, the picture of public-sector procurement – the procurement landscape – was not comprehensive. We knew that there were many public-sector bodies buying autonomously, from individual schools right up to large local authorities, but we did not realise just how fragmented it was.

Work done by the procurement workstream team has identified over 50,000 buyers, with large variations in the prices paid for identical or similar goods. For example, the rates for 1kwh of electricity can vary by over 50%, and the price paid for printer toner cartridges by up to 100%. And these examples are not unique.

The procurement landscape has formed organically, without any overarching strategic direction. While there is coordination and collaboration in some areas, there is considerable room for improvement.

With this improved understanding of the procurement landscape, we are able to harness our unique "helicopter" view of public-sector procurement. We can look at who has negotiated good deals and where best practice is to be found. We then promulgate this information to other areas of the public sector, and challenge those areas that are underperforming to do better.

The task is challenging, but a lot of good work is being done. Central government has achieved efficiency gains of more than £1 billion so far. Local authority buying consortia are already providing good deals to their members. The Office of Government Commerce's trading arm, OGCbuying.solutions, delivered savings of about £250 million in 2004/05 through framework agreements and other activities. The procurement workstream team will work with the public sector to drive the procurement efficiency agenda.

Targeting the rich veins of opportunity

The procurement workstream is targeting the procurement of commodities – goods and services – as well as the construction and facilities management sectors for big efficiency gains. We estimate that the public sector spends well over £25 billion a year on purchasing commodities. Construction accounts for 8% of GDP, of which 40% is carried out by the public sector. These are big numbers, with big opportunities for efficiency gains.

In the commodities area we are working to improve aggregation of demand and effective harnessing of supply. We are corralling demand across the public sector to help shape and standardise demand and specification, and get commitment to volumes. We are working together within and across sectors, and within and across regions. We are helping to improve understanding and management of supply, with no "let and forget". We will harness national and regional procurement organisations and consortia (such as the NHS's Purchasing & Supply Agency and local authority consortia) – not reinvent the wheel.

We are committed to aggregation where appropriate, but not dogmatic about it. We promote intelligent aggregation that respects supplier diversity and the concerns of small and medium-sized enterprises. We recognise that SMEs play an important role in supplying government.

We need to strike the right aggregation balance. Too much and we risk creating monopolies, stifling innovation and breeding supplier complacency. Too little and we are missing out on economies of scale, lower contracting costs and the savings that standardisation can bring. We are considering every category of spending on its own merits.

We are working to improve efficiencies across the public sector in construction and facilities management. We support the initiatives throughout the wider public sector to deliver agreed efficiency gain targets, and to do so in a way that cuts waste, not functionality.

We are improving our understanding of public-sector efficiency objectives and contextual constraints, and helping to develop robust efficiency plans, trajectories and measures. In parallel, we are developing productive partnerships with key organisations to generate and support change and building a knowledge base of successful experiences and approaches.

We are also identifying and pursuing market-wide opportunities for efficiencies and communicating across the public-sector construction community. The construction and facilities management efficiency team is actively engaging with the three major complex supply chains – social housing, health and education – including budget holders, and delivery and purchasing organisations, as well as the construction and facilities management supply industry, including manufacturers.

We cannot deliver this alone, so we are working with intermediary organisations such as regional centres of excellence, local government taskforces, Constructing Excellence and others. Local government is the largest collective contributor of construction and facilities management efficiency savings, so it is important we harness their networks effectively.

E-procurement – putting the "e" into efficiency

The procurement workstream's cross-sector e-procurement team assists the public sector in realising the benefits of electronic procurement, and making significant contributions to the delivery of efficiency savings.

The Department for Environment, Food & Rural Affairs spends £448 million a year on operations and administration, but wanted to streamline its purchasing system. We helped it develop a fully automated financial e-procurement process called "buy4defra". This features online catalogues with standard products and services, contracts, tenders, auctions and billing systems. Using buy4defra saved the department £600,000 in the first year alone. By 2006, at least 60% of DEFRA's £1.4 billion expenditure will go through the system.

We are also promoting electronic reverse auctions (e-auctions) as an efficiency tool for the public sector. This is an innovative procurement technique, using secure internet-based technology, whereby prequalified suppliers bid against each other in real time.

E-auctions offer efficient, open and transparent negotiations as part of a full procurement process. This means that the time needed to carry out competitive negotiations is often reduced, as it starts at or near the market price.

Contrary to what some might say, e-auctions are not about price alone; they are a powerful tool for the procurement professional. They can be very effective at increasing efficiency – improvements in public-sector contracts of 20–25% are not uncommon. They have proved particularly successful when used with requirements that have clearly defined specifications and where there is a vibrant market.

The Office of Government Commerce is sponsoring suitable e-auctions in the public sector to encourage their uptake. For example, we are working with the local government commodities steering group to set up a programme of funded e-auctions, and we have so far identified 15 suitable auctions.

The Office of Government Commerce paid for 18 e-auctions between January and October 2005, yielding more than £11 million in savings. There are also many other e-auctions taking place throughout the public sector, not paid for by the Office of Government Commerce, which are yielding significant further savings for the public purse.

Getting the right people to do the job

In his report, Sir Peter identified the need to increase the involvement of procurement professionals in public-sector procurement. We can already see that the importance of procurement, and the procurement cadre, has increased under the impetus of the efficiency review.

In 1997, there were 17 police buyers qualified by the Chartered Institute of Purchasing & Supply; now there are 250. The growth has been stronger in the public sector, which has outpaced the private sector by a factor of two.[12]

The Office of Government Commerce's procurement workstream will build on this momentum, and work with our public-sector partners to ensure that the public-sector procurement function delivers significant efficiency gains. These efficiency gains are money available for the public services that we all use.

12 CIPS *Supply Management.*

Chapter 9

A worm's eye view

Peter Dixon, Chairman of the Housing Corporation and of University College London Hospitals NHS Trust

The new University College London Hospital is a clear example of public-private partnership success – but it also highlights some of the problems with this model: in particular, the problems of inflexibility built into a 35-year contract, and doubts over cost. Consideration of alternatives should focus on flexibility, risk management and partnership.

A worm's eye view
Peter Dixon

Anyone who has been along Euston Road recently will have seen the good news. The first phase of what is so far the largest NHS private finance initiative in the country is now a very visible landmark building in the centre of London. Practical completion was achieved by the target date, some five years after contracts were initially signed, and patients who were being treated at the old Middlesex Hospital and University College London Hospital are in the process of being transferred there.

Within weeks of the first patients being moved in, the hospital passed its first test with flying colours when victims of the 7 July London bombings were treated there, and two weeks later it achieved another first, being treated as a crime scene after the attempted Warren Street Station bombing. About the only lighter moment in that very difficult time was when the police brought in a battering ram when looking for the individual who was thought to be hiding somewhere in our 16 floors. The look on my chief executive's face when he contemplated what was about to happen to his shiny new hospital was a picture.

There is no doubt that the construction phase was a major success. The safety record was exemplary; despite deep piling within 15 feet of the Tube lines, there was no disruption to transport; there was just one complaint from 130 flats immediately adjacent over the whole build period. The discipline of the PFI contract undoubtedly concentrated our minds, so that changes were made only when absolutely imperative and the old "wouldn't it be a good idea if" syndrome just didn't make an appearance. We got what we had contracted for pretty much on time and at the price we expected.

Time to look deeper
But that is the point at which we need to start asking questions. Contestability is one of the watchwords for the new NHS, and rightly so, but it also needs to apply to PFI. After all, a hospital like the new UCLH is owned and run by the private sector for the next few decades. Our job is the provision of clinical services in the building, and we need to look critically at whether this is the best, or indeed the only way of delivering those services.

What are the downsides? Are the procurement and running costs higher than they should be? Why do we need 35-year agreements? How do we incorporate change and flexibility? These are the sorts of questions we should be asking, not to rubbish PFI, but to move it on and make it fitter for purpose and indeed, to see if there may be alternatives.

I should make it clear at the outset that I am not in any way criticising UCLH's PFI partners, with whom we have an excellent relationship. My comments are about the system, and some of the outcomes in terms of service delivery and organisational behaviour that result from it.

Limitations of PFI planning

There is no doubt that the discipline of the PFI build contract is a good one. You are forced to think and plan clearly, because the cost of change is huge. The corollary to this is that you do not make changes that you should because of changing practice – a couple of examples will suffice here.

We did not include any day-case capacity in our plans, because there was a theory that all day-case work would be carried out at another trust, with which we assumed we would merge. That was never going to happen, and we are now having to scurry around with stop-gap solutions. Given the imperatives of the payment-by-results regime under which we now work, we absolutely have to have that day-case capacity in order to be cost-effective. We also planned our accident and emergency department around the then fashionable system of triage. Times change and we no longer use that system, but the rooms for it remain when a different configuration would be much better.

These examples are gathered before the hospital even opens. Imagine how many other changes there will be over the next 30 years, and how much more difficult it is going to be to make changes when we have contracts not just for the buildings but for the provision of most of the services in them.

The lead for health matters at our local authority phoned me up recently and asked why we didn't get the famous Jamie Oliver to advise us on our food. I explained that he would have to deal with our PFI partner, and that the configuration of kitchens and space was such that precooked and reheated meals appeared to be the only system available. The building design, based on the long-term solution chosen, in effect locks us into prepared meals from Wales, frozen and trucked in daily.

The question of cost

What about procurement cost? Given that there is no open-book system – and there are very real commercial issues here – it is probably impossible to make firm judgments at this stage. The propagandists on both sides are inevitably very clear and very vocal. Supporters of PFI look to the delivery of buildings on time and to budget, against a long history of delay and overruns on public-sector developments in health and elsewhere. Opponents point to the higher than routine returns on investment compared with normal contractors' margins, and the very substantial profits being taken on refinancing deals once the construction phase is over.

The company responsible for the Norfolk and Norwich hospital PFI made a profit of more than £60 million on refinancing that scheme. And that money has to come from somewhere – at the end of the day, the taxpayer. Most early deals had a 90/10 split of such profits. We have now moved on, but this remains a real issue.

Another pointer to the cost question is the recent recognition by the Department of Health that the NHS tariff – based on, among other things, existing plant and buildings – needs modifying for hospitals with significant PFI deals, to reflect the higher cost base. In the case of UCLH, we shall be receiving some £45 million over five years to reflect this. Presumably the same support is going to have to be provided to all hospitals using PFI. What is not clear is whether the same sort of support would be needed for new developments procured in other ways.

Aside from procurement costs, there are also the on-going and legitimate debates about the contracting-out of services, about risk transfer and about the length of contracts. Why, outside the demands of the public-sector borrowing requirement and the necessary risk transfer, are we entering into 35-year contracts for services? It simply is not something that happens in the private sector. Every routine commercial lease has an early break clause, without the requirement to go through a whole series of hoops around performance issues.

I believe that the attempt to predict what sort of services we are going to be requiring so far into the future is doomed to failure. Control by contract is fine in theory, but the cost of negotiating the recent deals for the London Underground – in excess of £500 million – just serves to demonstrate the sort of difficulty involved. This was of course not a PFI contract as such, but the example still remains highly relevant. The more complex the contract, the more difficult it is either to enforce or to modify.

And that really is one of the fundamental problems here, because we have to be able to change as service requirements change and the PFI contract, by its very nature, is arthritic. It will become even more so if bonds are used to maximise refinancing profits. Anyone who has tried negotiating with American lawyers over changes to synthetic financial instruments will know what I mean.

Looking beyond the numbers

Outside the simple cost issues, there are deeply important issues about the provision of crucial services by a workforce paid little more than the minimum wage. I am not going to venture into the politics of this, but inevitably it means the deskilling of much of the work and the inability to do much more than follow a series of routines.

We measure performance by ticking the box as to whether a cleaner has appeared, rather than by asking if something is actually clean. If we want something done, we have to work through systems that have no memory and no autonomy. We have trained nurses wrestling with paperwork to get shelves put up or rubbish taken away.

In taking out cost, we have also taken out the goodwill in many systems, and we need to find ways of putting it back. Organisations are not machines, but like machines they do need lubricant where surfaces come together or they seize up. Of course we should not be trying to do things that we are not good at – but equally we cannot contract out and forget.

Recent debate over cleaning in the health service has been notable more for its heat than its light, but it is important that we look at the full costs of decisions and not just the simplistic headlines. The "best value" processes in local government are intended to be a step towards this, and certainly have a part to play, but I do not believe they have given us anything like enough answers.

The successful management of outsourced contracts is going to be a key skill for the future for all of us, whether we are a public body or British Airways. My guess would be that the 35-year contract, in its present form, is unlikely to be a part of that successful future.

These are just some of the issues we need to be looking at. There are others, but I have chosen to concentrate on these because I do think there are some ways forward, and perhaps some alternatives, on these issues in particular.

Finding alternatives

One of the things I did when preparing this chapter was to look back at an article I wrote on PFI in 1997. I was advocating then that the NHS should look at the model of housing finance introduced by the 1988 Housing Act and introduce something that looked very much like foundation trusts, complete with a regulator. I don't think I can claim much credit for where we are now, but the DoH did look at the idea seriously for a while before kicking the ball into the long grass.

What was instructive looking back at that article was the enormous growth there has subsequently been in private finance for housing, under the traditional loan model and all outside the public-sector borrowing requirement. We have seen the provision of £11 billion of facilities in 1997, £30 billion in 2005, and still no losses to the bank providers.

Inevitably, I take considerable pride, mixed with rather more trepidation, in the success of the Housing Corporation over that period. What is also noticeable is that PFI has so far had a relatively modest role in housing provision, despite various attempts to make it attractive to local authorities and housing associations.

There is no doubt that this system of traditional lending has produced capital funding on a large scale, with every sign so far that the appetite of banks is continuing, despite the departure of some lenders from the scene. The funding is also cheap. Housing associations, regulated by the Housing Corporation, are borrowing at rates that blue-chip commercial companies envy. All-up costs of 45 basis points for 30-year funding have been regularly achieved.

I do have a concern that the banks may not be discriminating adequately between the good and the less good borrowers, but the point is that the combination of predictable income streams and standard security has produced funding from the private sector on a huge scale, and in a way that is simple and flexible.

Flexibility is key

The huge advantage of loan finance of this type is that it does not tie providers to a particular configuration of real estate or service provision. The better housing associations have been pursuing active asset-management policies for years – not as an end in itself but as a means to maximise what they do well, that is, provide a range of housing solutions for those who need them.

This sort of flexibility is going to be essential to the health service, and indeed other public services of the future, and it is difficult to see how we are going to provide it from our present funding and service arrangements.

The big issue is that housing associations are outside the public sector, and hence their funding does not score against the public-sector borrowing requirement; while hospitals – foundation or otherwise – schools and so on are not. But could they be? The debate around foundation hospitals at the time of the passing of the Health & Social Care Act 2003, which established foundation trusts among other things, suggests that in theory they could, but the political and technical economic issues are obviously outside the scope of this chapter.

The point to be made is that the revenue streams for housing are very much dependent on state-funded housing benefit, and it is that income stream that drives the lending models. Revenue streams for health or education could undoubtedly fund similar bank or bond finance, if the structures could be devised for keeping the organisations outside the public-sector borrowing requirement but still providing public services. The public benefit corporation model established for foundation trusts may just be the start of something.

This is not about more privatisation. It is about finding solutions that work in the public interest and are not confined by dogma. As it happens, I believe very strongly that systems that did give hospitals the ability to access loan finance in this way would also have to have ways of delivering some sort of strategic planning to avoid fragmented service delivery. Market mechanisms alone would deliver chaos.

Who takes the risk?

What about risk transfer under this model? My answer would be that we should be talking about risk management, rather than risk transfer. The latter is always going to be more expensive and, frankly, is not always necessary.

PFI providers to whom I have spoken have confirmed what they regard as the over-simplistic approach of some public-sector bodies, leading again to contracts that are more difficult to change when change becomes necessary. As far as initial procurement is concerned, there is no reason the discipline and certainty of a PFI-style contract cannot be built into the construction contract.

Many of the horror stories of huge cost overruns in the past were actually about changes to design or function over the contract period. Controlling this can be achieved with suitable project management. The Procure 21 framework and similar approaches can be used to give the benefits of the Egan-style partnering approach, which avoids the need for large risk premiums to be built into contracts.

There is no reason modern supply chain management techniques should be beyond the remit of managers in public service. Nor should we always assume that the public sector should not run services directly. If our managers cannot be trusted or trained to run services well, I for one would have doubts about letting them sign up to 35-year deals that will bind their successors! Let us at least look at the option of direct provision, if it can be done well.

The final suggestion I have for improving the way we take PFI forward is to look at how we can move service contracts closer to the partnership-style contracts that now characterise construction and much service provision elsewhere. The halfway house between the rigid, fixed-price contract and the discipline-free cost-plus is fruitful territory. We were using techniques like open-book accounting in engineering nearly 20 years ago, and the development of those approaches looks to me the sensible direction of travel.

What may be difficult is finding a way to link the practical side of good, flexible, cost-effective service delivery, encompassing change, with the financial engineering needed for long-term funding, but let's at least try.

Above all, what we need to get away from is the fixed mindset that says this is the only game in town. Constant, constructive questioning is the way forward in most activities. PFI needs to be the same.

Chapter 10

The exemplar model: lower costs, better outcomes

Jack Pringle, President of the Royal Institute of British Architects; with contributions from John Cole, Chief Executive of Health Estates, Northern Ireland

Problems with the private finance initiative at present include cost-effectiveness – as the cost of bidding limits competition and pushes up bid prices – establishment of affordability and the quality of delivered projects. Design quality has not been sufficiently emphasised under PFI, and the public sector bears all design risk. The RIBA suggests that the use of exemplars would both improve design quality and streamline the bidding process, generating cost savings for the awarding authority as well as improving the project outcome.

The exemplar model: lower costs, better outcomes
Jack Pringle and John Cole

The nature of the problem
The private finance initiative has been extremely successful in attracting private-sector finance, entrepreneurship and value-engineering skills to the procurement of buildings for the delivery of public services or for use by the public sector.

It is an important methodology in the pursuit of government objectives, in that it can make funding available for public-sector projects earlier than otherwise. However, there are several risk areas in the present implementation of the methodology. The cost-effectiveness, length of process, establishment of affordability of client requirements, and, most importantly, the overall quality of the facilities being constructed – most of which will have to serve the public for up to 50 years – can be less than satisfactory.

The Royal Institute of British Architects is seeking to support government in developing and implementing mechanisms to maintain the benefits of the PFI while eliminating unnecessary inefficiencies and improving the quality of outcomes.

Cost-effectiveness
Cost-effectiveness is only achieved when sufficient bidders are available and able to enter the market. Over recent years, there have been increasing calls from the supply side that the cost of bidding is a barrier to entry.

A significant element of this cost is the requirement for each bidder to commission separately a full design for what are usually multimillion-pound, highly complex projects. Only one of these design solutions will be taken forward and frequently, once the competitive aspect of the process is over, this design will go through considerable change – sometimes being completely redesigned as the client representatives become more involved.

The remaining design proposals, usually with a combined cost of many millions of pounds, are abortive. This factor has had four impacts on cost-effectiveness:

- Some of the companies who were willing to bid in the past are now much less willing to bid, as the cost of losing is so large.

- Only a small number of large organisations can afford to bid, excluding a range of smaller but highly competent and possibly more efficient companies.
- The considerable abortive costs incurred in lost bids have to be recouped by the losers building them into future bids, thus pushing up costs.
- In this environment, clients are so anxious to attract scarce bidders that the balance of negotiating power has moved to the bidder side, thus again reducing competitiveness.

Affordability and length of process

The inefficiency of the above process, in itself lengthy, can be further exacerbated by the lack of clarity of the client brief, and thus of the affordability of what the client actually requires.

It is commonly accepted that client involvement with an informed, creative design team in the process of brief finalisation and early design conceptualisation is essential for successful projects. This dialogue enables both the client and the designer to understand better the functional, spatial and environmental needs of the client – both in terms of future strategic service delivery issues, and within the context and constraints of the site options available.

Only if this is done in a comprehensive manner can a proper understanding be established of the cost and affordability of meeting those needs. The more specialised the services to be provided by the client, the greater the levels of client information and involvement required.

Suppliers have expressed considerable concern that frequently this issue of affordability has not been properly addressed prior to engagement with them. This has often resulted in long drawn-out processes in which, once the client's true needs are clarified, the project becomes no longer affordable when measured against the original public-sector comparator and business case.

This can result in increased abortive design work and associated costs to the bidders, and major delays or failure/abandonment of the process. It should be noted that the public-sector client also incurs significant abortive bid costs in these circumstances. There is a recognised trend of upward cost creep after the preferred bidder stage, reflecting this often major reworking of the design.

Design quality

It is important in discussing design that we understand design in the holistic sense, not just the aesthetic. The recent development of design quality indicators facilitates the detailed interrogation of design solutions under three key headings: functionality, impact and build quality. Only if a design scores highly in each of these key areas will it be considered excellent.

The Commission for Architecture & the Built Environment has been most effective in promoting the importance of design quality and the commitment of the present government to achieving that objective, particularly in relation to public buildings.

While previously we intuitively understood the benefits of high-quality design on building users, such as hospital staff and patients, and on the general public in terms of enhancing their built environment, there is now a growing body of compelling research evidence that demonstrates very significant improvements in the achievement of service objectives and operational cost-effectiveness, where design has been focused on improving outcomes.

People respond positively to environments designed to meet their practical, social and emotional needs. The Treasury has increasingly promoted the importance of whole-life operational costs (not just capital and maintenance costs), and the impact design can have, positively or negatively, on these costs. It has given indicative cost ratios for the cost of construction to the cost of life-cycle maintenance to life-cycle operational costs as 1:5:50-200.

It is clearly evident from this analysis that while we should always seek to optimise capital (1) and maintenance costs (5), having a design focus aimed at optimising operational costs (50-200) can pay huge dividends in efficiency over the lifetime of the building.

While there are some examples of good design in completed PFI projects, it is a widely held view that design quality, both in its aesthetic and its more holistic sense, has generally not received sufficient emphasis, often being relegated to a minor consideration compared with contractual, commercial and deal-closing priorities.

Design risk rests with the public sector

One reason for this is that in those buildings where the core services are to be provided by the public sector, there is no relationship between the effectiveness of the design solution in delivering core services and payment to the private-sector supplier, and therefore little incentive to focus on this.

Once the public sector has signed up to the proposed functional content, overall layout, functional relationships, capacity and sizes of accommodation, specification of engineering systems and quality of space, materials, landscape and art, it also takes on the risks of design effectiveness.

The private-sector partner will continue to get paid as long as the building is available and is warm, dry, clean and structurally sound, irrespective of how efficiently or inefficiently it enables the public-sector body to deliver its core services. In effect the strategic planning, variation in service need and concept design risk remains with the public sector, with only the construction, physical maintenance and availability risk being transferred to the private sector.

It is important here to differentiate between the situations where private-sector organisations are taking on full operational responsibilities – as is the case in recent prison projects, where it is very much in the contractor's interest to ensure that the design delivers operational effectiveness – and those where the public sector retains this responsibility.

The main areas of risk regarding design quality, in the current process, are as follows.

User client input

Under existing guidance, user clients have been required to limit their briefing to an output-only specification. Intensive dialogue between client and designers in the subsequent early design development is impractical, because of the logistics of the client having to provide this input simultaneously to several competing consortia and their design teams.

There is a clear need for a mechanism that will allow the client to transmit a more comprehensive understanding and articulation of design requirements to the consortia, and to reinforce the design quality objectives.

Resourcing the early design stages

During the competitive phases of the PFI process, many consortia are working with a significant exposure to risk, as their remuneration is directly linked to the success of their bid. Because of the output-only specification, they have to spend significant additional time in translating the outputs into inputs to create a more conventional briefing document.

They are also expected to be able to understand often highly complex client requirements and the impact on the design of changing strategies, demand, operational practices and technology as used by the client, with only limited access to the users and within normally quite demanding timetables.

Without considerable research, on-going close collaboration with the expert practitioners and assurance of adequate remuneration, it is naive to assume that the competing design teams will be able to introduce design innovation that is likely to improve operational effectiveness and efficiency.

Time and cost of bidding

As set out above, the most frequently heard complaints about the PFI process regard how extended the process has become and the very significant costs borne by both bidders and public-sector clients.

In many cases, significant elements of these costs arise from the fact that each of the consortia is replicating the production of information that could more easily and more accurately be produced and provided by the client body.

Much of the additional and cost-consuming time is generated through incomplete understanding, on the part of consortia, of the client's detailed requirements, and the resultant need for many – often fundamental – changes to the design proposals.

Implementation of agreed design

Unfortunately, a frequently observed phenomenon in completed PFI schemes and those under construction is the tendency by design-and-build contractors to seek to minimise construction costs by the omission of design features, reductions in areas/volumes and adoption of lower-quality specifications for finishes and services within the building.

The quality of the completed building can vary greatly from that implied in the presentations to the user client. The design team employed by the consortium is frequently excluded from undertaking their traditional role of ensuring the compliance of the finished building with the standards set out in the contract documentation.

The exemplar model

The exemplar model provides a mechanism that Royal Institute of British Architects believes can help resolve many of the above problem areas and result in a significantly improved design solution, while simultaneously reducing both the cost and time required to undertake the PFI bidding process.

The fundamental difference between this and the existing process is that in the exemplar model, the public-sector client takes responsibility for developing the establishment of need, strategic planning, quality objectives, concept design and determination of affordability.

It does this by appointing a design team, chosen through a competitive design interview process for their creative skills and understanding of the client's area of expertise, to work with them in establishing:

- a well researched and comprehensive design brief;
- a concept design/sketch scheme for the project, achieving full client sign-off on content, layout and quality;
- a full performance specification, identifying all aspects affecting the quality of the project;
- a costing based on the actual design solution, and taking account of site-specific costs;
- a further client sign-off to confirm the affordability of the project; and
- outline planning approval.

It is important to note that the exemplar design does not develop construction information as to *how* the building is constructed, as this is a risk fully transferred to the private sector. Rather it conveys *what* the client requires in terms of content, form, quality and performance specification. The consortia employ their own design teams to produce the detailed design.

This information, including the signed-off sketch scheme, is brought together as a client's requirement document for inclusion in the invitation to negotiate, with the challenge to the consortia to be innovative in competing on how most efficiently to deliver the required design solution – in terms of building methodologies, value engineering, lean construction, facilities management, financing and so on – without reducing the quality of the exemplar design.

As part of this, they are invited to identify any areas of the design where they feel improvements could be made, or any opportunities for additional income generation offered by the site.

The exemplar sketch design, as opposed to the exemplar design team, is then passed on to the preferred bidder. The design team that prepared the exemplar for the public-sector client is retained by the winning bidder as employer's agents, to ensure that the design as developed and subsequently executed by the preferred bidder maintains the quality standards required by the client.

Conclusion

The advantages of this process are:

- The user-client, with responsibility for the strategic delivery of core services, retains control of the strategic planning, concept design and quality issues, leading to better-quality design solutions.
- The public-sector client has a proper understanding of cost and affordability issues prior to engaging with the private sector.
- The user-client has signed off the exemplar design as fully meeting its needs, thus removing uncertainty and the need for prolonged negotiations after preferred bidder selection.
- It obviates the need for the production of multiple, hugely costly and abortive design schemes, which in turn drive up the cost to the public purse in subsequent bids.
- Bid costs and times should be significantly reduced, as the private-sector consortia are required to develop, not to recreate, a concept design.
- Reduced bid costs and times and pre-tender confirmation of affordability should encourage new entrants to enter the market, bringing greater competition.
- The private sector continues to take full responsibility for the funding, detailed design, construction, maintenance and availability of the facility.

The above model is a development of a process at present being used by the Department of Health, Social Services & Public Safety in Northern Ireland. It represents a broad consensus of opinion within the Royal Institute of British Architects, and across much of the industry, as to the need to refine the process to eliminate inefficiencies, and to seek to improve the quality of buildings being produced.

Chapter 11

Private finance and infrastructure – an international view

Simon Hipperson, Business Unit President of Skanska UK

Public-private partnership has been introduced around the world to meet governmental aims for improving infrastructure, thanks to the budgetary and other advantages it offers. While the UK is seen as a world leader in this area, the private finance initiative is still in its infancy and there is much room for improvement. Examples from Chile, the USA and Norway suggest ways of ensuring optimum value over the life of the project.

Private finance and infrastructure – an international view
Simon Hipperson

The international proliferation of the public-private partnership as a means to modernise infrastructure, and more parochially the private finance initiative, has been dramatic. The majority of developed nations have embarked upon a full-scale programme of PPPs, are testing the water through pilot projects, or are at least considering their ideological and legislative implications.

This near-universal adoption of the principles of privately developing and managing infrastructure to meet a public service need has happened across the political spectrum, because the underlying benefits are so compelling and the application is so adaptable.

This chapter examines some of the benefits of PPPs and the ways in which they have been delivered in a variety of political and economic climates around the world.

The universal need
The obvious common feature of PPPs is that a governmental authority, charged with the delivery of a service for either the general public or other public-sector users, procures new or upgraded infrastructure to deliver better services.

The desire to turn to the private sector to develop that infrastructure can be driven by a number of factors, including:

- budgetary pressures and priorities, driven by a demand for demonstrably improved public services across a broad front within increasingly short timescales – globalisation is not limited to private enterprise but is also manifested in ever-increasing public expectations;
- maintenance backlogs and increasing costs, keeping underinvested infrastructure performing well beyond its original design capacity;
- public-sector capability or capacity constraints – it is increasingly difficult for the public sector to retain the capability to deliver one-off programmes of development, and the general trend internationally is towards the strategic roles of "decider" and "procurer";
- limitations on public-sector borrowing, such as those resulting from the economic constraints of the Maastricht Treaty; and
- pressures to limit or reduce public-sector employee numbers.

These factors give rise to intense pressure on governments and public servants to be seen to deliver infrastructure and improved public services, and quickly. Giving the private sector meaningful incentives to deliver these outcomes on time and at an agreed cost has been shown to work very effectively. It is an easy choice for politicians when it comes to getting a new road, school or hospital built.

But having such highly visible products delivered as promised does not necessarily mean that a PPP scheme is genuinely successful. Success can properly be claimed only when the service has been provided over the long term in changing circumstances, and gives sustained value for its users and those who pay for it.

This kind of success is most likely when the public and private sectors each rely upon the other to perform, and non-performance has a tangible adverse effect on the well-being of both parties. It is the job of the procurement authority, the advisory community and the negotiators on both sides to create these conditions in the contract.

There are limits to this argument, in that an arrangement of mutually assured destruction is likely to be unpalatable to funders. As in all partnerships, it is a question of balance.

How the balance is struck

It is a truism that you get what you pay for, and rarely is it truer than in a long-term, output-driven contract such as a concession. The nature of businesses is such that, left to their own devices, they will optimise their structures and processes to generate the maximum returns for the minimum outlay.

This is not necessarily a bad thing but it is a state of affairs that is resistant to change. Properly to meet a public-service need that is likely to change significantly over the typical 10- to 30-year period of a PPP, some balance to this tendency is needed. The incentives in a contract and the consequences of the behaviour they encourage need to be fully considered by all parties; the more directly the private and public sectors are rewarded for meeting the changing needs of end-users, the better the arrangement is likely to be.

One way to create this linkage is to introduce payment for the service at the point of use, rather than indirect and indiscriminate payment through general taxation. Toll roads are a good example of this system in action. For instance Santiago, Chile, faced an increasingly intolerable level of smog, caused largely by traffic congestion.

Concession contracts were issued to build a network of urban toll roads to get the traffic moving again – both the commuters trying to get to work and return home, and commercial vehicles making their way through Santiago to the port of Valparaiso, a key part of Chile's recent economic success.

The private sector funded and constructed the new road system, which is paid for directly by road users. Drivers receive monthly bills generated by an automated tolling system. The balance mechanism employed by the public authorities to encourage the right behaviour from their private-sector partners is that the tolls charged are continuously varied according to average transit times; more congestion equals higher pricing per vehicle, which discourages use of the roads, and revenues fall.

The public authorities' part of the bargain is providing the regulatory and enforcement framework to ensure that tolls are paid, encouraging people to consider using public transport rather than their cars and even whether their journey is necessary at all. Ideally, this system should ultimately find a point of equilibrium where traffic flows are optimised to provide reasonable income, after operating and maintenance costs, for the concessionaire; while congestion and resultant pollution are reduced to acceptable levels, consistent with continued economic growth. Time will tell.

Problems with user-pays systems

The model of payment by the consumer at the point of use, while seeming fair in the context of the private car, would not be appropriate for the British education system or the National Health Service. In these environments the linkages between the end-users (the pupils and patients), the service providers (the teachers and clinicians) and the private-sector owners and operators of the infrastructure are harder to systematise.

This means that to be properly effective and responsive to the public need, the private sector should ideally take some financial interest in the outcomes, and the public sector should invite its private-sector partner to have an input into the process, as well as into the organisational design and operational management of the institutions that deliver the service – a seat at the top table.

Again, there are examples from around the world where private-sector optimisation can be shown to deliver beneficial outcomes for the end-user. This is strikingly true in the competitive market for routine, not necessarily simple, clinical procedures in North American healthcare. In the NHS, the combination of the patient choice agenda and the diagnostic and treatment centre schemes should demonstrate public demand for the benefits that PPP can deliver in this area.

It is not always the case that private finance and off-balance-sheet treatment are needed to assist the public exchequer. In Norway – where there is a healthy surplus in the balance of payments, thanks to a small population and large North Sea oil reserves – the economic argument for privately financed infrastructure carries little weight. There, it is all about the benefits of placing risks with the partner best motivated and equipped to manage them.

The private sector's approach to designing in safety and minimising whole-life cost in constructing the Norwegian E39 road (a new arterial road in western Norway) meant that the road had longer tunnels than the reference design, so it cost more to build, but the overall cost was less and the public will be better served in the long run.

In the Amazonian region of Brazil there is a PPP to develop and operate a dam and hydro-electric power system, to ensure that the "big blackout" of 2001 is not repeated. Dams and their environmental impact are always sensitive subjects, and rightly so. In this case the private-sector partner has a strong incentive to work closely with community stake-holders, to involve them fully in development decisions and to ensure that habitats are regenerated and environmental sustainability is at the top of the agenda.

The ideal state of affairs, in fact, is where the outcomes of the partnership are deemed to represent success for each stakeholder. This is an aspirational goal and will rarely be achievable; there will almost always be someone who must compromise. While the party to compromise should not normally be the consumer, there are occasions on which the government must act in the broader public good, seemingly in defiance of popular opinion.

As the case for taking action to control climate change grows more compelling this consideration is likely to become more prevalent, particularly when it comes to transportation and major public building projects.

Procurement perspective

If the premise is correct that the contract, particularly its incentive mechanisms, determines the behaviour of the parties and hence the success of the project, then it follows that procurement is critical in setting up PPPs to succeed.

There has been much vociferous criticism of the PFI procurement process, but the fact is that the UK is the benchmark by which most other nations measure themselves. We have the most experience, the most diverse market, the best advisers and the best-developed processes. Given the sheer number of deals, there will always be some that struggle and mistakes are bound to happen; inevitably, it is these that receive press attention.

There are examples from around the world where deals are done very quickly, where little or no time is spent negotiating the contract – standard terms and conditions are just that, and bids are made with fully committed finance, or winning bidders are selected on the strength of outline designs and high-level service plans. These things tend to happen in markets where there is a wholesale transfer of risk to the private sector and the service being procured is largely commoditised; for example, roads in the Iberian peninsula.

In the UK we are often working at the cutting edge to procure bespoke services of national importance. Negotiation is necessary to ensure that the benefits are delivered and meet the expectations of all stakeholders.

The process in the UK can seem prescriptive and cumbersome. This is largely a function of the maturity of the PFI, and the natural tendency to make each iteration of the documentation more exhaustive (and therefore more voluminous). It might be useful to hold an honest dialogue to examine the real necessity and value of each standard clause and schedule, with a view to reducing the sheer weight of paper involved.

An interesting feature of the US road procurement process is the "unsolicited proposal". Essentially, a private-sector developer can submit an unsolicited privately financed proposal for a project that is on a state transport department's long-term plan but not yet funded from the public purse. If the proposal is considered viable then an open competition is run to solicit competing proposals from the market.

The future

In the developed world, the benefits of bringing private-sector funds and know-how to bear on public infrastructure are all in the margins of achieving excellence in already very good facilities and services. In the developing world, on the other hand, the impact that the private sector can make is enormous.

New markets are opening up in such places as Eastern Europe, South America and possibly India. With their vast, sustainable natural resources and increasingly stable economic and political climates, they are more than eager to develop their infrastructure base as a driver for economic growth and prosperity.

This presents a huge opportunity for the private sector to help this growth happen and to share in the economic returns; it also brings commensurate responsibility to do this in partnership with the governments and the people. The contracting mechanisms need to be flexible to respond to rapid change, and the partnerships need to encourage behaviours that benefit all parties.

Mutuality must be the watchword of responsible developers and contractors looking to work in these new PPP markets. The public sector too should play its part, in transferring the many years of knowledge gained through the largely positive experience of PPP and the PFI.

Chapter 12

Better planning for better value

Mike Adams, President of the Civil Global Business Unit, Bechtel Ltd

Extensive experience of infrastructure projects and public-private partnership supports Bechtel's suggestions for improving the procurement process. These suggestions focus on: defining the project's scope at an early stage; realistic funding decisions and risk management; endeavouring to attract a sufficient number of market participants; and establishing mechanisms to share learning from similar projects.

Better planning for better value
Mike Adams

In the course of the past 20 years, Bechtel has participated in a number of high-profile infrastructure projects in the UK involving various forms of public-private partnership, private finance initiative schemes, and privatisation. These have included the Channel Tunnel, the Channel Tunnel Rail Link, the London Underground PPP, Luton Airport and several Scottish waste-water projects.

We have not participated in PFI projects in the healthcare, prison, education or accommodation sectors. Nevertheless, with our experience of large-scale infrastructure projects and in view of our desire to take part in future such opportunities in the UK (and in other countries, which look to the UK's PFI as a model for procurement), we have an interest in exploring how the procurement and commercial arrangements of such projects might be improved, in order to increase efficiency of delivery and ensure that their long-term performance affords better value for the UK government.

With that aim in mind, we offer the following observations and suggestions regarding the procurement process, certain commercial elements of the contractual arrangements and the nature of market participants.

Fixed versus variable requirements

Some projects may lend themselves to a well-defined and stable set of requirements over time. In such cases, the public sector has an opportunity to achieve the lowest life-cycle cost by contracting with a third party to provide, maintain and operate the infrastructure over an extended period. Efficiency might be maximised by giving consideration to the following guidelines:

- The procuring entity needs to make an up-front investment to define clearly the scope of the project to be built and the services to be rendered over the term of the concession. These specifications should then be frozen. Variations of the scope and commercial terms during the procurement phase can add considerably to the time and cost required to implement the project. If there is a time to defer a project in order to clarify requirements, it is before the formal procurement process has begun. Similarly, seeking to implement changes during the term of an agreement – which has been based on the presumption of a fixed set of requirements – can represent a substantial additional cost to the public sector and undermine the project's value for money.

- During the procurement stage of every project, as well as during the relevant concession period, each procuring entity learns lessons. The lessons learned may relate to how the procuring entity has best achieved its objectives or, equally, how it has fallen short. The government should undertake to identify and foster the use of best practices that can be spread uniformly across spending departments, in much the same way as Partnerships UK and the Treasury have sought to optimise the participation of government in the refinancing of projects.
- In certain markets, where significant similarities exist between projects, the procuring entity should seek to standardise specifications so as to improve the efficiency of procurement. At the same time, however, standardisation should not lead to a stifling of innovation. The optimum approach would be for the public sector to focus on specifying only those inputs or outputs that are essential to achieving its objectives for each specific project. In any event, it would be preferable not to allow the end-user to make each procurement specification bespoke.

On the other hand, some projects do not lend themselves to such well-defined and stable requirements. In such cases, the public sector still has the opportunity to achieve benefits by contracting with a third party. However, the terms and conditions that govern changing the requirements need to be carefully developed.

The London Underground PPP is one example of where provisions were incorporated into the contract in anticipation of a need for such flexibility. While these provisions might be less amenable to standardisation, there are, nevertheless, lessons from the efforts that went into developing these contracts that may be applied, for example, to the proposed PPP contract with the Highways Agency for the M25 widening works.

While it was evident to the architects of the London Underground PPP that the public-sector requirements over a 30-year period could not be firmly established at the outset, this situation may appear less obvious with respect to a motorway. However, if one considers the changes in the requirements on the M25 over the past 30 years and the importance of this infrastructure for transport around London, it would seem unlikely to expect requirements over the next 30 years to remain static.

Commercial and financial structure

From the beginning of the process, the procuring entity needs to be realistic about the amount of funding that might be available to implement a project. Understanding the limitations on funding should take into account not only what is affordable today, but the potential claims on government funding in the future.

It is true that making an investment today via the PFI and PPP route enables the early introduction of infrastructure, which in turn supports the growth and development of the economy. However, such investment also in effect defers payment for the infrastructure to future years, thereby placing a burden on successive generations.

The responsibility lies with those who are charged with preparing a project to tailor its scope in order to achieve the greatest probable value, within the practical constraint of what funds are available. Crossrail and the Manchester light rail projects are two examples of projects where such consideration should be applied.

The public sector does not necessarily achieve the highest value for money by pushing unnecessary or inappropriate risk on to the private sector. There are two principal reasons for this. On the one hand, the private sector will use its best efforts to put a reasonable price on whatever risks it is obliged to adopt, and this may represent a premium in the case of extraordinary or unusual risk.

At the same time, the private sector will in most cases limit the actual level of risk it takes on by procuring the concession through a special-purpose vehicle with limited capital. In such cases, in the event that this vehicle is unable to sustain a substantial loss, the impaired asset would in effect revert back to the public sector.

To give an example, revenue risk in light railways seems inappropriate for the private sector, as their control over use of the asset is restricted, and the ability to manage revenue is substantially dependent on public-sector management of transport policy and practices.

While many PFI and PPP projects have in the past been financed on a limited-recourse project finance basis, this does not necessarily always offer the best value. A strict project-financing structure might be appropriate for certain projects, where revenue sources are reasonably dependable, project scope can be well defined in advance, and contractors are financially capable of taking the risk of construction cost and schedule.

For larger and more complex projects, the commercial constraints of this financing approach might result in premium pricing of all levels of funding. More creative financial structures might then be appropriate – for instance, structures that reflect a participation of the public sector in the security arrangements.

The financing for the London Underground PPP incorporated a number of features of public-sector participation which supported its financing (though there were certainly lessons learned from that experience which could be applied to future efforts). The public sector should define the optimal delivery structure for its project first and then craft the financing to suit this structure, rather than finalising the financing in advance.

Market participants

Subject to the above comments, we accept that a fair competition offers the prospect of the most efficient procurement. An important factor in maximising the effectiveness of a competition, however, lies in ensuring that there is a broad market of interested potential participants.

The public sector should tailor the procurement and delivery structures to match the capability of suppliers. This is particularly critical for very large projects (say, those involving capital works to a value of more than £500 million), where there may be very few creditworthy suppliers who can guarantee delivery.

We have seen a couple of solutions applied to address this problem. In some cases, consortia are formed to share the risk. The fact that there is a need to form consortia raises a concern that there may not be sufficient, if any, natural participants in the market to provide a competitive environment for the scope of services being procured.

Furthermore, even if a sufficient number of consortia are formed to provide some sort of competition, this is not an ideal solution. Such entities tend to be bespoke, and bring with them additional challenges of internal management and control, which may hinder their ability to manage the assets efficiently.

A more effective solution would seem to be to enable the private sector to manage the implementation of such projects and to procure delivery of capital works from a broader cross-section of suppliers, generally via a number of smaller-valued contracts. Our view is that this would lead to a greater and more efficient level of competition, and ultimately better value for money.

The nature of participants in the PFI/PPP market is changing. In the early years, the market was dominated by contractors – both construction companies and asset/facility operators. Of necessity, these same parties became the equity investors in these projects.

While the contractors may not have been natural equity investors, they were obliged to step up to this role, as there was little equity capital available from other sources. Generally, such contractors are not looking to be long-term owners of these businesses, which may lead to conflicts with customers and other sources of funds. That situation is changing.

A number of equity investment funds that are focused on infrastructure projects have sprung up in recent years, with John Laing and Innisfree being early examples. While many of these are secondary funds that are seeking long-term, stable investments in established projects – that is, after completion of construction – others are prepared to provide the initial equity, making them better aligned with the interests of long-term owners of assets.

Conclusions

In summary, we put forward the following recommendations for improving value for money on large-scale infrastructure projects:

- The public sector should invest up-front in defining a project's requirements, in order to freeze its scope early in the procurement process and avoid costly variations.
- As funds are inherently limited, the scope of a project should be tailored and optimised in light of the benefits that it brings and the amount of funding that is available.
- The public sector should define the optimal delivery structure for its project first and then craft the financing structure to suit.
- Certain projects may lend themselves well to a repetitive PFI structure. The government should make every effort to standardise the procurement process, commercial arrangements and technical requirements for these projects.
- Some projects, which tend to be larger and more complex, are less likely to fit within standardised frameworks. In these cases, the public sector should not only identify the life-cycle technical requirements, but also create a commercial structure that reflects the appropriate risk allocation among parties, including a financial security structure, and fair and practical procedures to implement change over time.
- Due to the limited capacity of the market truly to bear the risk, it may be more effective and efficient for the private sector to deliver large, complex projects through a project management approach. A project manager could secure an appropriate mix of fixed-price and target-price contracts that are structured, scoped and sized to match the capacity of the market to deliver such work.
- The government would benefit from undertaking to assess lessons learned from the implementation of individual projects, and to develop mechanisms to disseminate and apply these lessons to future projects across all spending departments.

Chapter 13

Is there a better way?

Dr Timothy Stone, Chairman of the Financing Group, KPMG LLP

Is the public sector the best provider of public services? Private financing offers solutions to inherent problems of accountability, but the experiment has been muddied by questions of value for money and an overemphasis on asset procurement. The direction in future must prioritise increasing transparency and contestability; public-service businesses are mooted as a possible alternative.

Is there a better way?

Dr Timothy Stone

The private finance initiative has been running since at least 1992 and there is now a large body of transactional experience, based on around 680 completed deals worth some £40 billion in the UK alone.

Although originally conceived as a way for the public sector to access additional finance for asset procurement, private finance is in essence the *enabler* for delivering public services other than by conventional public provision. Service and asset provision require finance, so if the government is not the provider, the source is private.

This chapter reviews the public sector's performance as a provider of services, suggests reasons for perceived shortcomings and considers ways of improving the efficacy of the relationship between the public sector as procuring authority and the private sector as service provider.

Transferring public service provision to the private sector requires not only private finance, but also the creation and development of businesses (not always necessarily for profit) to deliver those services.

The choice of public- or private-sector delivery should be driven by the duty to secure the required policy outcome (an inalienable government responsibility) for the best value for money. Proper transparency, contestability and accountability for the long-term quality and consistency of those services are vital conditions for achieving best value for money.

Before any consideration of what a better way might look like, it is important to understand the backdrop against which any improvement would be set, the underlying problems of public service delivery, the limitations of public administration processes and the market limits that constrain the solutions.

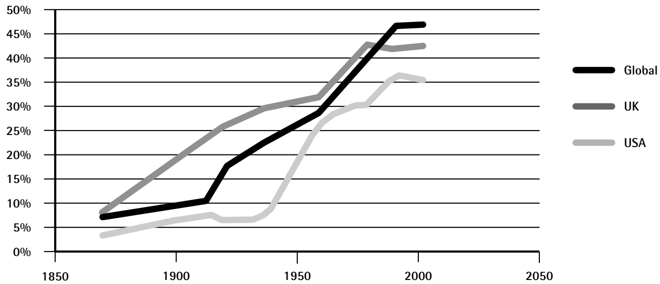
Why PFI is so important

The development of the public sector, from the era of Northcote-Trevelyan in the 19th century[13] and the design of the "modern" civil service, has been one of astonishing expansion with limited true accountability.

13 The Northcote-Trevelyan report in 1853 was the basis for the modern British civil service and led to the introduction of rules which require that UK civil servants are recruited and promoted on merit and in open competition rather than as a result of patronage or political affiliation.

Across OECD countries as a whole, growth has been dramatic, with the ratio of public expenditure to GDP rising from about 10% at the beginning of the 20th century to nearly 50%.[14] The main proportion of that staggering growth has been within the monopoly provision of the public sector itself.[15]

Figure 1: Ratio of public expenditure to GDP



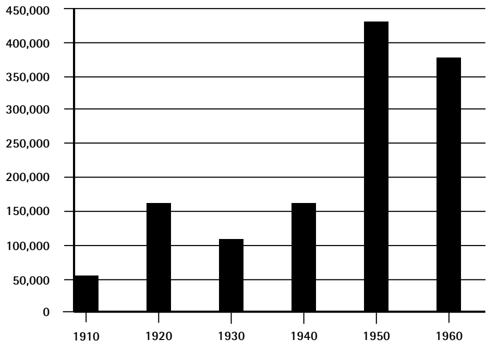
Over the last couple of decades of the 20th century, many elements of public services began to be opened up to increasing contestability. The private and voluntary sectors became increasingly involved in providing significant parts of these services, and the dawn of the new millennium was accompanied by pleas for the control of service delivery to be challenged and made more contestable.

There has always been a complex web of relationships between the monopolistic public-sector delivery agents and the other sectors. As original command-and-control structures have been superseded by more complex relationships, as public services have become more sophisticated, and as citizens have become more discerning consumers of public services, it has become more difficult to drive change from the centre, or to be confident of the outcomes achieved from attempts at change.

What is needed is a systemic change in how governments view public services, how they are managed and how all parties within the delivery chain (both private and public) should be properly held to account.

14 IMF *World Economic Outlook* (May 2000), table 5.4, p172 and OECD.
15 Fry, Geoffrey *Civil Service Systems in Comparative Perspective* (School of Public and Environmental Affairs, Indiana University, 1997).

Figure 2: Growth in non-industrial UK civil service numbers



Underlying problems that demand PFI-type models

At the heart of public-sector service provision lies a major failure of accountability. It stems largely from the monopolistic nature of the relation between the state as provider and the citizen as recipient, compounded by the absence of economic "messaging" that results from providing services free at the point of delivery.

In the conventional model, the state procures the assets, designs and delivers the service, has the right to raise (from debt issuance and ultimately taxation) whatever money is required to fund the service, and can operate, change or discontinue any element of this chain. It does all this largely insulated (at the level of the specific service) from the signals or challenges that businesses constantly receive from finance sources, the suppliers of labour (employees) or service users.

Thus, the economic consequence of anything other than catastrophic failure is traditionally poorly recorded, and fails to attribute any individual measure of cost or personal accountability. The public sector is uniquely able to sweep all manner of costs of failure under the administrative carpet. Although the ultimate consequences may be higher taxation, lower standards or quantity of public services, and poor standards of employee treatment, there is no direct mechanism to allocate consequences to actions, thus no incentive to change.

The second major problem stems from the fact that decisions taken by politicians or senior bureaucrats often have consequences that last for generations. These consequences are rarely captured and evaluated in any form that informs future options and decisions. Accounting techniques, as applied to governments, generally fail to capture these effects in a transparent and economically complete manner.

Given the long-term consequences of decision making – exemplified by Minister of Communities David Miliband's statement that "7% of schools were built before the telephone was invented" – the need for a far better mechanism of accountability is self-evident.

The final weakness in many Western government administrations is the almost total lack of personal responsibility for decisions and consequences over anything more than a very short term.

Whitehall and its senior civil servants are the guardians of the public sector. Yet the same people are expected to provide and implement solutions for system failure, when they themselves are products of a system that is part of the problem.

The great bulk of public-sector activity is still about managing existing programmes. Attempts at improving performance are undermined by an inbred, generalist culture, which elevates policy development above operational performance, prefers consensus to challenge and openness as a means of improvement, and is predisposed to tell people what to do and impose constraints rather than to set the rules of the game and let others deliver.

What must any model deliver?

A reasonable starting point for the evaluation of any improved approach to securing a required outcome would be to recall the inalienable public-sector responsibility, especially to secure value for money. Value for money should be evaluated over the whole life of a procured asset or service, meaning that decisions about implementation should be based on long-term delivery.

In any procurement model, factors conducive to securing and demonstrating value for money include:

- the maintenance of accountability, and transparency;
- contestability of solutions;
- clarity of roles and responsibilities for the asset/service providers;
- pragmatically optimal risk allocation;
- practical flexibility and interaction with evolving needs;
- proper motivation for both commissioner and provider; and
- attractiveness for the private sector.

Value for money, although capable of material improvement in its definition, is well enough understood as a basis to judge any improvement in the PFI process.

Whole-life accountability needs to address the failings referred to above, to achieve a state in which on-going measurement and incentive systems motivate consistent long-term stewardship of the assets and services. This is accompanied by the need to ensure that accountability and transparency are designed into the arrangements, both within the public sector and between public and private sectors.

Who bears the risk?

The process of risk allocation is, in the standard mantra, about the allocation of risks to those best able to manage and control them (for example, a contractor being at risk for the cost of maintenance or renewal, not for usage, where that is a function of on-going public-sector policy).

In practice, there are a number of instances of risks being allocated to those least able to resist them. For example, during the competitive tendering and negotiation process, bidders may accept risks simply in order to stay in the game, without adequate consideration on either side as to the sustainability of the position.

In other situations political commitments and timetables have apparently left procuring authorities with no choice but to assume risks that the private sector could (not considering the political dimension) more suitably bear.

In any new model, risk allocation, management and pricing practices need to be improved in light of the long-term consequences to both public and private sectors.[16]

Flexibility and evolving needs are two sides of the same coin. In conventional procurement (such as that of a new school or hospital), the economic consequences of building, operating, maintaining, changing or closing assets/services have generally been underestimated or disregarded (often being treated as a sunk cost).

By contrast, because PFI contracts make these issues (and associated costs) explicit at the time of procurement, PFI has been criticised for introducing inflexibility or additional cost. The reality is that these issues are present regardless of the procurement route. If flexibility

16 See, for example, Standard & Poor's series of papers on traffic forecasting risks, such as *Traffic Forecasting Risk Study Update 2005: Through Ramp-Up And Beyond.*

and evolving need are of concern (which they will increasingly be as, for example, technology transforms healthcare or education) they should be designed into what is being procured.

Any modified or future system has to be attractive to the private-sector bidders (either as principals or as financiers). The private sector needs to understand the market of providing public services – its nature, size and duration – so that providers can develop supply chains for human and development capital and make rational decisions about the deployment of that capital.

If that understanding is not achieved, the rising interest of UK bidding organisations in working abroad[17] will continue. In consequence, the UK public sector will find it hard to attract good-quality bids for any opportunity.

So is there a better way?

PFI has contributed to solving the failures of delivery and systematic lack of proper accountability in public services by: introducing contestability of solutions; clarifying roles and responsibilities for the asset/service providers, making advances in risk allocation; starting to incorporate flexibility and interaction with evolving needs; and refining the motivations for both commissioner and provider.

However, the procurement process has been heavily influenced by the desire to test whether private-sector ownership per se offered better value for money than public ownership. Furthermore, because asset procurement has been at the heart of so many PFI transactions, the thinking around the scoping of services and operations has received less attention.

The results have been mixed and less than optimal. For example, the demarcations for what the private sector does in a PFI service vary depending on political expediency, not on operational efficiency, ease of delivery or provider competence.

The boundaries between public- and private-sector provision within PFI prisons, hospitals, schools, roads, information technology services, accommodation services, defence training and so on therefore vary immensely. The only common theme is that the boundary is generally drawn in such a way as to complicate the interfaces between the two, create confusion about responsibilities, increase the costs of supervision, and create avoidable risks.

17 For example, the current enthusiasm for road projects in the USA or hospital projects in Spain and Italy.

It is critical to recognise that initial results indicate that PFI procurements perform better, in general, than the well-tried, tested and polished traditional methods. This suggests that there is significantly more to be obtained by sensible and careful development. But there undoubtedly is a better way.

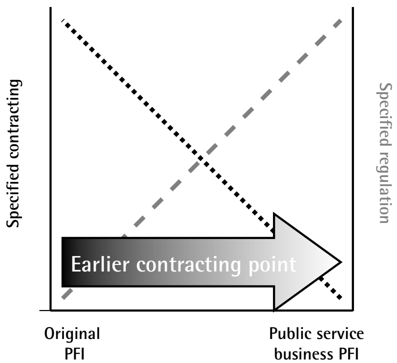
The process to date (the creation of PFI) must be viewed as a pilot project that has tested an alternative model of public-service delivery, after more than a century of increasingly monopolistic supply by the public sector and the marginalisation of the private and voluntary sectors.

Any future route cannot and must not reverse the direction of increasing transparency, contestability and accountability, which has enabled much to be achieved so far. While there are undoubtedly limits to how markets can effectively support or provide public services, some of those limits are perhaps transitory, and can be softened and expanded by probing the perceived boundaries.

For many public services, the government's role can be set on a continuum between direct provision and total control (the traditional model) through partial/shared provision, and control to service specification and regulation.

Conventional prisons are an example of the traditional model; the passenger railways are an example of the government specifying and regulating, but leaving provision totally to the private sector. Hospitals are at a moving point between these two ends.

Figure 3: PFI models – from total specification to regulation



What an alternative might look like

One possible approach to a better way is to examine more rigorously where the interface between the public and private sectors should be placed, based on the considerations listed above.

One outcome could be an increasing focus on true public service businesses. The essence of the approach is that service should be provided by organisations purely focused on the integrated long-term delivery of services (for example, healthcare) and not on the provision of individual commodity elements of that service (construction, floor cleaning, catering).

The roles that public service businesses fulfil are the development of the solution, the management of the detailed design and competitive procurement of the commodity elements of the deal, and the long-term integration of delivery, operation and risk management.

The public service business would have little economic interest in the provision of construction, facilities management or finance. Instead it would be motivated to deliver the total solution within the envelope of services identified as offering optimal value for money. The contract letting point should be much earlier in the overall process,[18] because the contractor is taking responsibility for the total solution, not fragmented elements of it.

The simple analogy is with a large retail organisation that neither designs nor builds its shops, does not own or drive the delivery trucks and does not manufacture any of the goods it sells. Its primary interest is in supplying products that meet the needs of its customers, and it adapts its supply chain and (less commonly) its major assets to enable it to react to those customers' long-term needs. The reader should pause for a moment to compare the basic manner of operation of other "normal" businesses with traditional PFI deals.

There are four particular areas that point to the way forward.

Role of commodity suppliers

The initial PFI model has almost exclusively been implemented by consortia of organisations whose primary pursuit was that of a commodity contract.

18 See, for example, speeches and articles by the author at the City & Financial Construction Industry Summit in Cape Town, South Africa, in 2000, and "Word on the Street" in *Infrastructure Journal* (2002).

The key skills that will always remain at the centre of the public service business must be that of an effective operational manager, bringing together the commodity components, and a robust and financially sound risk manager. Models might be found in the likes of Serco, Laing, Bouygues, Bovis Lend Lease and Vinci.

An early example of this alternative model can be found in the Ministry of Defence's Military Flying Training Services, where bidders are being asked to provide fully trained pilots, navigators and flight engineers while managing and providing ancillary equipment such as flight simulators and aircraft.

The contracting point

The next point is to examine where along the spectrum between defined outcome and minutely designed end-product contracts could be well enough defined for a deal to take place. If the public service business were indifferent to the placement of the bulk of initial expenditure, being primarily interested in integration risk and management, the contracting point could be very much earlier in the process.

As an integrator, the public service business could procure the detailed design, the construction, the operation and the life-cycle elements of supply externally on a pass-through basis to the public sector, with appropriate packaging of the various elements of risk.

By letting the contract quickly after the public sector's decision about its detailed requirements, much of the long, expensive and overly cautious work of the PFI process could be significantly streamlined.

Two material benefits flow; first, the elimination of a large amount of duplicated detailed design work, with a likely increase in focus on innovation. Second, the many man-years involved for both public and private sector would be reduced considerably, with both a long-run reduction in cost (ultimately a gain largely for the public sector) and, in the light of earlier comments about market capacity, an increase in the number of available bidding teams.

Medium-scale solutions

The evolution of, first, the local improvement finance trust model for the provision of primary care facilities,[19] and latterly the associated Building Schools for the Future,[20] has

19 At the time of writing, 40 LIFT deals have been signed with a total value of £1 billion, and 14 new facilities are already operational with 31 open to the public.
20 "Building Schools for the Future: Guide and Analysis" in *PPP Bulletin* issue 3 (Oct/Nov 2005).

shown how to create a partnership between the private and public sectors to create much smaller-value service contracts than would ever be economically viable as stand-alone project finance deals (such as traditional PFI deals).

Both these approaches offer a method of providing many small, individual facilities (such as doctors' surgeries – costing £1 million to £5 million each – or individual schools, costing £10 million to £20 million each) in a single deal. The provider and operator are acting at a slightly higher level than would be the case for the provision of, say, a single acute hospital.

The real prize is the application of the public service business model to the many medium-sized public service delivery opportunities. The Department of Health has signalled intent to provide many community hospitals,[21] building on the early experience of the independent-sector treatment centres and successful provision of fully serviced hospitals under PFI.

Similarly, the Department for Education & Skills is examining how to rebuild, refurbish, relocate or reconfigure all the primary schools in England and Wales.[22] Whereas the average secondary school has a capital value of around £17 million, primary schools are much smaller indeed and cry out for a far simpler model than Building Schools for the Future.

A more business-focused approach, such as has been described here, may be more appropriate to address the need for both economy of bid costs, speed of delivery and better long-run operational management.

Operational focus

Finally, it is important to consider another aspect of the potential applicability of public service businesses. Operational effectiveness in traditional deals appears to vary from deal to deal, with some leaving significant room for improvement.

What is clear from the problems surrounding traditional provision of public services is that the long-term focus of any public service business must be on operational effectiveness as well as asset creation and management. In this sort of approach – where the focus is purely on service provision, without the distractions of commodity activities such as construction – operational effectiveness should naturally be a much higher priority for the operators.

21 *Creating a Patient-led NHS – Delivering the NHS Improvements* (March 2005).
22 Chancellor's Budget statement, March 2005.

This should, undoubtedly, force a much greater understanding of the design and implementation of payment mechanisms in their role as part of the control systems. In lower-value deals, this plays naturally to the strengths of the established service companies such as Serco, Laing and now I2, but for the larger deals the public service business model would seem to provide a better fit with long-run operational performance.

Conclusion

The PFI process has undoubtedly delivered a sea change in contestability into the provision of public services, providing a proper challenge for monopolistic provision from purely within the public sector.

That a better way exists is not in question; the forum for debating and devising it is much less clear. Governments need to develop a broad-based consensus for the reform of public services with social, voluntary and private partners.

The platform for this consensus will ultimately be forced on the system, at least in the UK, as the economic climate limits the ability to inject ever more public finance into services, and as reform becomes exponentially more necessary to deliver better-quality services. Creeping incrementalism cannot and will not work.

The issue of public service reform and the part that PFI plays within it is not merely a matter for intellectual or academic debate; it is now a matter of international economic competitiveness, as value for money will focus national economic resources on the efficient delivery of policy objectives.

It is necessary to define an approach to reform, and a narrative around this, that will enable socially responsible solutions to be devised and equity in access and provision to be achieved. Public service businesses could well be a key part of the answer.