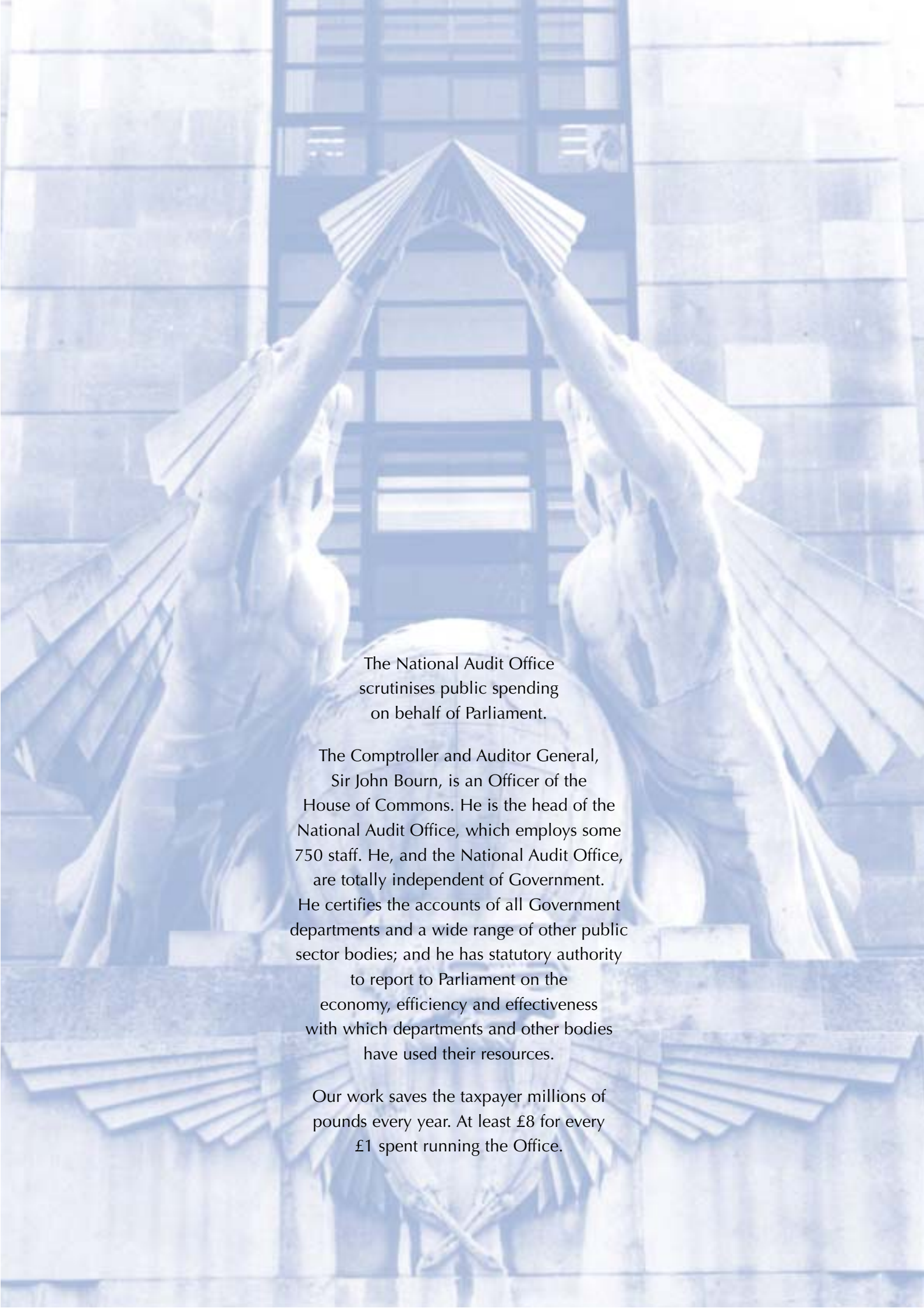


Managing the relationship to secure a successful partnership in PFI projects

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 375 Session 2001-2002: 29 November 2001





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Managing the relationship to secure a successful partnership in PFI projects



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This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

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executive summary

- 1 The Private Finance Initiative (PFI) is now established as a major form of Government procurement. It is used to procure a wide range of public services, including hospitals, prisons, roads, computer systems and Government accommodation. There are over 400 PFI contracts currently in force committing departments to future expenditure of around £100 billion.
- 2 Although there is now considerable experience of the PFI procurement process, there is much less experience of the issues that arise once the contract has been let. Most PFI contracts are still in their early stages. It is important, therefore, that initial lessons arising from the management of these contracts, some of which relate to how the contracts were procured, are identified and disseminated quickly to authorities so that they can be taken into account in current and future projects.
- 3 This report highlights key issues which authorities need to keep in mind when developing and managing relationships with private sector PFI contractors.



The scope of the study

- 4 Our study has been based on surveys of authorities and contractors responsible for managing 121 PFI projects where contracts had been let prior to 2000. It is the first major examination of central government PFI projects in progress. The key question we have sought to answer is whether authorities manage their PFI relationships to secure a successful partnership. A successful partnership allows the participants to work together to achieve their objectives to their mutual benefit: the public sector receives a service that represents value for money; and the contractor delivers that service for a reasonable return.
- 5 The methodology we adopted to undertake the study, which included obtaining views from contractors as well as authorities, is set out in Appendix 1. The information presented in this report is based, except where otherwise stated, on the views of the authorities and contractors at the time of our survey (late 2000). Details of the projects surveyed are set out in Appendix 2. In the course of our study we also obtained the views of the Office of Government Commerce and various other public and private sector bodies active in the PFI field. We are grateful to all those who responded to our survey and contributed their views as our study progressed.

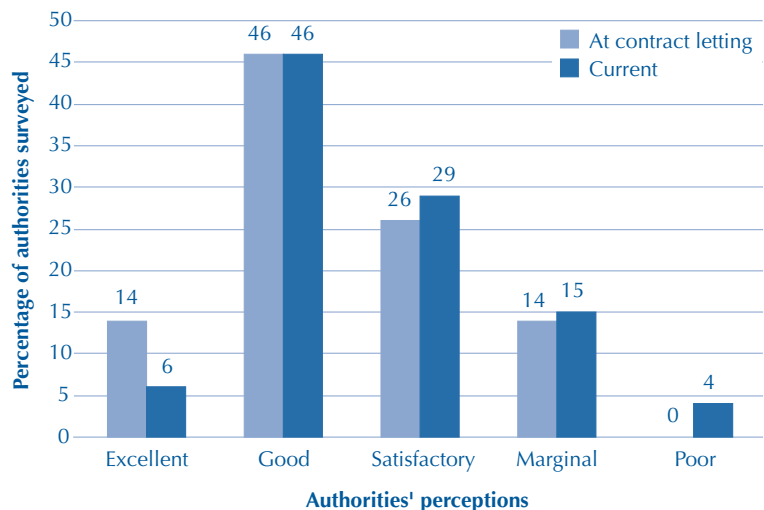
- 6 The study focussed on how authorities and contractors were managing the PFI contracts they had entered into. But how easy it is to create a successful partnership often depends on decisions made during, and often early in, the procurement process. Although this study did not examine in detail how the authorities procured their projects some of the results of our survey identified issues relevant to the procurement process.

Most authorities consider that their PFI projects are good value for money

- 7 We asked the authorities in our survey for their current perception of the value for money of their contracts. We also asked them how it matched up to their original expectations when the contract was let (**Figure 1**). Over half the authorities in our survey said that the value for money of their PFI projects was currently good or excellent. In total 81 per cent of authorities said that value for money was currently satisfactory or better, 15 per cent said it was marginal and 4 per cent said it was poor. There has been a slight decline, however, in perceived value for money since contracts were let. Some 86 per cent of authorities considered that the value for money of their PFI projects at the time of contract letting was satisfactory or better, 14 per cent said it was marginal and none said it was poor. There was generally positive feedback from users of the services although in some projects authorities and contractors were addressing areas where user feedback suggested improvements could be made.
- 8 These figures demonstrate the high expectations that authorities have for the success of PFI projects in delivering value for money in public services. But they also indicate that value for money is not guaranteed. Authorities need to ensure that the value for money anticipated at the time of contract letting is delivered in practice. To do so requires careful project management and a close attention to managing the relationship with contractors. Authorities also need to consult with users about their level of satisfaction with the services being provided. These important matters are addressed further in this report.

1 Authorities' perceptions of their projects' value for money

This is based on 98 authorities who gave us their perception of value for money at the time the contract was let, as well as at the time the survey was completed.

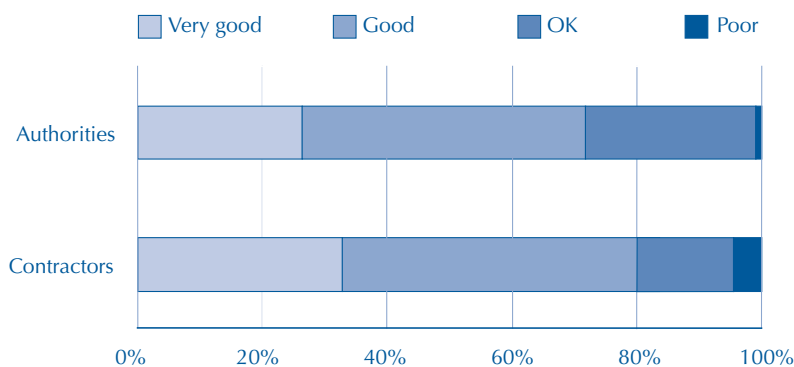


Source: National Audit Office survey of authorities

Most relationships between authorities and contractors are good

9 Our survey showed that 72 per cent of authorities and 80 per cent of contractors view their relationship as being good or very good. Very few (1 per cent of authorities and 4 per cent of contractors) consider that their relationship is poor (Figure 2). Some 45 per cent of authorities and 35 per cent of contractors said that their relationship had improved since contract letting. A much smaller number (18 per cent of authorities and 11 per cent of contractors) said that their relationship had worsened. These results suggest that authorities and contractors are making efforts to maintain a good relationship but that in a number of cases there is work to be done to improve relationships.

2 Authority and contractor view of current relationships



Source: National Audit Office survey of authorities and contractors

PFI projects need to be approached in a spirit of partnership

- 10 PFI projects involve long term relationships between authorities and contractors who, at first sight, appear to have inherently different objectives. A successful outcome for both parties can only be achieved if they are prepared to approach projects in a spirit of partnership. This requires an understanding of each other's business and a common vision of how best they can work together as partners.
- 11 Our survey showed that most authorities and contractors have made efforts to understand each other's businesses and to establish a shared vision for the project. On some projects, however, authorities and contractors have not taken steps to understand each other and establish common ground and this has often contributed to the subsequent development of an adversarial relationship.

A successful partnership needs to be established at the outset

- 12 Authorities and contractors need to consider how their relationship will be managed before contracts are let. Failure to do this can lead to misunderstandings and difficulties in the early years of the contract, a period which contains considerable risk as the required service is being brought into operation and the parties to the contract get used to working with each other. The Office of Government Commerce has issued best practice guidance on

'Managing Partnering Arrangements'. It outlines for senior managers the issues to be considered in managing partnering relationships, in PFI and other deals, and the key questions to be asked.

- 13** The development of a successful relationship between authority and contractor will be assisted by the right contractual framework. This will include allocating risks appropriately, establishing clearly defined quality of service and value for money mechanisms and building in arrangements to deal with change.
- 14** On these matters we found that:
- although most authorities are satisfied with the risk allocation in their PFI contracts only two-thirds of contractors shared the authorities' view that risks had been allocated appropriately;
 - virtually all contracts include clearly defined arrangements for assessing quality of service. In over half of these the authority had made performance deductions from the payments due to the contractor. There is also evidence that authorities and contractors are using performance review processes to bring about positive changes to the way that services are delivered;
 - many authorities had included mechanisms in their contracts which allow them to monitor or improve value for money although there is, as yet, very limited experience of making use of these mechanisms. Mechanisms most often included were benchmarking, gain sharing and open book accounting. But only 15 per cent of authorities told us that they had the right to share in refinancing benefits. The Office of Government Commerce is preparing revised guidance (see paragraph 1.9) which is likely to recommend that contracts should give authorities approval rights over refinancings and contain provisions on sharing gains; and
 - although most PFI projects are still at an early stage, dealing with change is already a significant issue. Use had been made of change procedures in 55 per cent of the contracts which contained such procedures. These changes related to alterations in services covered by the original specification, the introduction of new services, additional building works or design changes and amendments to performance measurement arrangements. Using the experience of early PFI projects to get the initial procurement right may reduce the need for contract changes on future projects. But some contract changes may well still be necessary and authorities need to ensure that value for money will be maintained where these occur.

Having staff with the right skills is critical to good contract management

- 15** Even where the right contractual framework has been put in place, the authority may fail to realise the full potential benefits of the project if it does not manage the contract effectively. This requires a thorough understanding of the project and the contractual arrangements and an ability to build effective relationships with contractors.
- 16** Most authorities considered that the staff in their contract management teams had sufficient skills and experience. But authorities' responses to our survey suggested a considerable variation in the extent of training provided in contract management skills, with some authorities providing little or no training. As part of the training that is required, lessons from managing current projects need to be disseminated quickly. There are also difficulties in achieving staff continuity. Authority staff who have experience of PFI procurement may be transferred to other PFI procurement teams or they may find that their experience is marketable outside the public sector.



- 17 Authorities would welcome further guidance on managing relationships with contractors and have identified a number of areas where further guidance would be helpful. Contractors also believe that there should be further training for authorities. They have emphasised the need for authority staff to have greater commercial awareness, which could be achieved through specialised training or work placements with commercial organisations.

The partnership framework must be made to work in practice

- 18 A good partnership relationship is one where both sides are open, share information fully and work together to solve problems. It is not easy to secure this form of relationship and there are challenges to authorities and contractors in achieving this in PFI projects.
- 19 In our survey, two thirds of contractors thought their relationship with authorities worked in an open and trustworthy environment most or all of the time. But some projects had clearly suffered from a lack of openness or poor communications. Some projects had successfully co-located authority and contractor staff to improve communications and to identify and deal with problems more quickly.
- 20 The responses to our surveys showed the following experiences of how aspects of the relationship between authorities and contractors have been working in practice:

Governance arrangements - PFI contracts include a range of governance arrangements dealing with how performance will be monitored, problems resolved and new services or other changes dealt with. Most authorities and contractors considered that governance arrangements were working well.

Innovation - Although most contractors said their contracts had given them scope to be innovative, some contractors who had high expectations of prospects for innovation found they were less able to be innovative than they had initially anticipated. They attributed this to departments having fixed views on design features or other aspects of how the service should be provided. Most authorities considered their contractors had been partially innovative in taking projects forward.

Authorities' monitoring of contractors' performance - Authorities need to ensure that contractors are providing accurate and valid performance data. Three quarters of contractors thought authorities had adopted an appropriate approach to monitoring their performance. Some contractors, however, felt their relationship with the authority had suffered as a result of the authority becoming too closely involved in performance monitoring.

Reassessment and review of the relationship - Authorities and contractors need to review their relationships on a regular basis to establish how they can be improved and maintained. A number of authorities and contractors had done this, for example by holding an away day or other form of joint event.

Lessons for procurement and management of PFI projects are pertinent for other means of procurement

- 21 PFI has introduced changes in the way public services are procured and managed. For example, PFI contracts require clearly defined performance levels and financial penalties to be levied for failure to meet those defined performance levels. Authorities and contractors have devoted a great deal of



effort to create effective governance arrangements to manage their relationships. While the scope allowed for innovation has varied, the PFI method of procurement has shifted authorities' focus from the rigid specification of inputs to a concentration on critical outcomes.

- 22** Our recommendations for improving the management of PFI contracts are pertinent for other types of project. Departments and the Office of Government Commerce should, therefore, ensure that good practice developed under the impetus of PFI is also followed, where appropriate, in conventionally funded procurement and directly managed public services.
- 23** There is existing Treasury Taskforce guidance 'How to Manage the Delivery of Long Term PFI Contracts'. The Office of Government Commerce has also already issued best practice guidance called 'How Major Service Contracts Go Wrong'. This highlights how important it is to manage the relationship with service contractors and areas that might cause potential failure to occur. The Office of Government Commerce is also: considering commissioning the development of further contract management guidance based on its own feedback from departments, updating the standardisation of PFI contracts guidance and developing a PFI practitioner skills module to form part of the wider skills framework for government procurement. In addition, its Gateway review process will be used to monitor how contracts are being managed and to identify areas where guidance needs updating.

Recommendations

24 As a result of this examination we make the following recommendations:

- A Authorities and contractors should always seek to understand each other's businesses and establish a partnership approach to each of their PFI projects based on a common vision of how they will work together to achieve a mutually successful outcome to the project.
- B Authorities must give attention at an early stage in the procurement process of a PFI project to contract management issues and how their relationship with the selected PFI contractor will be developed.
- C Authorities need always to consider when developing a PFI contract the factors which may require changes to the contract after it has been let. The authorities' priorities may change or other factors may arise such as the opportunity to take advantage of improved technology. Appropriate contractual procedures for dealing with change should be built into the contract. The procedures need to ensure that value for money is maintained when contract changes occur.
- D During the procurement stage authorities must develop a staffing and training plan to ensure that they have staff with the right skills and experience to manage the contract after it has been let and to build a good working relationship with the contractor.
- E Authorities should regularly re-assess their relationships with contractors, and the value for money their projects are delivering, to identify ways in which relationships can be improved.
- F The Office of Government Commerce should take forward its plans to consider further guidance on contract management issues and should consider facilitating opportunities for staff from different authorities to share experiences of managing PFI contracts and relationships with PFI contractors.

We have set out in Appendix 3 points to be considered in taking forward these key recommendations.

Part 1

A partnership approach is required supported by the right contractual framework

1.1 A project procured under the PFI is based on a relationship between a public sector authority as procurer and a contractor as provider of a service. The length of this relationship will vary according to the project but can be for 30 or more years. As authorities and contractors have inherently different objectives there is a need to reconcile their different aims if their long term relationship is to be successful. It is likely to be a successful relationship only if the authority and contractor approach it in the spirit of partnership and base their relationship on a sound contractual framework.

The public and private sectors need to work as partners

The parties to a PFI contract need a single business focus

- 1.2 Authorities and contractors will achieve a successful partnership where they each meet their respective objectives over the life of the project. For authorities, a PFI project can be described as successful if it delivers value for money in the form of cost effective, reliable and timely services at agreed prices and to agreed quality, as defined in the contract. Authorities also expect the service to be delivered consistent with legal standards, financial probity and management accountability. A contractor will view a PFI deal as successful if it delivers the authority's requirements whilst yielding a reasonable return.
- 1.3 Both parties to the contract need to understand their respective objectives as barriers of mistrust and suspicion can adversely affect the relationship between the public and private sectors. If authorities and contractors see their relationship as adversarial this is unlikely to lead to a successful outcome. To build a successful relationship the public and private sectors need to adopt a flexible and co-operative approach where they understand each other's objectives, concentrate on establishing common ground, and see each other as partners with a single business focus.

Most authorities had assessed prospects for a partnership

- 1.4 The procurement stage of a PFI deal is very important, not only in obtaining a deal which represents value for money, but also in establishing the basis for a good relationship between the authority and contractor for the contract period. Authorities will, therefore, need to assess bidders' approaches to partnership working. This should encompass their commitment towards continuous improvement of the services provided under the contract and their acceptance of certain contractual provisions based on partnership working such as open book accounting. Authorities should also explore softer factors such as a contractor's willingness to work jointly with the authority through the establishment of joint governance arrangements, joint working groups and co-location, and the attitude and approach of key individuals. Contractors will also wish to assess the authority's approach to partnership working.
- 1.5 Our survey of PFI contracts which had been let prior to 2000 showed that 71 per cent of authorities assessed bidders' attitudes to partnership working when procuring the contract. This is an important issue for authorities to consider when assessing the suitability of a bidder for a long term PFI contract. We would expect all authorities to consider this when assessing bidders.

Efforts had been made to understand each other's businesses

- 1.6 To achieve their respective objectives and work to a common goal with a single business focus, each side needs to understand the objectives and business of the other, and that understanding needs to be gained during the procurement stage of the deal. We found that authorities and contractors had made efforts to do this. **Figure 3** shows how National Savings and Siemens Business Services (Siemens) gained an understanding of each other's business. Both parties regard their relationship as being very good.

3 How National Savings and Siemens came to understand each other

How National Savings gained an understanding of Siemens' business

Contractor's view

'National Savings were very clear that the strategies of the businesses needed to be aligned. They were pro-active in seeking information from us about our operations, strategies, and financial standing. National Savings also visited Siemens AG to satisfy themselves that Siemens as a whole fully supported the proposed partnership.'

Authority's view

'National Savings sought a genuine understanding of Siemens AG's strategy and Siemens' organisational structure and attitude and approach of key individuals. Detailed evaluation undertaken of Siemens' financial position and future strategy of the business.'

How Siemens gained an understanding of National Savings' business

Contractor's view

'A pre-condition of Siemens bidding for the contract was that the National Savings business strategy was aligned with that of Siemens. During the procurement this was achieved through understanding the procurement documentation, which was comprehensive in this respect, and numerous discussions with National Savings.'

Authority's view

'Understanding was vital given the scale of the outsourcing. Numerous workshops, discussions and interviews undertaken as well as an extensive due diligence process.'

Source: National Audit Office survey of authorities and contractors

- 1.7 Some contractors, however, considered that authorities made little effort to understand their business. One contractor felt the authority had relied on its advisers to build a relationship with the contractor during the procurement. In another example, a contractor said that the authority did not appear to comprehend that the special purpose company formed to deliver the PFI project was a commercial organisation with business objectives.
- 1.8 Some authorities and contractors have found it valuable to have their respective objectives set out in the contract. An alternative is to document them outside the contract but in a format where they can be easily accessible to staff working on the project.

The right contractual framework needs to be established

- 1.9 The PFI contract sets out the key terms on which the authority and contractor agree that their relationship will be based. It will include the allocation of risk, the quality of service required, value for money mechanisms and other working arrangements. These decisions made during the procurement of the contract have an impact on how well a successful partnership can be created. In July 1999, the Treasury Taskforce published guidance on Standardisation of PFI contracts. That guidance, which is now the responsibility of the Office of Government Commerce, is being reviewed on its behalf by Partnerships UK. There will be a period of public and private sector consultation before the revised guidance is published.

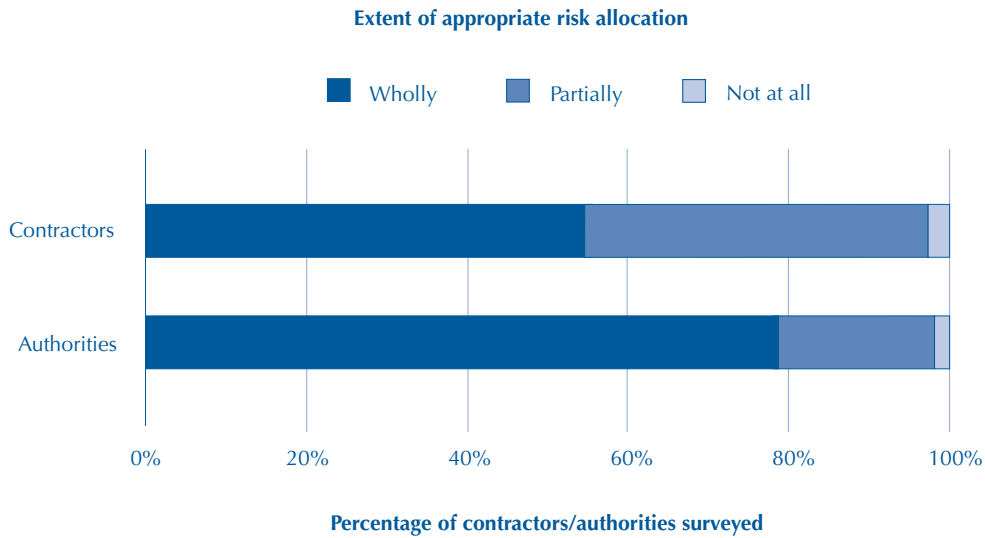
Contracts need to allocate risk appropriately

- 1.10 The Treasury publications, Public Private Partnerships - the Government's Approach, and Appraisal and Evaluation in Central Government, recognise that appropriate risk allocation between the public and private sectors is a key requirement to the achievement of value for money in PFI projects. This reflects the principle that value for money will be achieved where there is optimum transfer of risk such that individual risks are allocated to those best placed to manage them. However, if authorities seek to transfer risks which the private sector cannot manage, value for money will reduce as the private sector seeks to charge a premium for accepting such risks.

There is some disagreement on whether risks have been allocated appropriately

- 1.11 Our survey identified that in some projects there is disagreement between authorities and contractors on whether risks have been allocated to the party best able to manage them. Only two-thirds of contractors shared the authorities' view that risks had been allocated appropriately. 79 per cent of authorities thought the risk allocation was totally satisfactory but only 53 per cent of contractors had this view (Figure 4). Contractors told us that risk allocation was an important area where there were often problems. For example, the Business Services Association told us that risk allocation is the biggest area of concern in many PFI projects and is often misunderstood by the public sector.

4 Fewer contractors than authorities consider that there has been an appropriate allocation of risks



NOTE

Full details of projects surveyed are at Appendix 2

Source: National Audit Office survey of authorities and contractors

1.12 All the contractors who were dissatisfied with the risk allocation thought that risks had been inappropriately transferred to them rather than inappropriately retained by authorities. Examples of inappropriate risk allocation in the view of contractors are shown in **Figure 5**.

Some contractors may be too willing to accept inappropriate risk

1.13 Some authorities may have been tempted to transfer as much risk as possible to the private sector. But if contractors accept inappropriate risk to win the competition, the subsequent realisation of those risks within a very competitively priced contract may lead to problems for the contractor and, therefore, for the authority. The due diligence carried out by contractors' banks may sometimes stop contractors taking on too much or inappropriate risk. Some contractors told us, however, that in their experience banks would accept a deal where too much risk was being transferred if the contractor provided a parent company guarantee. It is important to recognise that bankers' due diligence is done on behalf of themselves and may not give full reassurance about project risks to other parties.

1.14 The Gateway process, introduced by the Office of Government Commerce in January 2001 for civil procurement, aims to help to ensure that risks are allocated to the party best able to manage them. The

Gateway process will require high risk PFI projects, and all information technology projects, to pass through five gateway reviews at key decision points in the procurement process. These decision points include before the procurement strategy is defined, before tenders from bidders are invited and before contracts are signed. Each of these points will provide incentives for authorities to review the proposed risk allocation and, if necessary, to amend it.

Some authorities may transfer risk back to themselves

1.15 The essence of PFI is that authorities provide contractors with an output specification of the services they require. Contractors then have the responsibility and risk for deciding how they will provide those services. If authorities tell contractors how the services are to be provided, they are transferring the risk back to themselves. Contractors told us that authorities sometimes attempted to define the technical solution, or had expectations on how a service should be provided, which limited contractors' freedom to propose alternatives. Where an authority believes it must prescribe aspects of how a service should be delivered then, where practicable, this should be made clear to all bidders at the outset of the procurement.

5 Examples of contractors' perception of inappropriate risk transfer

TAFMIS	A19	RAF Mail
'There have been some minor risks, principally arising from uncertainty over requirements e.g. quantity of terminals, that have in the contractor's view been inappropriately passed to it.'	'Traffic flow risk transferred to the contractor was inappropriate because payment depended on traffic flows which the contractor cannot control.'	'The contractor is carrying all of the cost risk. However, the revenue is dependent on the number of users which is not guaranteed. There are variable tariffs to compensate for low use but very low use will reduce revenue dramatically.'

Source: National Audit Office survey of contractors

Risks retained must be carefully monitored

1.16 Under PFI contracts not all risks can be or are suitable for transfer to the contractor. It is clearly important that authorities continually monitor risks to which they may be exposed and take steps to manage them. In our survey, we were told by the Ministry of Defence that, under the terms of their Fixed Telecommunications Service contract, it had become exposed to the possibility of having to pay the contractor (BT) compensation of up to £12 million because the anticipated numbers of users paying for secure speech services was not sufficient to enable BT to recover its initial investment in developing this service. Proactive management by the Ministry, working in conjunction with BT, enabled a satisfactory resolution of this situation which involved changes to required volumes of users and the mechanisms for funding BT's investment in the service. On this basis, BT had agreed not to press for the compensation to which it was entitled under the contract.

Ultimate business risk cannot be transferred

1.17 Ultimate business risk cannot be transferred to the contractor because if the contractor fails to deliver the specified project, the public sector still has the responsibility for delivering the required public service. There have been notable cases where PFI projects have failed or been delayed with significant adverse consequences for the public sector. In its reports on the contract to develop and update the replacement National Insurance Recording System¹ (NIRS2) the first sizeable IT project signed in 1995, the Committee of Public Accounts commented on the delay in implementing the project. The Committee said that departments should ensure that they understand fully the potential impact of delay on their business and customers and that it is the department's responsibility to draw up contingency plans to cover the risk that delivery of the project would be delayed.

Further understanding is required of the returns contractors earn

1.18 The returns which private sector participants in a PFI project expect to earn can affect relationships between authorities and the private sector. The private sector participants in a PFI project may earn returns from providing services as contractors to the project or on their investment in the project, either as shareholders in a special purpose company established specifically for a single PFI project or as shareholders in an existing business which has been awarded a PFI contract. Very low returns could affect contractors' performance on a project and could deter them from bidding for future PFI projects. Very high returns could affect the authority's perception of value for money and their approach to future procurements. Further information is required on the extent of contractors' returns on PFI projects. The Office of Government Commerce is reviewing value for money and levels of return the private sector gets on its investments to ascertain whether this is commensurate with the risks it accepts in undertaking government contracts.

Contracts must include clear quality of service mechanisms

1.19 Availability of the services specified to the required standards is necessary if a PFI contractor is to receive full payment of the unitary charge. The payment mechanism puts into financial effect the allocation of risk and responsibility between the authority and contractor. It determines the payments the authority will make to the contractor and the incentives for the contractor to deliver the service required. It is established best practice, as recognised in Treasury guidance on standard contract terms², that PFI contracts should clearly set out required service standards, the performance measurement system and associated performance deduction system, and performance review processes. The performance measurement system and

¹ Committee of Public Accounts: 46th Report, 1997-98, HC 472, *The Contract to Develop and Update the Replacement National Insurance Recording System*
² *Standardisation of PFI contracts (HM Treasury July 1999)*

6 Examples of contractors' thoughts on performance criteria and performance review processes

<p>Bay Community National Health Service Trust</p> <p><i>They work very well</i></p> <p>'It is a vigorous system which highlights problems and precludes continued non-conformity with the agreed standards identified in the concession agreement.'</p>	<p>National Savings</p> <p><i>They work very well</i></p> <p>'National Savings and Siemens teams work very closely together on a daily basis. Process includes "lessons learnt" as standard practice, and work is focussing on improving service. Breaches are reviewed fully in joint sessions.'</p>	<p>South Manchester University Hospital National Health Service Trust</p> <p><i>They are satisfactory</i></p> <p>'Some of the payment calculation formulae in the contract are complex and unwieldy. However, despite these problems, effective joint working and a good relationship help to apply the principles of the processes satisfactorily.'</p>
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Source: National Audit Office survey of contractors

associated performance deduction system should not be too complex as this can lead to disputes. The performance measurement system should consist of output measures, and, where appropriate and practical, include surveys of the users of the services provided.

on one contract to £5.6 million on the Ministry of Work and Pensions' PRIME project. Deductions made in the second year of the PRIME project were lower than in the first suggesting that the performance regime was having the desired impact on improving performance.

Most authorities said they had clear quality of service mechanisms

- 1.20 96 per cent of authorities indicated that their contracts included clearly defined performance levels with associated information requirements for judging performance. 94 per cent indicated that the methodology for calculating payments including performance deductions was clearly defined, and 89 per cent said they had agreed performance review processes. 56 per cent of authorities told us that they assessed the level of user satisfaction with the services their contractors were providing.
- 1.21 Contractors generally considered that the mechanisms worked well: 54 per cent thought the mechanisms worked well or better, 43 per cent thought them to be satisfactory, and only 3 per cent considered them to be poor. **Figure 6** shows examples of contractors' thoughts on performance criteria and performance review processes.

- 1.23 64 per cent of authorities told us that they had learnt lessons from the performance review process and over half of these told us that they had implemented changes as a result. Our survey also showed that 60 per cent of contractors have also learnt how to improve the service they provide through these processes. Examples of lessons learnt and changes implemented are shown in **Figure 7**.

Value for money mechanisms are needed

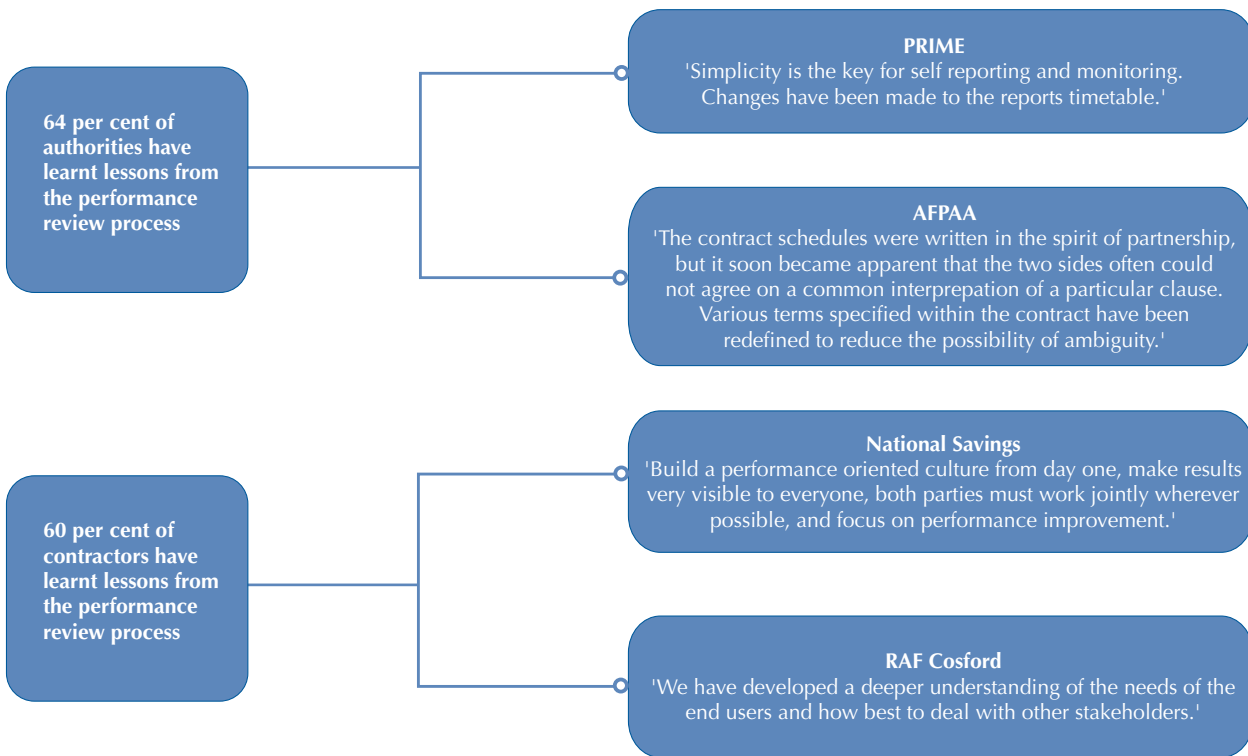
- 1.24 Although authorities should ensure that they obtain competitive prices by holding well run competitions, they will take additional comfort if there are contractual means for maintaining value for money during the contract period. For example, authorities will wish to ensure that the price they have agreed to pay in future years will not be in excess of future market prices for such services. Authorities can do this through benchmarking services, both in terms of price and quality, against market comparators, or through market testing. Where it is not possible to market test for new services, the authority and contractor need to have an agreed pricing system set out in the contract. Many contracts include value for money mechanisms (**Figure 8**) in line with the Treasury's Standard PFI contract terms.³
- 1.25 Profit and other gain sharing mechanisms can incentivise contractors to reduce costs to the authority, and allow the authority to share in profits made by the contractor through third party business generated by the deal. Such mechanisms may allow the authority to share in any profits above a certain defined level. A particular example where such gains may arise is where a project is refinanced.

Lessons are being learned from performance review processes

- 1.22 A normal feature of PFI contracts is that the authority will be entitled to reduce the payments due to the contractor if the contractor's performance falls below certain contractually defined standards. The amounts that can be deducted will vary depending on the extent of the shortfall in performance. 58 per cent of authorities who had an agreed performance and performance deduction review process told us they had made performance deductions in accordance with those processes. 25 authorities told us that they had made deductions totalling £10.3 million, ranging from £1,000

3 Standardisation of PFI Contracts (HM Treasury July 1999)

7 Lessons learnt from performance reviews



Source: National Audit Office survey of authorities and contractors

1.26 Any mechanism for profit sharing will require the contractor to supply relevant financial information to the authority. The inclusion of open book accounting will help to ensure that these value for money mechanisms are working as they should. It will also give the authority a greater understanding of the contractor's cost drivers and the impact on its profitability of authority actions or any changes made to the contract.

Around half of authorities have benchmarking mechanisms in their contracts

1.27 To date only eight of the 54 authorities who said they can use benchmarking to assess the value for money of the services they receive, have made use of it. This is because it is often a requirement that contracts should run for a number of years before benchmarking is used. Some found benchmarking difficult to use. Either few comparable services existed or it was not easy to find robust comparative data. Authorities need to consider how they can find comparative data when planning to include benchmarking as a value for money mechanism in contracts.

1.28 Benchmarking can be useful in setting prices for new services where contracts include pricing systems for the provision of new services. Each side needs to understand such systems and agree on how they will be interpreted.

Authorities have already benefited from gain sharing mechanisms

1.29 More than half of the 43 per cent of authorities which included profit and other gain sharing mechanisms in their contracts have already benefited from them. Mechanisms used have enabled authorities to share profits on third party revenue, profits over a defined threshold, facility management efficiency savings, unspent redundancy provisions, and property development gains. A notable example of profit sharing mechanisms being used has been the PRIME deal where the authority has secured about £30 million from these arrangements.

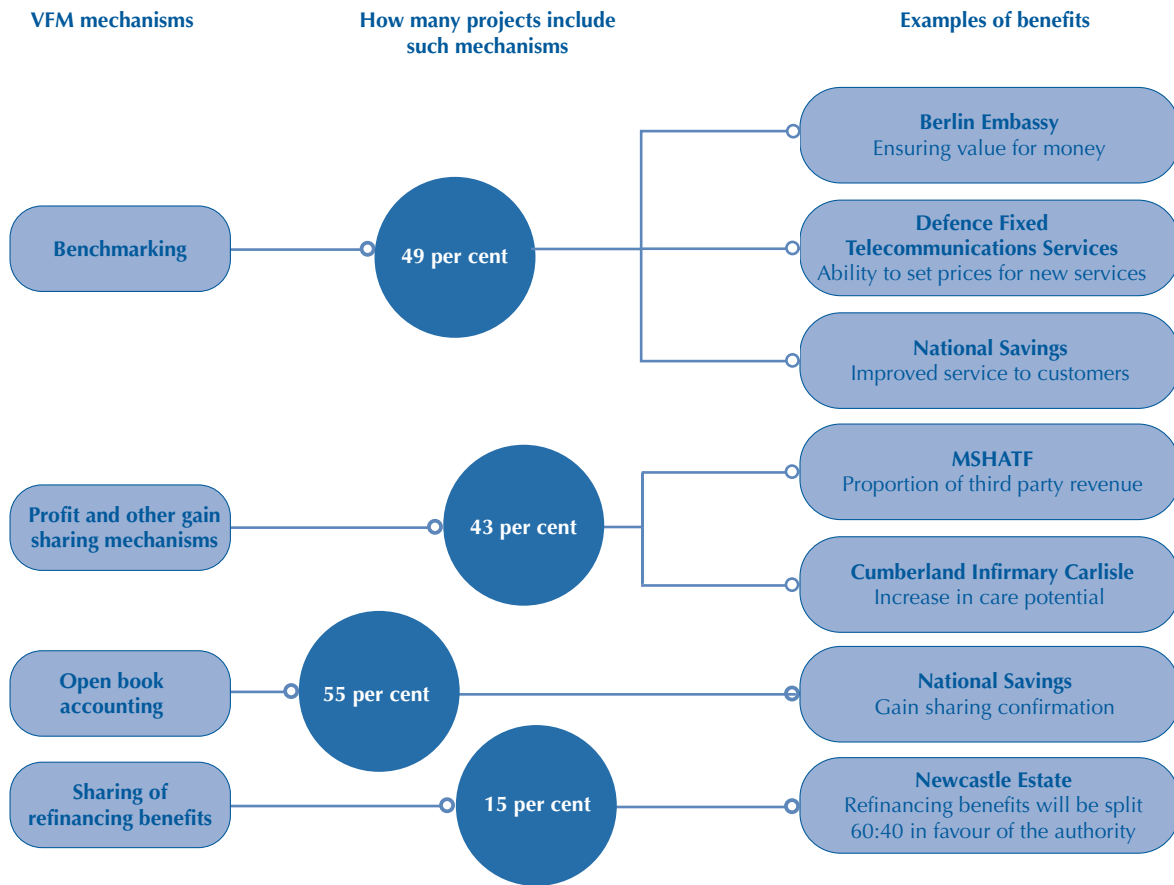
But few authorities have rights to share in refinancing benefits

1.30 As was highlighted in our report on the refinancing of the Fazakerley PFI prison contract⁴, and the subsequent report by the Committee of Public Accounts⁵, the perceived value for money of a project can be affected if a contractor receives significant windfall gains as a result of refinancing a PFI project. Only 15 per cent of authorities, however, told us that they had the right to share in refinancing benefits. Other authorities may, nevertheless, have other contractual rights which could enable them to negotiate over sharing refinancing gains. This was the case in the refinancing of the Fazakerley prison project where the

4 The National Audit Office's report on the refinancing of the Fazakerley prison PFI contract HC584 (1999-2000)

5 Committee of Public Accounts: 13th Report, 2000-01, HC 372, The Refinancing of the Fazakerley PFI prison contract

8 Examples of the benefits derived from VFM mechanisms



Source: National Audit Office survey of authorities

Prison Service had the right to approve the increase in its termination liabilities arising from the proposed refinancing. This gave it an opportunity to negotiate a share of the contractor's refinancing gains.

1.31 Guidance on refinancing in the Treasury's Standardisation of PFI contracts published in 1999 said authorities should seek a share of refinancing gains only in limited circumstances. Following the recommendations of the Committee of Public Accounts the Office of Government Commerce is preparing revised guidance, which is likely to recommend that refinancings should always be subject to authority consent and that contracts should give authorities approval rights over refinancings and contain provisions on sharing gains.

1.32 55 per cent of the contracts we surveyed had provisions for open book accounting. As well as helping authorities to understand the contractor's financial position and determining the outcome of any profit sharing arrangements, open book accounting can also enable an authority to work in a collaborative manner with its contractor. For example, National Savings takes care, when planning a marketing campaign, to time it to run

when there is a trough in Siemens' workload so as to even out Siemens' costs.

1.33 Open book accounting could also help a contractor to draw to the attention of an authority any problems to which the contractor believes the authority has contributed. For example, one contractor told us that it had incurred additional costs because the authority had ordered a new service but did not deliver sufficient users of the service to generate the expected additional revenues for the contractor to offset the costs of developing the service. Another contractor said the authority sometimes asked for a new service to be developed but then changed its mind.

Contracts must also provide for dispute resolution

1.34 Authorities and contractors will generally wish to avoid going through the courts to settle any disputes arising under a PFI contract. Dispute resolution procedures are often more efficient and cost effective. Dispute resolution procedures generally involve four stages: (i) internal

resolution between the authority and contractor; if this fails, (ii) provision for independent expert resolution; and, if either party disagrees with the expert's decision, (iii) provision for the dispute to go to arbitration; or (iv) to the courts for a final and binding decision.

Disputes most frequently arise over interpretation of the contract

1.35 **Figure 9** shows that the most frequent reason for disputes is over the interpretation of the contract. This may indicate that the pressure in place to reach a deal is such that authorities and contractors agree contracts without reaching a clear mutually agreed understanding of how certain issues covered by the contract should be dealt with.

Most disputes have been resolved by governance procedures

1.36 The dispute arrangements that authorities and contractors have put in place are working such that no authorities in our survey reported disputes which had gone to court for resolution. Only nine of the authorities surveyed had gone through the formal dispute resolution procedures. All other disagreements had been resolved by arrangements, known as governance procedures, which set out how the authority and contractor will deal with matters relating to the contract.

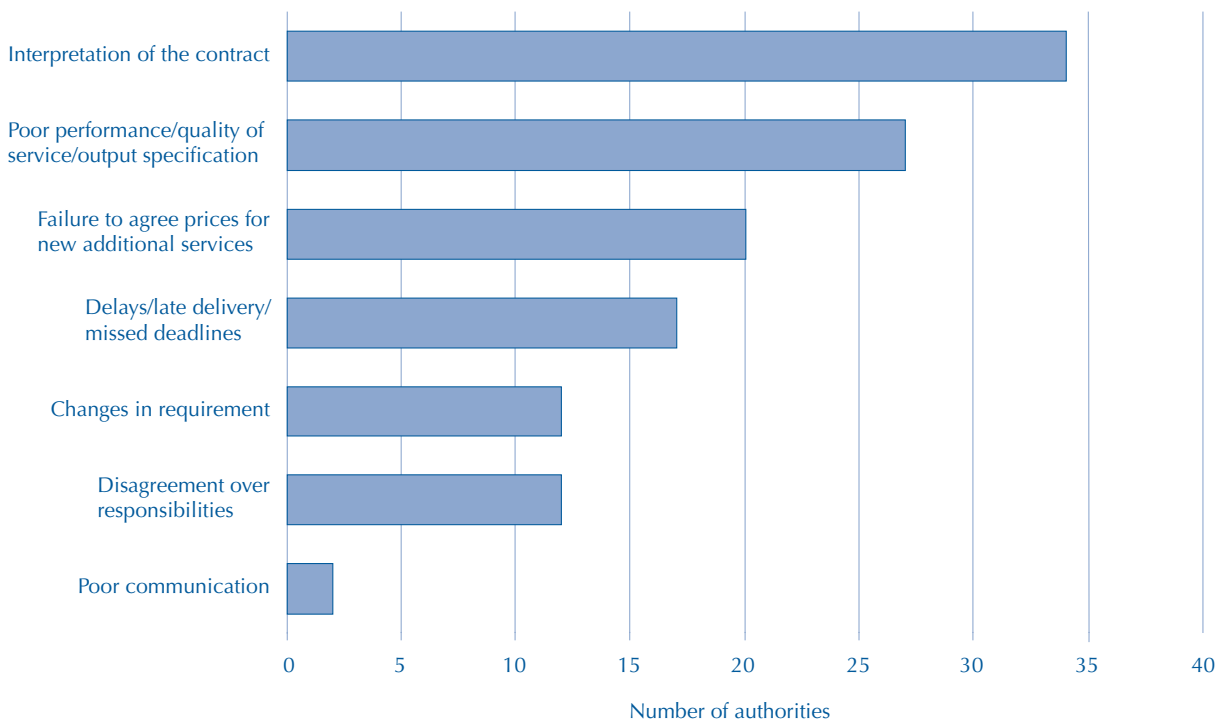
Change procedures are important

1.37 As PFI contracts are generally of a long term nature, the service requirement which is set out in the contract should take into account not only the authority's current requirements but also its future ones, to the extent that these are identifiable and quantifiable. Over the life of a PFI contract, however, not all possible changes, whether in the authority's requirements or the contractor's methods of delivering those requirements, can be foreseen. Relationships are dynamic so contracts should be capable of change, and change should be accepted as a normal and necessary part of a major programme rather than a sign of failure. The contract should, therefore, contain a mechanism by which changes may be proposed by either party and evaluated and approved prior to implementation. That evaluation should also consider the impact of change on the value for money of the deal, how the change will be priced and how costs and savings should be apportioned.

Change procedures have already been used in many contracts

1.38 A high proportion of authorities (89 per cent) said their contracts included procedures for dealing with change. Although most PFI contracts have not been in existence for long, 55 per cent of these authorities have already used the change procedures to update their contracts. Most of the changes made relate to changes in services, the

9 Main reasons for disputes



Source: National Audit Office survey of authorities

introduction of new services, and additional works and changes to the design of buildings. The fact that so many changes have already been made indicates the importance of including agreed change procedures in the contract. Using the experience of early PFI projects to get the initial procurement right may help to reduce the need for contract changes on future projects although some changes are still likely to arise. Of the contractors who indicated their degree of satisfaction with the change procedures, 82 per cent considered they worked satisfactorily or better but 18 per cent considered that they worked poorly or worse.

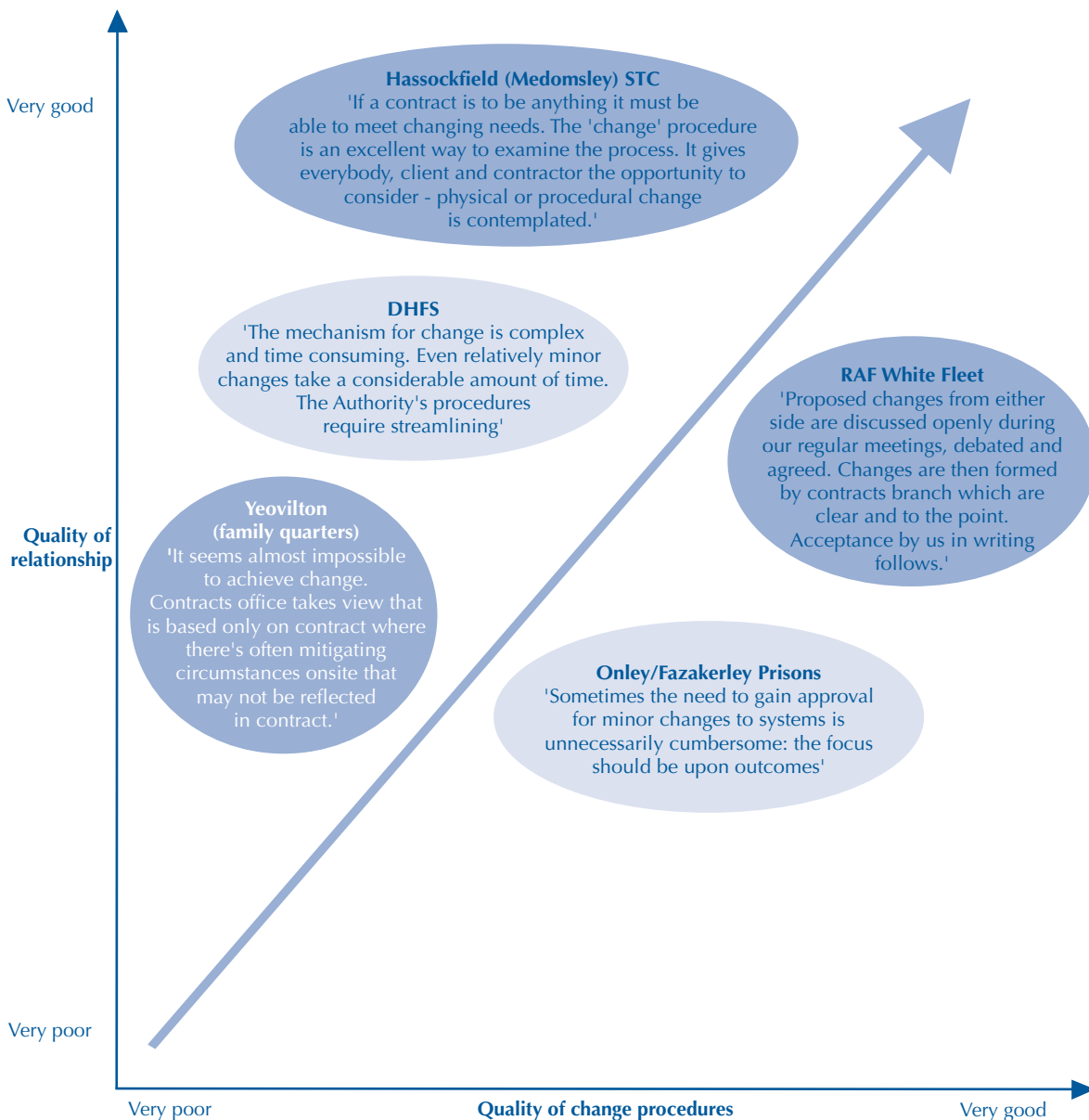
protect their interests arising from change by contractual arrangements which set out the basis of how new services would be charged for or which allowed the prices of new services to be benchmarked. Perceived high charges for additional services were, however, an issue which some authorities said had caused them to reassess the value for money of their contract. Given the long term nature of PFI contracts, authorities should ensure that they have change procedures which give them the flexibility to introduce new services where this will be advantageous but which will also ensure that such additional services will be value for money.

1.39 Once the contracted services have been brought into operation greater focus is often then given to considering the possible introduction of new services, particularly in the field of information technology and communications, where the market frequently develops new products. A number of authorities had sought to

Good change procedures help the relationship

1.40 Our analysis shows that there is a strong correlation between the quality of change procedures and the relationship between authorities and contractors. This is demonstrated at **Figure 10**.

10 Good change procedures have a positive effect on the relationship



Source: National Audit Office survey of contractors

Taking advantage of new technology may be an important consideration

1.41 New forms of service delivery are likely to emerge during the contract period, particularly in fast changing sectors such as communications and information technology. Authorities such as the Ministry of Defence (**Figure 11**) have found that change procedures greatly assist the introduction of new services and that lessons have been learnt in seeking to use these procedures.

Termination and re-tendering arrangements are needed

1.42 Although the intention of the authority and contractor should be that the contract runs its full course, the contract must, as recognised in Treasury guidance⁶, deal comprehensively with events for which the contract may be terminated and the consequences of early termination. The contract should specify precisely the levels of compensation payable by either party depending on the reasons for early termination. Our survey did not identify any PFI contracts which had been terminated early.

1.43 The contract should also specify certain matters after the contract has run its full term. Such matters may include the quality of the assets to be transferred to the authority, the treatment of intellectual property rights, and the arrangements for re-tendering the contract if appropriate.

11 Example of the importance of change procedures

The contract for the Defence Fixed Telecommunications Service

In July 1997, the Ministry of Defence let a ten year contract to BT for the provision of a new Defence Fixed Telecommunications Service for the whole of the Department including the three Armed Services.

Contracts for telecommunications and information technology carry risks because these markets are subject to rapid technological changes and purchasers may want new forms of service delivery. In view of these concerns, the Department required BT and other bidders for this contract to consider future changes and to incorporate in their proposals the ability to expand and to include new services and types of technology. Working arrangements were also put in place to enable the Department and BT to meet regularly to consider jointly whether service changes are desirable throughout the contract period.

Since the letting of the contract, and the subsequent introduction of the new Defence Fixed Telecommunications Service, the Department has been placing much greater emphasis on exploring with BT how business benefit can be derived by exploiting emerging technologies under the terms of the contract. This is now the main area of discussion between the Department and BT. New services which have been introduced include the Internet Gateway Service, the Managed Public Switched Telephone Network Service, and the Managed Electronic Directory Service, and others are under consideration.

Although the Department and BT had established in their PFI contract procedures for dealing with change they have both learned lessons in seeking to apply these procedures. The main lessons have been:

- The need for robust procedures to demonstrate value for money in a non competitive environment.
- The need to agree jointly at a very early stage the precise meaning of terms such as cost, price, fair business return and value for money.
- The requirement for a thorough and shared view of the risk involved in new business, particularly in a demand led environment.
- The need for the Department to keep in view the totality of the deal when negotiating small value service additions.
- The need for the Department to understand that the management overhead of bringing new business onto contract must be in proportion to the value of the business to both parties.

Source: National Audit Office survey of authorities and contractors

Part 2

Authorities need the right skills mix at the right time

2.1 To build a successful long term partnership with PFI contractors authorities will need trained staff with relevant skills. The skills needed may vary at different stages in the life of the project. As authorities have, to date, only limited experience of the contract management phase of PFI projects emphasis needs to be placed on identifying and developing the skills which are needed for this important role.

Authorities need to consider the different skills required

2.2 To manage effectively a long term PFI contract authorities will need staff with the following skills: a thorough understanding of the project; familiarity with the contractual terms and how they are supposed to operate; good communication skills; and good relationship skills.

2.3 Authorities will need to give careful thought while the project is being developed about the staff they will deploy to manage the contract after it has been let and the skills those staff will require. Where possible, it will be advantageous to have staff continuity between contract procurement and contract management although this may often be difficult to achieve in practice.

2.4 The skills required will differ during the two distinct phases of the project after contract letting: design and build, and the provision of services. The authority may also find that it needs to employ more staff during the early stages of the project when problems are more likely to occur.

2.5 The project manager needs to have clear delegated authority and be supported by other staff with the necessary skills to manage the relationship. The number of such staff will depend on the size of the deal. In addition, the authority may choose to establish a distinct contract management unit responsible for all of its PFI contracts.

Authorities mostly consider they have sufficient staff with the right skills

2.6 71 per cent of authorities with projects at the design and build stage and 82 per cent of authorities with projects at the provision of services stage considered they employed sufficient staff within their contract management teams.

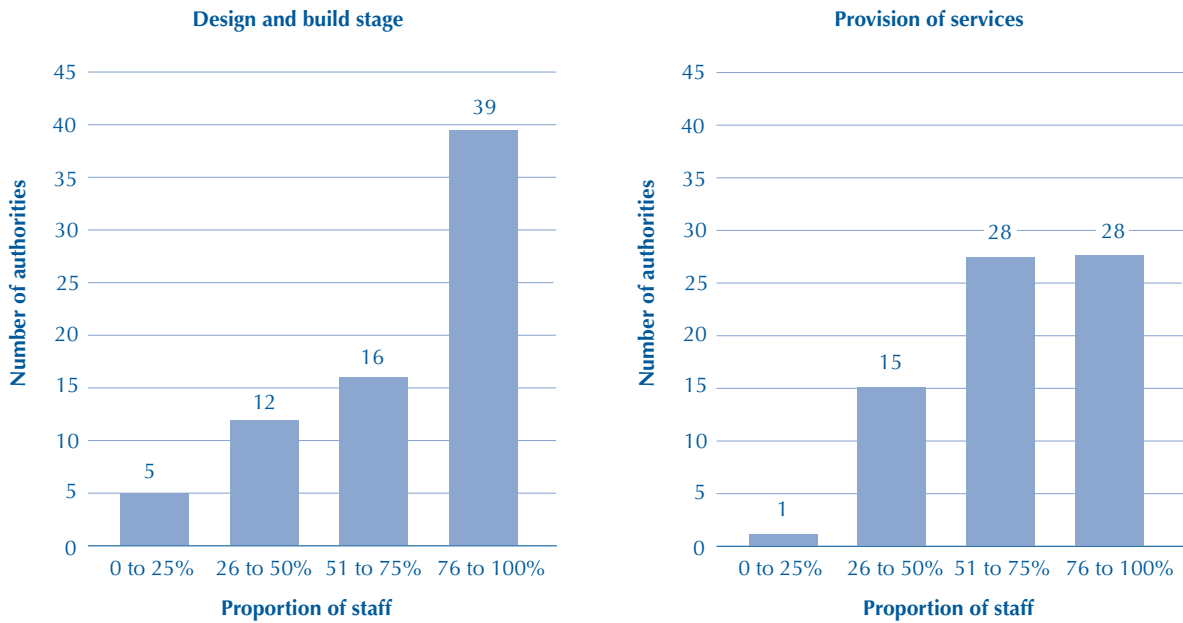
2.7 Similar proportions (55 out of 72 authorities at the design and build stage and 56 out of 72 authorities at the provision of services stage) considered that more than half of the staff within their contract management teams had experience and appropriate skills (**Figure 12 overleaf**).

Training for contract management staff, however, varies considerably

2.8 Given the range of skills required for effective contract management and that, as yet, authorities have had only limited experience of managing PFI contracts, relevant training becomes very important. The results of our survey show, however, that although a high proportion of authorities thought that most of their contract management staff had the right skills, the amount of training that authorities give their staff varies considerably. **Figure 13 (overleaf)** shows two projects where the authorities have invested in significant levels of training in contract management. There were, however, many authorities which had provided little or no training in contract management skills either before staff took on contract management duties or in the form of follow-up training.

2.9 Contract management manuals can be useful, particularly to assist the training of new staff. Although only a minority of authorities had produced such manuals, our survey showed that authorities and contractors were more likely to view their relationship as very good where authority staff had been able to follow guidance set out in contract management manuals.

12 Proportion of their contract management team that authorities thought had experience and appropriate skills



NOTE

72 authorities responded to this question

Source: National Audit Office survey of authorities

Staff continuity is desirable but may be difficult to achieve

2.10 Ideally the project manager who procured the deal should also manage the contract. In some situations, however, staff continuity may be difficult to achieve. The experience of authority staff who have managed a PFI procurement is a valuable resource. They may, quite reasonably, be asked to put that experience to good effect by transferring to another public sector PFI procurement team. Or, they may find that their skills are marketable and seek employment outside the public sector⁷.

2.11 Our survey showed that 47 per cent of authorities transferred less than a quarter of the staff employed on the contract procurement team to the contract management team. Only 14 per cent of authorities transferred more than three quarters of staff with experience of the project (Figure 14).

2.12 A number of authorities and contractors said they had experienced problems because of the lack of staff continuity within contract management teams. Examples are shown in Figure 15. Because there is a risk that staff will leave the project after the procurement phase, authorities

should develop plans for staff succession. Authorities will also similarly wish to see that contractors have succession planning in place so that the relationship is not hampered if their most important staff leave a project.

13 Examples of significant training given by authorities

PRIME

'We fund external training for contract management staff to pursue relevant qualifications. We also research other external and internal provisions of suitable training on a regular basis. All individual training is subject to a full review in accordance with Investors in People to ensure that it is appropriate and sufficient to meet the needs of the business and the individual.'

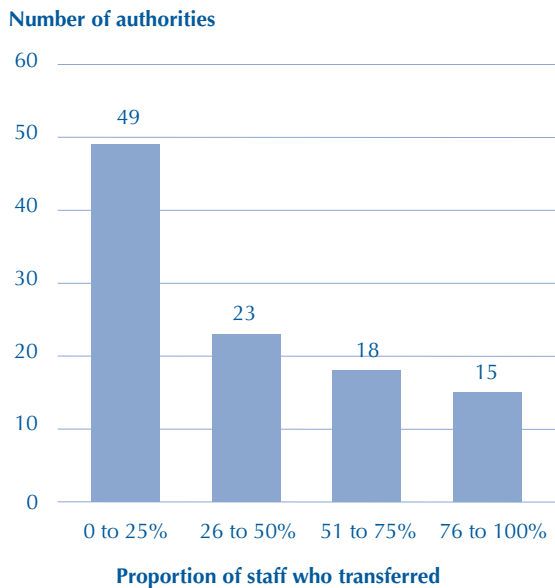
Newcastle Estate

'Introductory contract management training is provided; also on the job guidelines and instructions from colleagues. There is a modular approach to development in areas such as negotiation, finance, IT with opportunities to work towards competence and professional qualifications.'

Source: National Audit Office survey of authorities

⁷ Authorities should have regard to the rules and related guidance for Departments and Agencies on the acceptance of outside appointments by Crown Servants.

14 Proportion of staff employed on the contract procurement team who transferred to the contract management team



NOTE

105 authorities responded to this question.

Source: National Audit Office survey of authorities

Skills need to be fully developed and kept up to date

2.13 Authorities will need to ensure that staff employed in managing the relationship are doing so in accordance with PFI principles and in a manner which supports partnership working. This can be done through ascertaining best practice, having access to the latest guidance and providing follow up training. The procurement units, including those covering PFI, of the major departments have an important role to play in disseminating best practice.

Staff performing duties well contribute to a good relationship

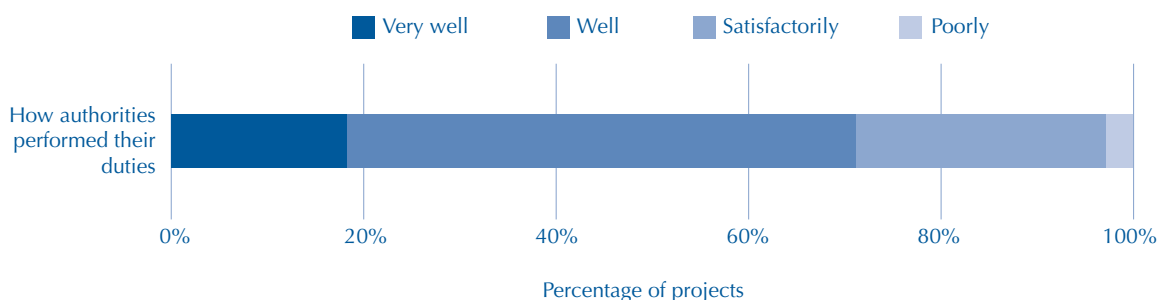
2.14 71 per cent of contractors consider that authorities' staff performed their duties well or better. Where staff are performing their duties well there tends to be a good relationship between the authority and contractor (Figures 16 and 17 overleaf).

15 The impact of lack of staff continuity

Contractor's perspective of authority staff turnover	Authorities perspective of contractor staff turnover
<p>South Manchester University Hospital National Health Service Trust</p> <p>'When good relationships are formed with key NHS Trust staff, and they are fully conversant with all aspects of the deal, it is frustrating when they move on and are replaced by new people who have to start from scratch.'</p>	<p>North Staffs Combined Healthcare National Health Service Trust</p> <p>'There have been several changes in the contractor's senior staff since financial close and this has caused some difficulty'.</p>

Source: National Audit Office Survey of authorities and contractors

16 Over two-thirds of contractors consider that authorities' staff performed their duties well or better



Source: National Audit Office survey of contractors

Authorities would like further guidance

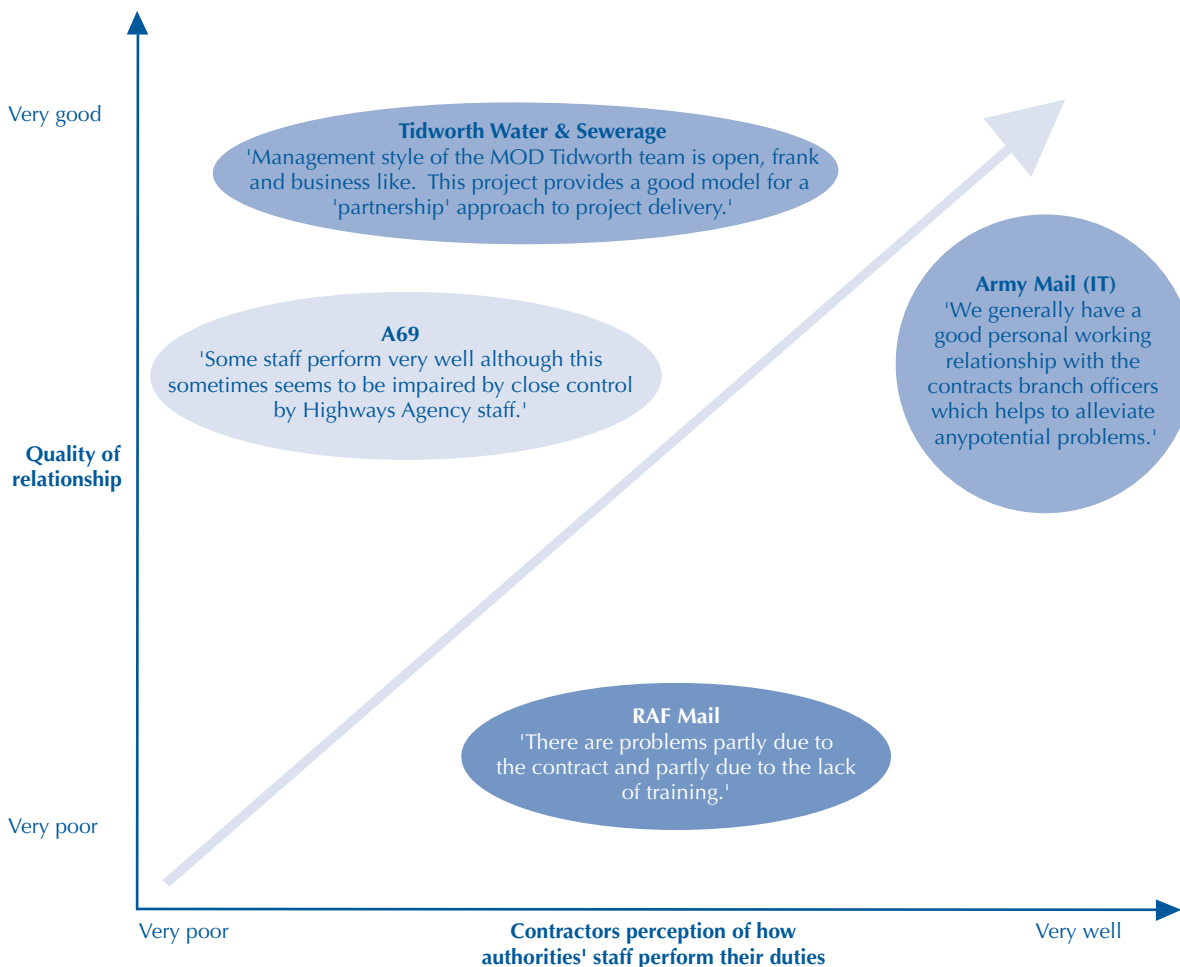
- 2.15 Authorities will not have all the expertise necessary to design and procure a PFI project in house, and are unlikely to have all the necessary skills for managing the relationship. Authorities have sought advice, often from external advisers, on areas such as legal and financial issues, contract management, and performance monitoring.
- 2.16 Authorities consider that the Office of Government Commerce would be the best central body to provide best practice guidance on managing relationships with PFI contractors. The major areas on which authorities would like more central guidance include contract management, performance measurement, payment mechanisms, change procedures, legal issues, and achieving and maintaining value for money. There is existing Treasury Taskforce guidance, 'How to Manage the Delivery of Long Term PFI contracts', and the Office of Government Commerce has issued guidance, 'How Major Service Contracts Go Wrong', which highlights how important it is to manage the relationship with suppliers. The Office of Government Commerce is also:

considering commissioning the development of further contract management guidance based on its own feedback from departments, updating the standardisation of PFI contracts guidance and developing a PFI practitioner skills module to form part of the wider skills framework for government procurement. In addition, its Gateway review process will be used to monitor how contracts are being managed and to identify areas where guidance needs updating.

Authorities' commercial awareness needs to be improved

- 2.17 Although many contractors thought that authorities' staff were performing their duties well, 37 per cent of contractors indicated that authorities' contract management teams could benefit from training in specific areas. In particular, they highlighted the need for authorities to understand the operations of commercial organisations (**Figure 18 overleaf**). They suggested that authority staff should be seconded to commercial organisations to gain a greater

17 Staff performing duties well contribute to a good relationship



Source: National Audit Office survey of contractors

18 Contractors' views on where authorities' commercial awareness could be improved

Defence Fixed Telecommunications Service

'For new staff it would be beneficial for them to have understanding of business management, management accounting and managing PFI contracts'.

Royal Parks Agency (Note 1)

'Greater understanding of the need for a PFI partner to, at least recoup capital invested'.

German White Fleet

'Contracts administrators need more commercial training, and specialisation within sectors, eg logistics or transport. This will enable them to understand the contractor and the nature of the service provided'.

National Insurance Recording System 2

'Increased awareness of the operations of a commercial organisation, either through specific training or work placements with a commercial organisation'.

NOTE

1. Since our survey, there have been significant management changes within the Royal Parks Agency resulting in a marked increase in commercial awareness. The Agency considers there was a need for all parties to understand better the transfer of risk in PRI projects.

Source: National Audit Office survey of contractors

understanding of how they work. Authorities could also benefit from exchanges of staff between authorities to gain experience of how others manage their relationships. There may also be benefits to the private sector through secondments to the public sector to gain a fuller understanding of how it works.

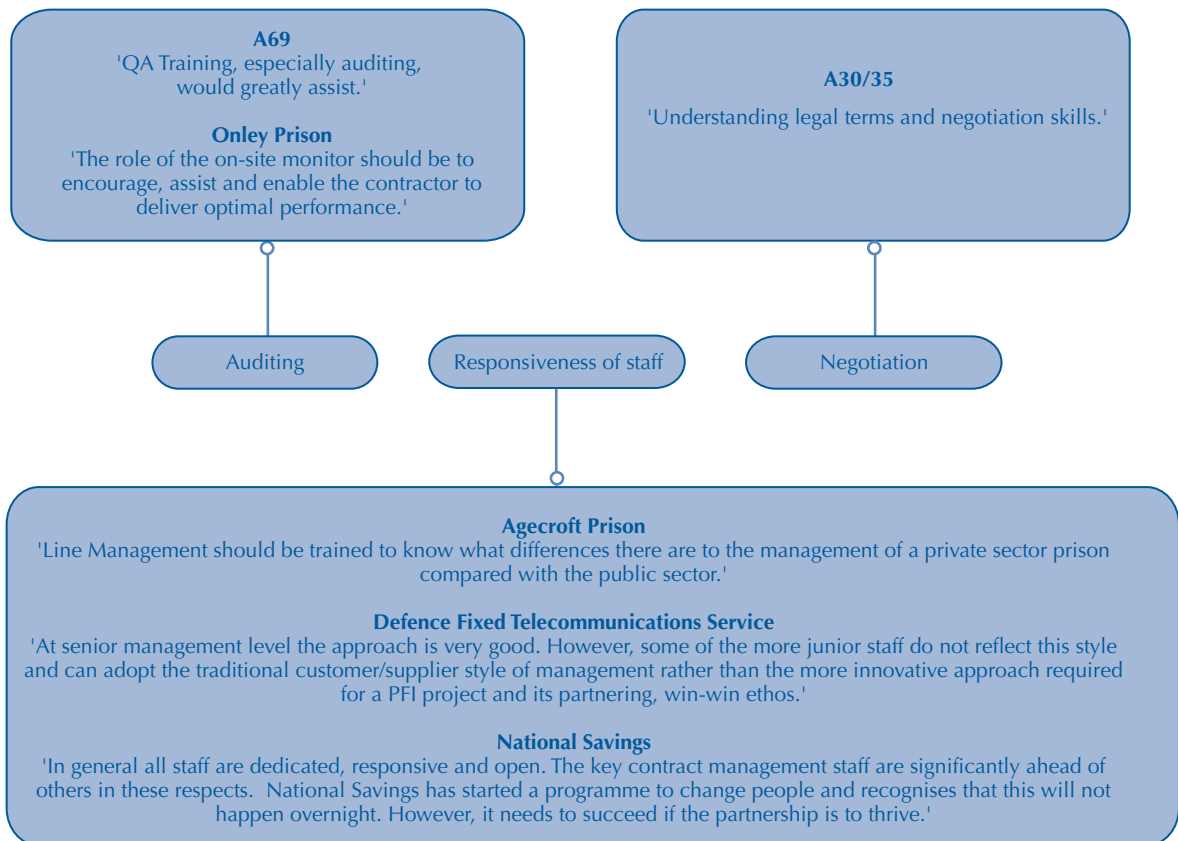
Authorities' skills could also be improved in other areas

2.18 **Figure 19** shows examples of where contractors think authorities need to make further improvements in their staffs' skills in areas such as auditing, negotiation and the responsiveness of their staff.

Authorities' staff can learn through dissemination of best practice

2.19 Only 27 per cent of authorities indicated that the department to which they belonged evaluates best practice in every contract. Where such an evaluation does take place, however, 90 per cent of departments disseminate this evaluation of best practice among its authorities.

19 Contractors' views on where additional skills would be helpful



Source: National Audit Office survey of contractors

20 How departments' PFI units meet their aims

Through the development and dissemination of guidance

Ministry of Defence

'MOD has set in place a joint working group with the CBI to allow partnering issues to be debated and guidelines to be produced and has made PFI teams aware of Treasury Guidance.'

Department of Trade and Industry

'Ensures that all relevant individuals are aware of the latest guidance on managing PFI contracts and receive appropriate training.'

National Assembly for Wales

'It is establishing a dedicated PPP/PFI web-site to increase accessibility to the latest guidance and project information with links to other relevant departments.'

Department for Transport, Local Government and the Regions

'The Private Finance Unit is responsible for disseminating good practice guidance, and responding to queries raised by project teams, and seeing that projects have access to high quality advice under a framework contract.'

Through involvement of the private sector

Ministry of Defence

'Sponsored PFI and partnering courses for project teams. The partnering course is open to the private sector.'

National Assembly for Wales

'The Assembly ensures regular contact with PFI players within the private sector, involving them in consultations, sharing feedback and information and encouraging the development of their relationships with authorities.'

Her Majesty's Prison Service

'It is maintaining continuous contact with its private sector partners; regularly solving problems with them; and engaging in two way exchange of important/technical information.'

Source: National Audit Office Survey

- 2.20 Authorities considered the most important areas on which to disseminate best practice were: commercial partnership issues, trust, developing business cases for new IT spend, monitoring procedures, the use of technical, legal and financial advisers, and production of output specifications.
- 2.21 42 per cent of authorities indicated that they disseminated best practice to other authorities or departments. They did this principally through speaking at seminars and conferences, meetings and visits, writing articles for magazines, and informal contacts. The Office of Government Commerce could contribute to the dissemination of good practice by hosting workshops and other events for staff from all departments involved in managing PFI contracts. The CBI and the Business Services Association told us it would be helpful if private sector companies were involved with such workshops, partly as a learning process for the private sector and partly to allow the public sector to absorb private sector experience and ideas on good practice.

Departments' PFI units are playing a major role in the learning process

- 2.22 The aim of departments' PFI units is to ensure that authorities' project teams effectively manage their relationships so that project objectives can be attained. They seek to achieve their aims through the dissemination of guidance and through the involvement of the private sector (Figure 20). Procurement units within departments also have similar aims.
- 2.23 Her Majesty's Prison Service and the Highways Agency are in a good position to disseminate best practice between their project managers as they serially procure projects. In the Prison Service contract managers are co-located and it is therefore easier to discuss and resolve problems. Within the Highways Agency, regional management staff attend regular contract co-ordination group meetings where common issues are debated and policies are determined. The Agency encourages managers to discuss individual contract problems and issues within this peer group.
- 2.24 The National Health Service, unlike the Prison Service and the Highways Agency, does not procure projects centrally. Individual trusts procure projects and their staff will probably only undertake one major PFI transaction. Thus every new transaction has a very steep learning curve for the individual trusts concerned. The NHS Private Finance Unit feels that it can get best results from trusts through advising them and their advisers on what is acceptable within an NHS PFI project, including standard contract terms, to ensure they spend as little time as possible reinventing the wheel. The Unit will be issuing to Trusts guidance on standard payment mechanisms and output specifications. The Unit also provides input to regular meetings of PFI project managers enabling contract management and other PFI issues to be discussed.

Contractors are able to learn from projects with different authorities

- 2.25 Those contractors with contracts with authorities from different departments will have a good perspective of what does and does not work well to bring about a good relationship. Contractors said they thought there was considerable scope for authorities to learn more about PFI issues, and to compare alternative approaches, by sharing experiences. This reinforces the view that the Office of Government Commerce should facilitate forums that enable authorities to network and to learn from each other.

Part 3

The partnership framework must be made to work in practice

3.1 Even with the right contractual framework a successful partnership between authority and PFI contractor will only be achieved if the framework is made to work in practice. This will require roles and responsibilities to be clearly defined, good communications, opportunities for innovation, and procedures for reviewing the relationship so that improvements can be identified.

Roles and responsibilities must be clearly defined

3.2 A good relationship is one where both sides are open, share information fully and work together to solve problems. To achieve this end, roles and responsibilities need to be clearly defined to minimise conflict, confusion and potential disputes. The governance arrangements for the contract - the system of joint working and responsibility for running the contract - should cover arrangements for discussing performance and service improvement, change, business and strategic development and the resolution of disputes. Where an authority and a contractor have established integrated project teams they should have appropriate representation at all levels and agreed terms of reference.

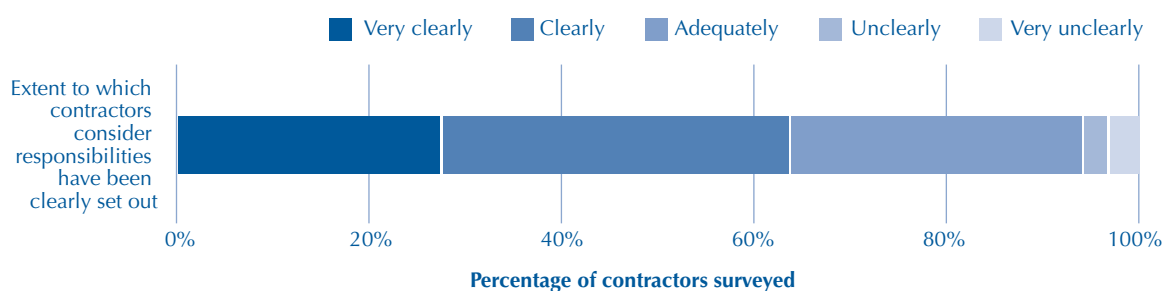
Roles and responsibilities have generally been clearly set out

3.3 **Figure 21** shows that 64 per cent of contractors thought that roles and responsibilities were more than adequately set out. There is a strong correlation between the quality of the relationship and how well the roles and responsibilities of authorities and contractors have been set out. Examples of the impact that contractors consider the clarity of roles and responsibilities can have on a relationship are set out in **Figure 22**.

Governance arrangements are working well

3.4 The arrangements for monitoring the long term contract and any changes to it are crucial if a partnership is to continue to deliver the services required. These arrangements, known as a governance system, usually comprise a number of groups of both authority and contract staff, with clear responsibilities for running the contract. The groups meet regularly to deal with issues relating to their area of responsibility. All authorities indicated that they employed a governance structure. **Figure 23** shows what has been included within governance arrangements.

21 Roles and responsibilities have mostly been more than adequately set out



Source: National Audit Office survey of contractors

22 Clarity in roles or responsibilities helps a relationship

How clearly set out roles and responsibilities have helped the relationship

National Savings

'Clarity has reduced the incidences of conflict and misunderstanding.'

Computer Services for Academic Research

'The clarity in the roles has had a positive effect, there being little or no confusion over responsibilities between all the parties concerned.'

How unclearly set out roles and responsibilities hinder the relationship

National Insurance Recording System 2 (before contract addendum)

'Contractor's direct responsibilities were reasonably clear. What was not clear were responsibilities retained by the authority. This led to considerable confusion around business implementation and did not help the relationship.'

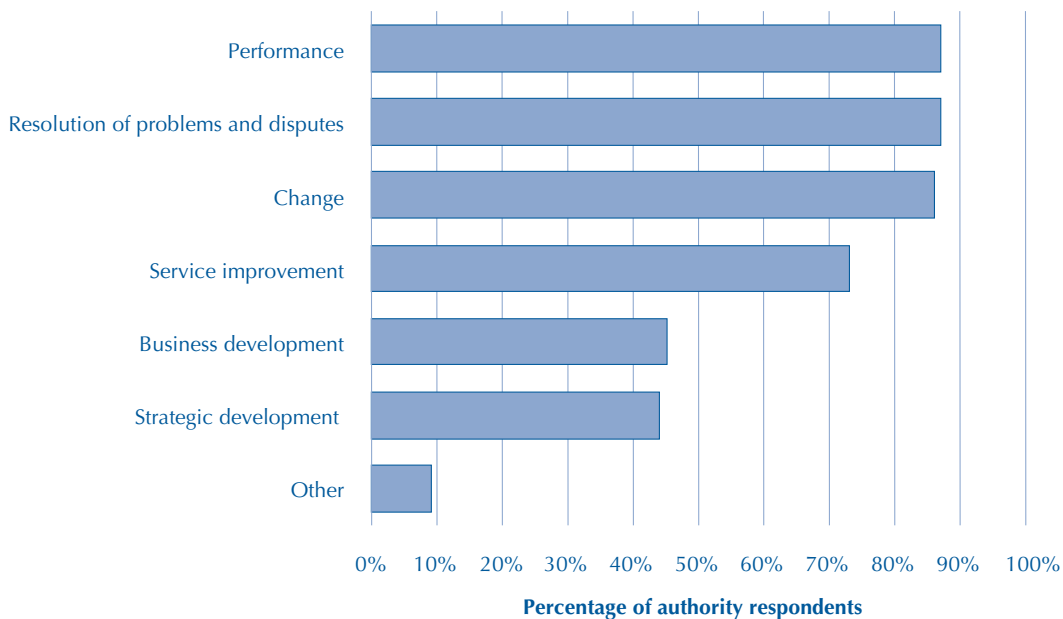
RAF Mail

'There has been continuous disagreement over roles and responsibilities and whether any costs are involved.'

Source: National Audit Office survey of contractors

3.5 67 per cent of authorities and 74 per cent of contractors consider that their project's governance arrangements are working well or better. Only four per cent of contractors thought they worked poorly. However, less than half of the governance arrangements considered business and strategic development. The business environment in contracts running for up to 30 years is unlikely to remain the same and there needs to be a forum in place to allow both parties to discuss business developments and to plan for future change.

23 Governance arrangements cover many events



Source: National Audit Office survey of authorities

There must be open communication

3.6 Maintaining open communications is key to ensuring that both parties continue to work in an effective manner. This will require good lines of communication to be established where both sides know who can make decisions and commitments. It does not preclude the informal communications which co-location of an authority and contractor's staff will encourage. Open communication is not just about lines of communication but also the ability of each partner to be open and honest with each other. This requires both sides to avoid seeking to blame each other for problems which arise. It also requires that each side should be open about all financial aspects of the project.

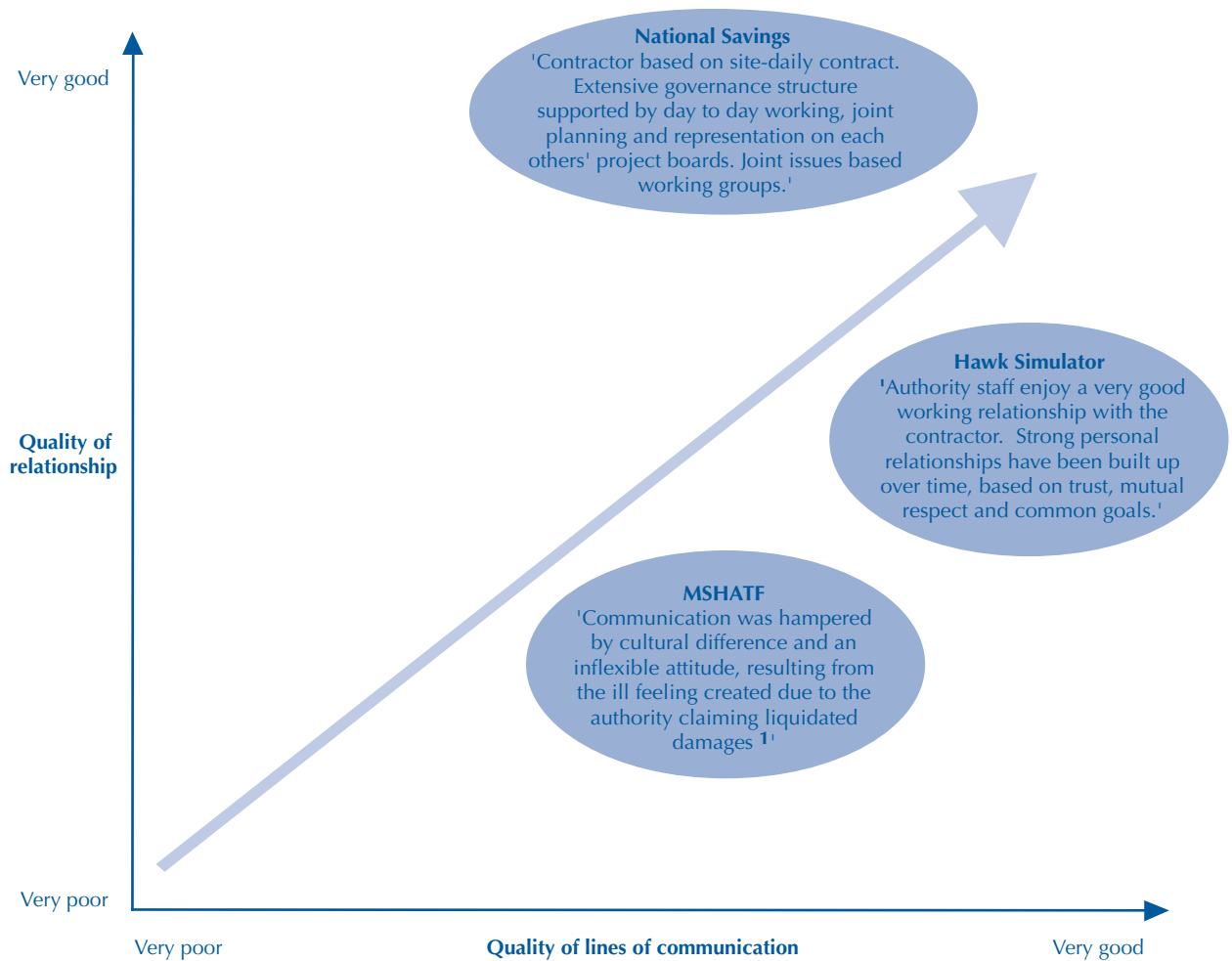
Those who have good lines of communication have a good relationship

3.7 Our survey results show that the quality of communications between authorities and contractors has a very significant influence on the quality of their relationship (**Figure 24**).

Co-location helps to improve communications

3.8 Co-location of the authority and contractor will improve lines of communication and should lead to problems being identified and dealt with earlier. **Figure 25** shows that co-location leads to a good relationship.

24 Good communication leads to a good relationship



NOTE

1. This comment relates to circumstances perceived to exist during the manufacture phase of the project. The project is now in its in-service phase and the Authority deals directly with the project company responsible for the service delivery at the RAF base. As a result, mutually agreed processes and procedures have been set up and communications have improved significantly.

Source: National Audit Office survey of authorities

There is an open and trustworthy environment on most PFI projects

3.9 The more open and honest authorities and contractors are with each other, the better their relationship will be. The relationship is less likely to be adversarial and the more likely it is that authority and contractor will work together to achieve a common goal. 89 per cent of the contractors surveyed considered that there was openness and honesty in their relationships with authorities most or all of the time. Relatively few contractors reported significant concerns about openness and honesty but, where they did, it was clear that such problems can seriously impair the relationship (Figure 26).

Authorities need to create scope for innovation

3.10 Innovation is recognised as a key factor which can contribute to better value for money in PFI solutions⁸. These opportunities are likely to be maximised when there is full scope for the private sector to develop innovative ways of delivering the outputs the authority requires. For this to be achieved, it is important that authorities ensure that any restrictions they may impose on innovation are justified. Over the life of a PFI project contractors also need to show continuous commitment to bringing innovation to the project.

25 Co-location leads to a good relationship

Good lines of communication

Army Mail

'Project is managed by a co-located joint authority/partnership team.'

Flying Training for University Air Squadrons

'Co-location of contractor and customer ensures daily contact and intimate partnership arrangements.'

OSIRIS

'We share the same accommodation and communication appears to be good.'

Scope for improving lines of communication

RAF Mail

'The contractor has been offered a desk at the authority premises, but has yet to take up the offer.'

TAFMIS

'Part of the problem with communication has been that the parties are not co-located despite offers from the authority.'¹

Defence Fixed Telecommunications Service

'Informal lines of communication exist, but these are hampered by the limited co-location of staff.'²

NOTES

1. Since completing our survey, the contractor to TAFMIS spends two days a week at the authority's site and the authority spends two days a week at the contractor's site.
2. Since completing our survey, the Defence Fixed Telecommunication Service has adopted an integrated management structure, with 91 BT staff colocated with MOD staff.

Source: National Audit Office survey of authorities

There has been innovation but it has often been limited

3.11 Some 70 per cent of contractors told us that they had at least fair scope to innovate in the contract (Figure 27). Some, however, said that their scope to innovate was constrained. For example, road contractors told us that road schemes were constrained by orders and commitments made at public enquiries and that, in their opinion, at the tender stage innovation is restricted by the desire to have all bidders competing on exactly the same terms. Hospital and prison contractors noted the building regulations they are required to follow. And, in the major accommodation project, PRIME, the contractor thought that the use of measurement techniques based on the method of service delivery, rather than the quality of service delivery, inhibited innovation and the contractor's ability to drive service improvement.

3.12 Most contractors considered that the scope to innovate in practice was in line with their initial expectations based on the contractual specification. Some who expected little scope for innovation found that there was actually more (3 per cent of the total surveyed). Some contractors, however, particularly those with high initial expectations of the scope for innovation, considered in practice they had less scope than they had originally expected (6 per cent of the total surveyed).

3.13 Although some 70 per cent of contractors considered that the contract gave them at least fair scope to provide innovative solutions, authorities considered that only around a third of contractors were wholly demonstrating innovation (Figure 28). Most authorities considered contractors were being partially innovative but a significant minority thought there had been no innovation from the contractor. Around 20 per cent of authorities thought there had been no innovation from the contractor during the procurement and the subsequent period when the service was being introduced (the design and build stage). Some 30 per cent of authorities said that there was no innovation from the contractor once the service was in operation.

3.14 The results of our survey, and comments made to us by contractors, suggest there may be scope for more innovation in PFI projects. Contractors' scope for innovation should only be constrained where the public sector has requirements for the form of service delivery which cannot be varied or where there is the need to conform with government regulations. To constrain innovation in other respects may preclude opportunities for improved value for money.

Some authorities questioned contractors' commitment to improvements

3.15 Authorities should not be satisfied with methods of service delivery which do not keep pace with developments. They and contractors should, therefore, be exploring the scope within the contract for improving either the standard or the pricing of services. Almost all contractors (94 per cent) said that they were committed to continuous improvement of the service. 24 per cent of authorities did not consider, however, that their contractors were committed to joint working towards continuous improvement.

26 Contractors' views of how openness and honesty affect relationships

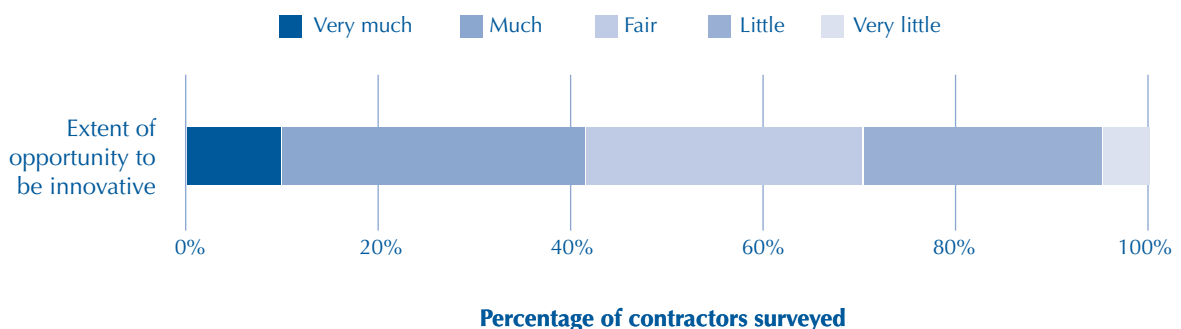
Examples	Extent of openness and honesty	Examples
<p>Bay Community National Health Service Trust</p> <p>'The external stresses on both sides throughout the PFI process have necessitated openness between the parties to resolve the problems. Once established this has become the norm.'</p>	<p>All of the time</p> <p>24 per cent of projects</p>	<p>Army Mail</p> <p>'We are fully integrated as one team, we work on an open book policy , there is mutual trust between the partners.'</p>
<p>National Savings</p> <p>'The relationship is the most open and trustworthy one that I have ever experienced. However, more still needs to be done on both sides to get everyone living these values.'</p>	<p>Most of the time</p> <p>65 per cent of projects</p>	<p>National Insurance Recording System 2 (after contract addendum)</p> <p>'This is one of the key principles we work under. For the most part the relationship is open and honest but this needs constant work and has been difficult to achieve.'</p>
<p>Onley Prison</p> <p>'The level of trust between the authority and the contractor depends upon personal and professional relationships, which take some time to establish.'</p>	<p>Some of the time</p> <p>Rarely or not at all</p> <p>11 per cent of projects</p>	<p>National Insurance Recording System 2 (before contract addendum)</p> <p>'The contractually adversarial approach used to manage the contract limited the opportunity for an open and honest relationship.'</p>

NOTE

- Both parties consider that their relationship is now operating on partnership principles. The current relationship is described as open, trusting and effective in managing the contract.
- The constraints of the first PFI IT contract enforced a contractually adversarial approach which limited the opportunity for an open and honest relationship.
- Now that Onley Prison is operational, the contractor considers that the relationship is open and honest most of the time.

Source: National Audit Office survey of contractors

27 Contractors' perceptions of opportunities to be innovative



Source: National Audit Office survey of contractors

A practical approach to the relationship is needed

Monitoring of contractors' performance should not be oppressive

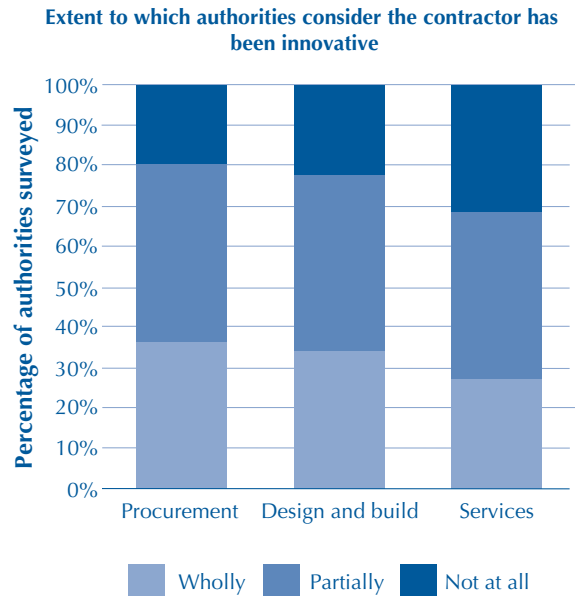
3.16 Authorities need to monitor how contractors measure and report performance. But, as contractors usually have the primary responsibility for performance measurement, they may resent undue interference in this process by the authority. Authorities should, therefore, adopt an appropriate approach to monitoring being neither too 'hands on' nor too 'hands off'. **Figure 29** shows that 76 per cent of contractors consider that authorities have adopted an appropriate approach to monitoring.

3.17 One contractor considered that the authority's approach was too 'hands on' in trying to second guess many of the contractor's internal management decisions but too 'hands off' in not working jointly with it on business implementation and wider issues concerning managing joint risks effectively. Another contractor told us that so many of the authority's staff became involved in the decision making process that it felt it was 'like wrestling with a jelly fish'.

Swift decision making aids the relationship

3.18 Some contractors have found the lack of swift decision making by authorities frustrating. We consider relationships could be enhanced if authorities improved the pace of their decision making. In most instances cited to us this could have been achieved by giving staff greater powers to make certain decisions. One contractor told us that the authority's decision making processes were so slow that it was losing the opportunity to deliver financial benefits.

28 Most authorities consider that contractors are demonstrating some innovation

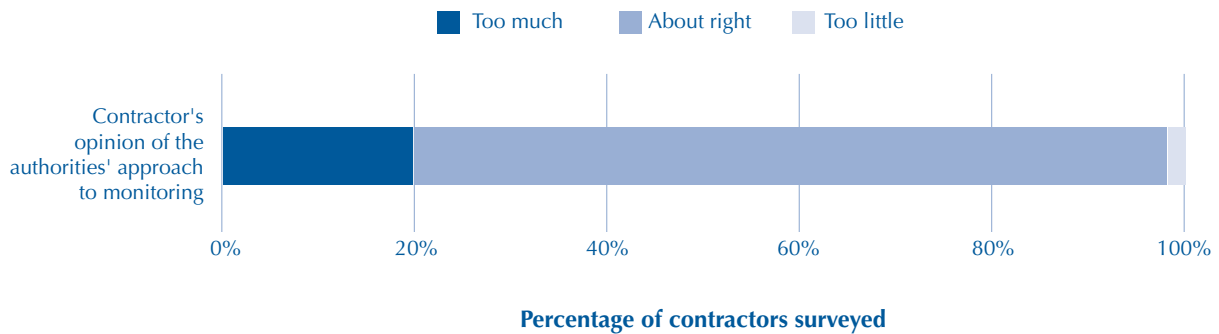


Source: National Audit Office survey of authorities

Practical interpretation of the contract also helps

3.19 The main reason for disputes arises from the interpretation of the contract (Figure 4, page 9). A number of contractors believe that authorities are being inflexible and are not taking a practical approach to the interpretation of the contract. Differences will be minimised if authorities and contractors have discussed and documented how contractual terms are to be interpreted before the contract is let. Where differences in opinion do subsequently arise, authorities need to assess whether the issue is sufficiently important that it merits the authority continuing to argue for its interpretation to be accepted or, on less significant

29 76 per cent of contractors consider authorities have an appropriate approach to monitoring



Source: National Audit Office survey of contractors

matters, whether it would be better for the relationship to reach a pragmatic compromise with the contractor. In other situations authorities and contractors will wish to consider agreeing amendments to the contract where they both see this as beneficial to the long term objectives of the project.

Regular review and monitoring of the relationship is needed

3.20 All business relationships can benefit from regular review to consider ways in which the relationship can be improved. Authorities and contractors should, therefore, reassess their relationships on a regular basis. This will be especially useful where adversarial attitudes have developed. But such reviews are also valuable where the relationship is good: 75 per cent of contractors who currently view their relationship with the authority as good or very good considered their relationship could still be improved. In a good relationship neither side should object to suggestions for improvement: for example, that staff should be provided with more training. Authorities should also regularly review procedures for monitoring the contractor's performance.

3.21 Authorities need to monitor the appropriateness of contractual incentives and performance indicators, especially where the services required have changed, to ensure they are measuring what the authority actually wants. Authorities should also ensure that performance indicators and associated deductions do not unintentionally provide incentives for undesirable outcomes or become unreasonably punitive.

Reassessment of the relationship is beneficial

3.22 Where a relationship is on a downward spiral, it will continue to get worse unless the authority and contractor recognise that this is happening and take steps, jointly, to improve the relationship. **Figure 30** shows two examples of relationships being re-examined and improved to the benefit of the project.

3.23 Authorities and contractors need to work as a team if they are to achieve a common goal. They need to build trust through team building and the development of partnering skills. It is not easy to secure this form of relationship and there are challenges to authorities and contractors in achieving this in PFI projects.

30 Relationships being re-examined

The Defence Fixed Telecommunications Service contract

The project team for the Ministry of Defence's Fixed Telecommunications PFI contract initiated, with external advisers, a reassessment of the relationship three years into their ten year contract with BT. The reassessment focussed on whether the full potential of their business relationship was being realised. The Ministry had become concerned that the relationship had been reverting to a traditional customer/supplier relationship and wanted to explore the scope for moving towards a greater emphasis on a partnering approach. The reassessment concluded that to realise the full potential of the relationship, new contract and management structures would be required. Following this reassessment, the Ministry and BT established a joint mission and objectives for the project, developed a joint business plan with milestones and performance measures and put in place a Business Planning Group to consider the management of new service requirements. They also decided to examine whether aspects of the contract needed to be renegotiated. In addition, BT committed themselves to co-locating staff alongside Ministry staff working on the project with a view to creating a single enterprise approach that would be capable of taking business decisions to satisfy the needs of their joint stakeholders.

The National Insurance Recording System 2 contract

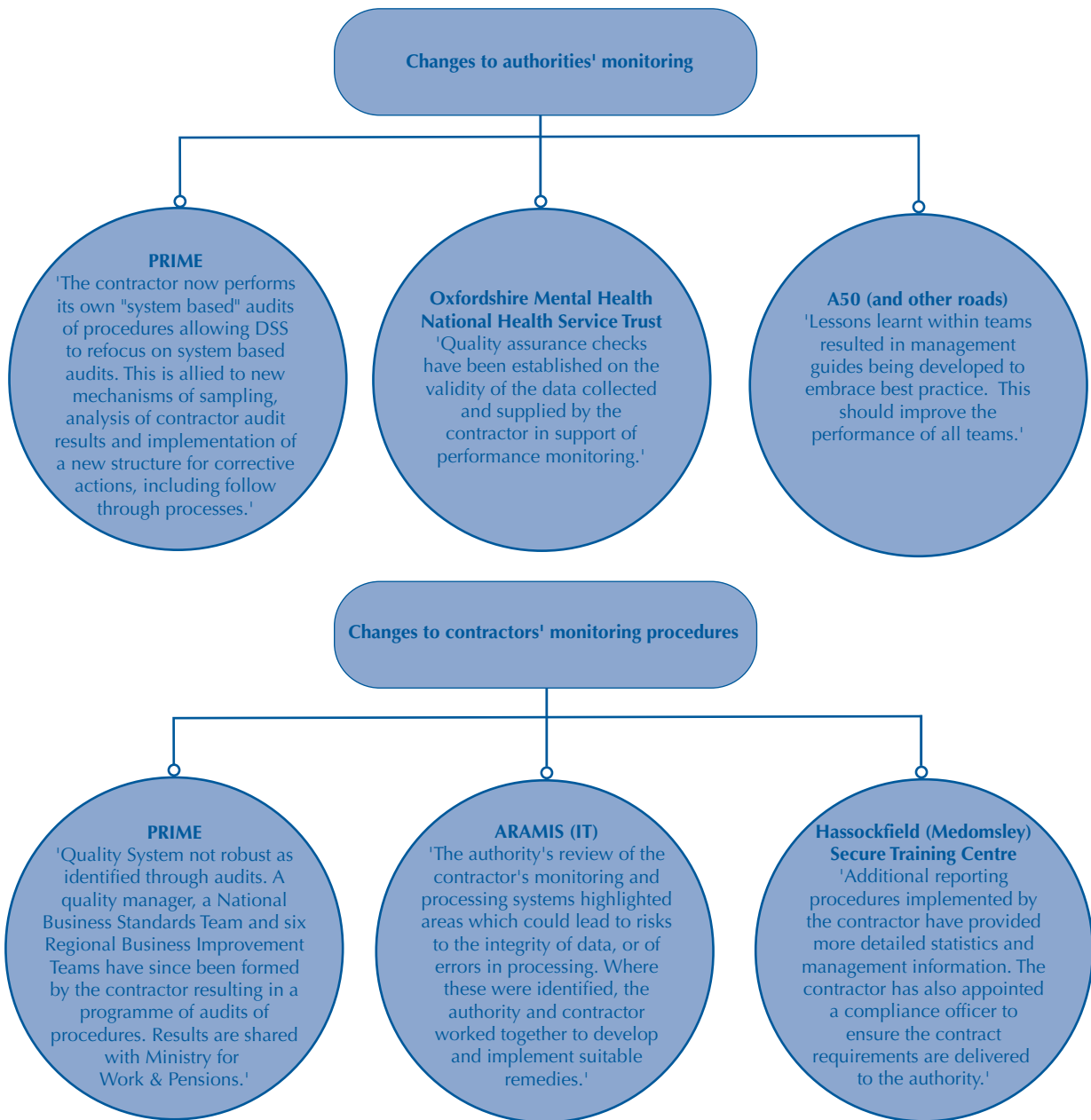
When the National Insurance Recording System 2 contract was in its original form, the contractor considered that the relationship was confrontational and it had no effective working relationship with the authority. After a change of authority, the contractor and the new authority used the opportunity presented by the need to create a contract addendum to enshrine their respective objectives, to establish a set of open monthly partnership meetings and a number of mechanisms aimed at improving joint working in an open and honest style. The contractor's relationship with the authority is now very positive. Jointly, 'off record' perceptions exercises to understand each other's mutual concerns and objectives were also introduced. The authority and contractor now consider they are working together in the spirit of partnership.

Source: National Audit Office survey of authorities and contractors

A small majority of authorities have the right to remove contractors' staff

3.24 58 per cent of authorities have the right to remove any of the contractors' staff from the project. Contractors generally do not have rights to insist on changes to authority staff. Authorities should, however, take note of contractors' views on the impact authority staff are having on the relationship, and be prepared to offer further training or, in extreme cases, remove them from the project if this will contribute to a more positive attitude to the relationship. Such an approach is more likely where authorities and contractors have an open and honest relationship.

31 Examples of changes to monitoring procedures



Source: National Audit Office survey of authorities

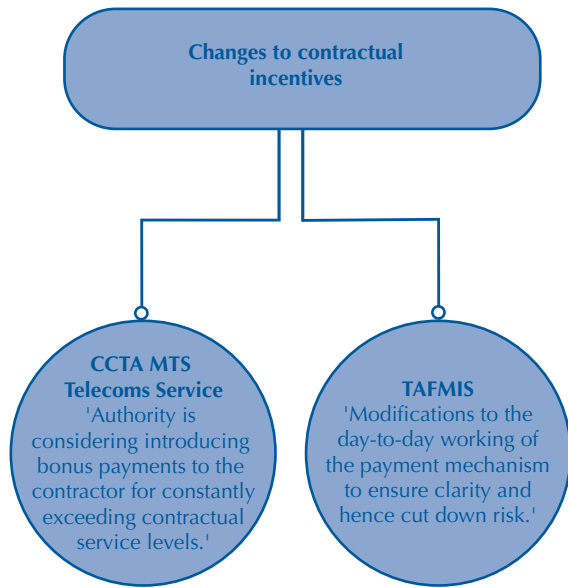
Reviews have resulted in changes to monitoring procedures

3.25 In most PFI contracts, the contractor is responsible for measuring the quality of the services delivered against the standards laid down by the authority. Authorities, however, have the right to monitor the validity of the contractor's information since it is this that determines whether any performance deductions will be made. Authorities should reassess monitoring procedures regularly to ensure their continued effectiveness. Our survey showed that 60 per cent of authorities regularly reassessed their monitoring procedures and 61 per cent

of these made changes to their procedures. Some examples are shown in **Figure 31**.

3.26 Authorities need to review contractors' procedures for recording and monitoring performance. This is necessary to ensure that contractors are providing accurate and valid data. 64 per cent of the authorities surveyed did carry out such reviews and most indicated that they had led to changes in contractors' procedures. Some examples are shown in **Figure 31**. Our survey also found that 67 per cent of authorities had required contractors to appoint someone to be responsible for the quality of services and the reporting of performance.

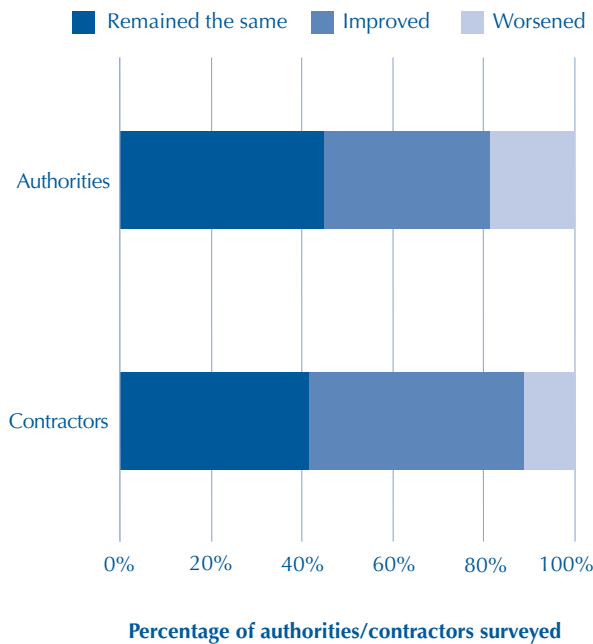
32 Authorities which regularly reassess contractual incentives



Source: National Audit Office survey of authorities

33 How relationships have changed

Current relationship compared with that at contract letting



Source: National Audit Office survey of authorities and contractors

Some authorities have negotiated new performance indicators

3.27 Authorities also need to reassess the appropriateness of performance indicators. They should consider whether the targets for performance indicators are set too high or too low, provide perverse incentives or result in unreasonable performance deductions. Our survey found that 51 per cent of authorities did reassess performance indicators and that 18 per cent of those negotiated new ones. For example, Her Majesty's Prison Service keep the performance measurement system under constant review and have made significant changes to performance indicators so they are more closely aligned with their overall goals.

3.28 Authorities should place priority on seeking an excellent service rather than financial penalty payments. A number of contractors, however, consider that performance mechanisms penalise failure instead of creating an incentive to provide even better performance than required. For example, on the PRIME deal, the authority accepted that there were some anomalies in the performance measurement system which resulted in scores which gave a disproportionate perspective on performance. The authority had spent three years trying to develop an incentive only system based primarily on results, without success. The authority and contractor continue, however, to seek improvements to the system.

Some authorities have negotiated new contractual incentives

3.29 67 per cent of authorities indicated that they regularly reassess contractual incentives and 27 per cent of those have negotiated new ones. Two examples of how authorities are putting in place new contractual incentives are shown in **Figure 32**.

Most authorities and contractors have a good or better relationship

3.30 72 per cent of authorities and 80 per cent of contractors told us that their relationship with each other was good or better. In addition, 45 per cent of contractors and 35 per cent of authorities thought their relationship had improved since the letting of the contract. This is encouraging and reflects the efforts of many authorities and contractors to develop a partnership approach to their relationship. There were, however, contracts where the relationship between the authority and the contractor was not going so well (**Figure 33**). 18 per cent of authorities and 11 per cent of contractors said their relationship had worsened since contract letting although only 1 per cent of authorities and 4 per cent of contractors described their current relationship as poor.⁹

9 Some authorities where the relationship had not been going so well at the time of our survey (late 2000) said they had subsequently taken action which they believed had improved their relationships with their contractors. See paragraphs 3.33 to 3.36.

34 Examples of authority and contractor views on why relationships have worsened and how they could be improved

RAF Mail	
<p>Authority</p> <p>'The idea of a partnership has not flourished, the contractor is only interested in maximising profits with the minimum of capital outlay.'</p>	<p>Contractor</p> <p>'The change in requirements has put pressure on the authority who have put pressure on the contractor to carry out un-contracted activity at no cost.'</p>
<p>How the relationship could be improved</p> <p>'Higher quality management of future requirements and documentation by the contractor. More face to face contact.'</p>	<p>How the relationship could be improved</p> <p>'Don't know.'</p>

Elgar (IT)	
<p>Authority</p> <p>'Original high hopes from both sides have perhaps not been fully realised yet. Although technology migration and transfer of responsibility went well, new services are perceived to be expensive, response to new service requests can be sluggish, and some technical and management personnel have departed without being replaced.'</p>	<p>Contractor</p> <p>'Both parties prepared to work for success.'</p>
<p>How the relationship could be improved</p> <p>'Internal resources (human and financial) have to be set aside for successful IT service delivery. Conversely, the contractor must understand the importance of consistent, high quality services as well as the constraints under which government operates, its needs for audit trails, transparent accountability and inspection of financial records in pricing proposals.'</p>	<p>How the relationship could be improved</p> <p>'Greater buy-in from users, and more direct discussion.'</p>

Defence Fixed Telecommunications Service	
<p>Authority</p> <p>'There has been a gap between the authority's expectations and the reality of the contract. During the implementation phase there was a large degree of working together to overcome the many problems. Introducing new services is now the main challenge but in many cases the parties are reverting to a traditional customer/supplier relationship.'</p>	<p>Contractor</p> <p>'As both parties better understand each other's requirements and pressures, the relationship develops, particularly as we have exceeded contractual requirements in most areas.'</p>
<p>How the relationship could be improved</p> <p>'Relationship needs to become more collaborative, with increased incentivisation for both parties, and underpinned by renegotiation of many of the contract schedules. Openness remains the key to success.'</p>	<p>How the relationship could be improved</p> <p>'A key area of improvement is that of empowerment. At times decisions can be slowed down if they are required to be reviewed and affirmed multiple times up through the ranks. This is understood by both parties and is being worked on over time.'</p>

NOTE

The authority and contractor for the RAF Mail project agreed in our survey that their relationship worsened after contract letting but steps have since been taken to address this (paragraph 3.34). For the Elgar and Defence Fixed Telecommunications Service projects the authorities think the relationships have worsened but the contractors think they have improved.

Source: National Audit Office survey of authorities and contractors

Lessons can be drawn from relationships to date

3.31 **Figure 34** gives examples where relationships had worsened since the letting of the PFI contract and how they could be improved. The evidence suggests that relationships have worsened where the spirit of partnership has not been carried through, and one of the parties to the contract believes that the other is interested in pursuing only their own objectives. Authorities and contractors reported that their hopes and expectations at the time of letting the contract were often not fully realised as they came up against various challenges in the early years of the contract. Collaborative working and a flexible approach to dealing with contractual issues were often absent in those projects where relationships had worsened since contract letting.

3.32 By comparison, relationships have improved where both parties to the contract have understood what is required of them, have understood each other's objectives, have taken a collaborative approach to the resolution of problems, trusted each other and worked to a common goal (**Figure 35**).

Some relationships have improved since our survey

3.33 Authorities and contractors on three projects, RAF Mail, LOCCS and AFPAA have told us that their relationships have improved since our survey was undertaken. The quotes we have used on the RAF Mail and AFPAA projects predate those improvements.

3.34 On the RAF Mail project, the contractor has now taken the opportunity to co-locate at the authority's premises, (**Figure 25**). The contractor's contract manager has changed. As a result, the authority considers the contractor is providing a greatly improved service and is more amenable to taking risks for its own benefit. There is also a greater sense of partnership and relationships are improving.

3.35 With regard to the LOCCS project, the improvement in the relationship came about as a result of changes in personnel on both sides, to people who were committed to the creation of a positive and co-operative working environment. This requires leadership and motivation from individuals who have the confidence to pose the hard questions, regardless of the people or service difficulties, and have the experience to deliver. Cynicism is being replaced by trust.

3.36 On the AFPAA contract, the authority told us that the contract has been reconstructed to ensure delivery of the original requirement on a robust partnering basis. As a result clarity over outputs and responsibilities has improved considerably.

Most authorities consider their projects are good value for money

3.37 We asked the authorities in our survey how they perceived value for money at the time of our survey and their comparative perception at the time of contract letting. At the time of our survey 81 per cent of authorities thought the value for money of their PFI projects was satisfactory or better. In most of these cases (52 per cent of the total) the authorities described value for money as good or excellent. 15 per cent of authorities, however, described value for money as marginal and 4 per cent thought it was poor.

3.38 We also asked authorities about the feedback they had received from users of the service. Most authorities told us that they had obtained generally positive feedback from users on their satisfaction with the services being provided with a number describing user satisfaction as high or very high. In some projects, user feedback had suggested areas where improvements could be made in service delivery and these issues were then addressed in meetings between the authority and the contractor.

Some authorities have found their perception of value for money has changed since contract letting

3.39 There has been a slight decline, however, in perceived value for money since contracts were let. Some 86 per cent of authorities considered that the value for money of their PFI projects at the time of contract letting was satisfactory or better, 14 per cent said it was marginal and none said it was poor. 23 authorities (23 per cent of authorities who gave us their current perception of value for money), considered that value for money was not as good as at contract letting although in two thirds of these cases the authority still considered value for money to be at least satisfactory (**Figure 36**). Authorities gave a variety of reasons for the change in perception. These included high charges for additional services, user dissatisfaction and expected benefits not being realised (**Figure 37**). 5 authorities (5 per cent of authorities which gave a perception) considered value for money had improved.

35 Examples of how relationships have improved

Authorities

Attack Helicopter Training

'As time has progressed a better understanding of each other's problems and a willingness to assist in their resolution has brought the two sides closer.'

Rainsbrook Onley STC

'There is a greater emphasis on partnership to achieve mutual objectives. Meetings between the authority and contractor are more frequent and reflect a spirit of greater co-operation.'

Army Mail

'It has improved because of the open relationship between the two parties.'

Probate Records Centre

'Regular meetings, being open and honest about problems and sharing objectives. Most important is that both sides have established a trust in each other through taking a pragmatic approach to potential problems during the early stages.'

Contractors

A30/35

'Maturing relationships with the authority which is gradually gaining a better understanding of the project company's business environment.'

Hawk Simulator

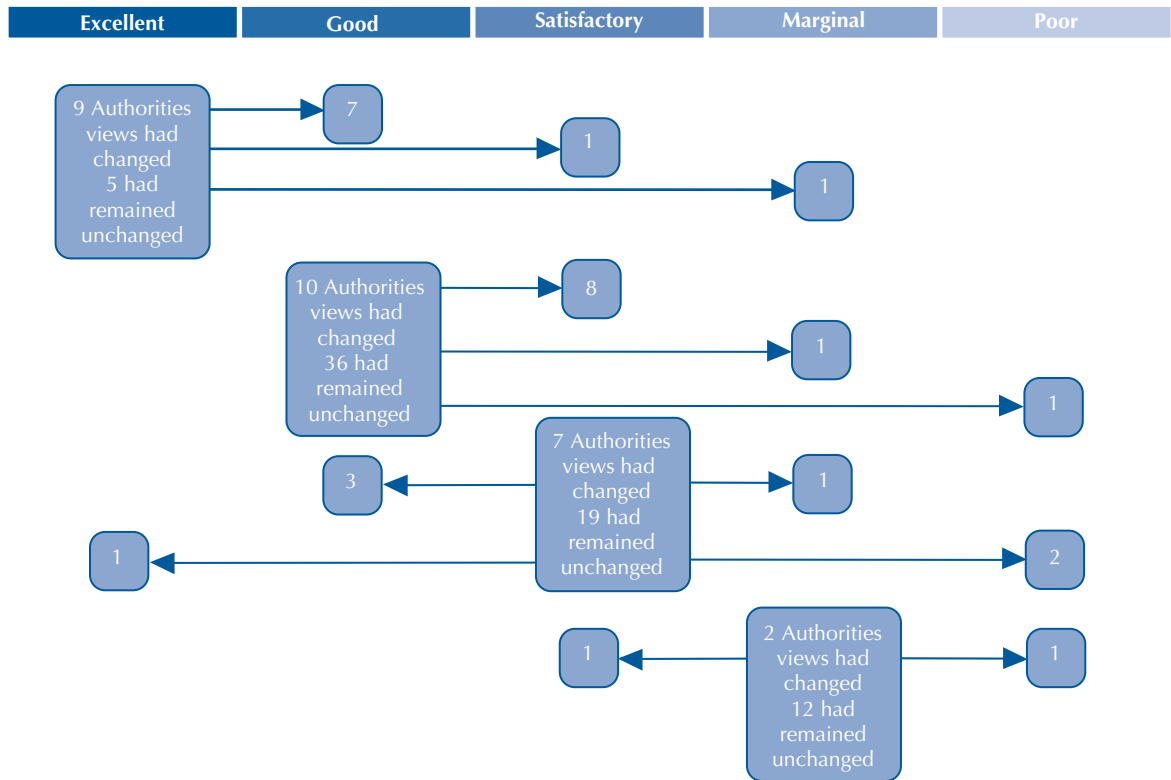
'Improved understanding of each other's views, needs, and objectives.'

Norfolk and Norwich Healthcare National Health Service Trust

'Relationships have improved as people have worked towards a common goal.'

Source: National Audit Office survey of authorities and contractors

36 Changes in authorities' perception of value for money to be gained from their projects



NOTES

1. In total the perception of value for money has changed since contract letting in 28 projects (28 per cent of the authorities who gave us their current perception). In 23 projects (23 per cent of the authorities who gave us a current perception) perceived value for money has decreased. In 5 projects (5 per cent of the authorities who gave us a current perception) it has increased.
2. In 16 (70 per cent) of the 23 cases where value for money was perceived to have decreased since contract letting, value for money was still considered to be satisfactory or better.

Source: National Audit Office survey of authorities

37 Examples of why perceived value for money has decreased

ELGAR (IT) - Excellent to Good

'On the standard infrastructure service, value for money is still 'excellent'. For new services, in a non-competitive situation, value for money is 'good' but allowances for profit, overheads and financing charges, together with contingency to cover risk, have increased the customer perspective that charges are 'too high' and more detailed scrutiny of overall value for money by the authority. Inevitably, this has brought a sharper focus on the 'bottom line' by the contractor'.

RAF Mail - Excellent to Marginal

'The performance of the contract, in terms of user satisfaction and take-up is not a consideration of the contractor, and much work has been needed by the authority to provide a satisfactory level of service.'

TAFMIS - Good to Satisfactory

'Delays in take up of the system, leading to delays in the pursuit of hard benefits'.

AFPAA - Good to Poor

'The contract has failed to deliver to MOD the expected business benefits while also failing to provide the contractor with the expected financial return. This is currently being addressed by a reconstruction of the contract'.

Source: National Audit Office survey of authorities

3.40 In a large population of projects, it is not surprising that some would not work out as well as expected. Nevertheless, in such cases, authorities and contractors should together determine the reasons for value for money being less than had been anticipated and what needs to be done to improve it. Such an assessment may lead to changes within contracts and perhaps the behaviour within the relationship for both parties. Departments may need to get involved in this process. There may be common issues which have led to a deterioration of performance across a number of projects and lessons should be disseminated.

3.41 The fact that perceptions of value for money have changed in 28 per cent of the projects surveyed highlights the need for authorities to establish methodologies for regularly assessing the value for money of each PFI project in progress to ensure that value for money continues to be delivered. This assessment should consider information on performance and pricing available from the contract monitoring procedures. It should also take account of feedback from users as part of a consideration of how well the contract is meeting the authorities' current and expected requirements. This overview of value for money will assist authorities in determining action which may be necessary in their relationship with the contractors on the project being assessed and also relationships with contractors on other existing projects and those under procurement.

Glossary

Authority	A public sector body which lets a PFI contract. This may be a government department, an agency of a department or, in the case of the health sector, a National Health Service trust.
Benchmarking	The process by which the contractor compares either its own costs or the cost of its sub-contractors providing services against the market costs of such services.
Governance	System of joint working and responsibility for running the contract.
Market testing	The re-tendering on the market of services to test the value for money of that service.
Open book accounting	A description of arrangements whereby part or all of a contractor's financial records for a project can be seen by the authority.
Refinancing	The process of changing the financial structure of the contractor or the terms on which the contractor has obtained finance. Refinancing may be possible where the risk of a project has reduced due to, for example, the construction phase of a project being successfully completed.
Ultimate business risk	A risk that there will be a major failure in the service delivery affecting the whole of the business operation which will need to be remedied quickly to ensure that the users of the service continue to receive the required service.

Appendix 1

Scope and methodology of the National Audit Office's examination

Scope of this study

- 1 Our study has been based on surveys of authorities and contractors responsible for 121 PFI projects where contracts had been let prior to 2000. We received responses from 90 per cent of authorities and 75 per cent of contractors who received our survey at the end of 2000. Some authorities or contractors were unable to meet the deadline for responses to our survey, for example, due to recent changes in personnel on the project. Authorities and contractors were very willing to share their experiences with us and to contribute to a discussion of the principles which should influence best practice in managing PFI relationships.
- 2 We collected and analysed the information from authorities and contractors on PFI projects through questionnaires to assess whether authorities were managing their relationships to secure a successful partnership. We also discussed with a number of authorities and contractors issues which they had raised in their responses. We examined the steps authorities have taken within their PFI contracts to establish a successful partnership with their contractors, the knowledge and skills which staff currently involved in PFI contract management possess and the issues which they have been facing in their particular projects. The topics covered through the questionnaires are described below.

For Authorities:

- 1 Relationship with the contractor
 - Assessment of potential partner's attitude
 - Development of relationship
- 2 The building blocks for a successful partnership
 - Inclusion of appropriate building blocks within the contract to ensure successful partnership
- 3 Contract management mechanisms
 - Mechanisms to ensure that value for money is achieved

- 4 Staffing of the contract management function
 - Level of appropriate knowledge of contract management staff
 - Assessment of contract management procedures
- 5 Administration of the contract
- 6 Learning from others
 - Usefulness of current guidance
 - Other guidance needed
 - Existence of best practices
- 7 Actual performance
 - Meeting target dates
 - Meeting cost targets
 - Level of performance deductions

For contractors:

- 1 Relationship with the Authority
 - Quality of relationship with the Authority at contract letting and at the time of the survey
 - Building blocks in the contract to achieve a successful partnership
 - Assessment of risk transfer
 - Representation within the Authority
- 2 Staffing of the contract management function
 - Contractor's satisfaction with the operation of the contract management function
 - Communication between Authority and Contractor
 - Monitoring procedures
 - Performance review process
 - Quality of change procedures in the contract

We used an external reference panel, comprising representatives from the Office of Government Commerce, departmental PFI units, and the private sector as shown below, to discuss and agree the overall direction of the study, the proposed questionnaires for the study, the interpretation of the results of the surveys, and the presentation of information in this report.

The members of our reference panel were:

Public sector

The Office of Government Commerce

Highways Agency Private Finance Unit

Her Majesty's Prison Service Contracts and Competition Group

National Health Service Private Finance Unit

Ministry of Defence Public/Private Partnership Unit

Private sector

WS Atkins

Carillion

We also sought the views of four industry representative bodies outside of our external reference panel. They were:

CBI

Business Service Association

Major Contractors Group

Construction Industry Council

Appendix 2

The projects surveyed by
the National Audit Office

Authority	Name of project	Value £M ¹	Financial year signed	Response received ²
Department of Culture, Media and Sport				
The British Library	Provision of Catering Service	0.9	1997	Y*
The Royal Parks Agency	Pembroke Lodge	1	1997	Y*
The British Library	Corporate Bibliographic Service	4.7	1997	Y*
Department for Transport, Local Government and the Regions				
Highways Agency	M1/A1 Link Road	214	1996	Y
Highways Agency	A1 (M)	128	1996	Y*
Highways Agency	A30/35	75	1996	Y*
Highways Agency	M40	65	1996	Y*
Highways Agency	A417/419	49	1996	Y*
Highways Agency	A19	29	1996	Y*
Highways Agency	A50	21	1996	Y*
Highways Agency	A69	9	1996	Y*
Highways Agency	Second Severn Crossing	331	1990	Y*
Employment Service	Employment Service IT Partnership	116	1998	Y
Department of Health				
South Tees Acute Hospitals NHS Trust	Single Site Development	121.9	1999	Y
Worcester Acute Hospitals NHS Trust	Worcestershire new hospital	86.6	1999	Y*
Hereford Hospitals NHS Trust	Hereford hospitals PFI	64.1	1999	Y
Barnet & Chase Farm Hospitals NHS Trust	Barnet Hospitals	54	1999	Y
South Durham Healthcare NHS Trust	Bishop Auckland Redevelopment	48	1999	Y*
Sussex Weald and Downs NHS Trust	Graylingwell Hospital Re-provision	22	1999	Y
North Staffs Combined Healthcare NHS Trust	Bucknall Hospital - Psychiatric Unit	19.2	1999	Y
Queen's Medical Centre NHS Trust	Queen's Medical Centre ENT Ophthalmology capital scheme	16.6	1999	Y

Authority	Name of project	Value £M	Financial year signed	Response received
Fulbourn School of Nursing	Fulbourn PFI	9.7	1999	Y
Plymouth Hospital NHS Trust	Patient Administration System	7	1999	Y*
Bradford Community Health	Leeds Road Hospital - Horton Park Centre	4	1999	Y*
North West London NHS Trust	ACAD Equipment	3.5	1999	
South Birmingham Mental Health NHS Trust	Monyhull PFI	2.2	1999	Y*
Mancunian NHS Trust	Mancunian Community Trust - Primary Care	2	1999	Y*
North Hampshire Hospitals NHS Trust	MRI Scanner	1.9	1999	Y
Norfolk and Norwich Health Care NHS Trust	Norfolk & Norwich Hospital	158	1998	Y*
Bromley Hospitals NHS Trust	Bromley NHS Trust - New Hospital	117.9	1998	Y
Greenwich Healthcare NHS Trust	Queen Elizabeth Hospital - Woolwich	93	1998	Y
South Manchester University Hospital NHS Trust	Rationalisation of inpatient services	65.6	1998	Y*
Calderdale Healthcare NHS Trust	Calderdale Hospital - Calderdale Redevelopment	64.6	1998	Y
North Durham Health Care NHS Trust	New Hospital	61	1998	Y*
Oxleas NHS Trust	Reprovision of Mental Health	15	1998	Y
Newham Healthcare NHS Trust	Newham NHS Trust - New facilities	12.8	1998	Y
Oxfordshire Mental Health Care NHS Trust	Medium secure unit	9	1998	Y*
Bay Community NHS Trust	Lancaster Moor Hospital	7	1998	Y*
Thames Gateway NHS Trust	Adult acute psychiatric unit reprovision	5.5	1998	Y
Black Country Mental Health NHS Trust	Black Country Mental Health NHS Trust PFI	5.2	1998	
North Bristol NHS Trust	Brain Injury Rehabilitation Unit	4.9	1998	Y*
Stockport NHS Trust	Old Age Psychiatry Services	4.7	1998	
Rotherham Priority Health NHS Trust	Elderly Mental Health	2.1	1998	Y*
North Hampshire Hospitals NHS Trust	Patient Management Centre	1.5	1998	Y
Dartford and Gravesham Hospital	Acute General Hospital Development	94	1997	Y
North Cumbria Acute Hospitals NHS Trust	Cumberland Infirmary Carlisle	66.7	1997	Y*
South Buckinghamshire NHS Trust	Wycombe and Amersham developments	45.1	1997	Y*

Authority	Name of project	Value £M	Financial year signed	Response received
Leeds Community & Mental Health Services NHS Trust	North West and West Central community units for the elderly	5	1997	Y*
Poole Hospital NHS Trust	Poole Hospital NHS trust residences	3.48	1997	Y*
Hull and East Riding Community Health NHS Trust	Withernsea Community Hospital	3.3	1997	*
Nottingham Health Authority	Standard Court Health Authority HQ PFI	3.25	1997	Y
Northallerton Health Services NHS Trust	Richard Friary Community Hospital	3	1997	Y*
Queens Medical Centre	Nottingham University - CHP generator	2.8	1997	
Plymouth Hospital NHS Trust	Linear accelerators	2.73	1997	Y*
North Hampshire Hospitals NHS Trust	Energy Management Scheme	2.7	1997	Y
Mayday Healthcare	Mayday Healthcare (Front Entrance)	1.8	1997	
Surrey & Sussex Health Care NHS Trust	Crawley Hospital Energy Management	1.8	1997	Y*
Ministry of Work and Pensions				
MWP Estates	Private Sector resource initiative for management of the estate (PRIME)	350	1997	Y*
Department of National Savings				
Department of National Savings	Public-Private Partnership with Siemens Business Services	635	1999	Y*
Department of Trade and Industry				
Natural Environment Research Council (NERC)	Shipping Services	22	1999	Y*
Engineering and Physical Sciences Research Council (EPSRC)	Computer Services for Academic Research (CSAR)	15	1999	Y*
Department of Trade and Industry	National Physical Laboratory	88.6	1998	Y*
Department of Trade and Industry	Electronic Government through Administrative Re-engineering (ELGAR)	26	1998	Y*
Radiocommunications Agency	RA Strategic Partnership	15	1998	Y*
Coal Authority	Mining reports and surface drainage system	3	1997	Y
Foreign and Commonwealth Office				
Foreign and Commonwealth Office	Berlin Embassy	51	1998	Y

Authority	Name of project	Value £M	Financial year signed	Response received
Home Office				
HM Prison Service	Marchington Prison	48	1999	Y*
HM Prison Service	Onley Prison	34.7	1999	Y*
HM Prison Service	Agecroft Prison (Forest Bank)	38.6	1998	Y*
HM Prison Service	Pucklechurch Prison	30.7	1998	Y*
Youth Justice Board	Hassockfield (Medomsley) secure training centre	42.8	1998	Y*
Youth Justice Board	Rainsbrook (Onley) secure training centre	10	1998	Y
Home Office	Passport Agency Contracts	30	1997	
HM Prison Service	Prisons Energy (Tranche 1)	9	1997	Y*
HM Prison Service	Lowdham Grange Prison	32	1996	Y*
Youth Justice Board	Cookham Ward (Medway) secure training centre	10	1996	Y
HM Prison Service	Quantum: PFI	6	1996	Y
HM Prison Service	Fazakerley (Altcourse) Prison	88	1995	Y*
HM Prison Service	Bridgend (Parc) Prison	74	1996	Y
Inland Revenue				
Inland Revenue	Newcastle Estate Development Scheme (NED)	163.8	1998	Y*
Inland Revenue	Bootle St John's House (IR)	12	1998	Y
Inland Revenue	Stockport IR Office	6	1998	
Inland Revenue	Manchester IR Office	32	1997	
Inland Revenue	Glasgow IR Office	10	1997	Y*
Inland Revenue	Edinburgh IR Office	10	1997	Y*
Inland Revenue	National Insurance Recording System 2	44	1995	Y*
Lord Chancellor's Department				
Lord Chancellor's Department	Libra	60	1999	Y*
Lord Chancellor's Department	Probate Records Centre	11	1999	Y*
Lord Chancellor's Department	A Resource Accounting and Management Information System (ARAMIS)	40	1997	Y*

Authority	Name of project	Value £M	Financial year signed	Response received
Lord Chancellor's Department	Local County Court Systems (LOCCS)	20	1996	Y*
Ministry of Defence				
Ministry of Defence	Tornado GR4 Simulator	65	1999	Y
Ministry of Defence	Naval Recruiting and Training Agency Fire Training	35	1999	Y*
Ministry of Defence	Flying Training for University Air Squadrons and Air Experience Flights	113	1999	Y
Ministry of Defence	Central Scotland FQ	13	1999	Y
Ministry of Defence	RAF Cosford/Shawbury	13	1999	Y*
Ministry of Defence	Attack Helicopter Training	165	1998	Y*
Ministry of Defence	Joint Services Command and Staff College	68	1998	Y*
Ministry of Defence	RAF Lossiemouth (FQ)	24	1998	Y*
Ministry of Defence	RAF Mail	12	1998	Y*
Ministry of Defence	Yeovilton (Family Quarters)	8	1998	Y*
Ministry of Defence	RAF Fylingdales (Power)	7	1998	Y*
Ministry of Defence	Tidworth Water & Sewerage	6	1998	Y*
Ministry of Defence	RAF Lyneham Sewerage	5	1998	Y
Ministry of Defence	Armed Forces Personnel Administration Agency (AFPAA)	150	1997	Y
Ministry of Defence	Medium Support Helicopter Air Crew Training Facility (MSHATF)	100	1997	Y*
Ministry of Defence	Defence Fixed Telecommunications Service	70	1997	Y*
Ministry of Defence	Army Mail (IT)	11	1997	Y*
Ministry of Defence	Hawk Simulator	10	1997	Y*
Ministry of Defence	Helicopter Flying School	118	1996	Y*
Ministry of Defence	German White Fleet	52	1996	Y*
Ministry of Defence	RAF White Fleet	35	1996	Y*
Ministry of Defence	Training, Administration and Financial Management Information System (TAFMIS)	14	1996	Y*
Ministry of Defence	Hazardous Stores Information	1	1995	Y*

Authority	Name of project	Value £M	Financial year signed	Response received
Office of Government Commerce				
CCTA	CCTA Metropolitan Telecoms Service	10	1995	Y*
Serious Fraud Office				
Serious Fraud Office	Docman IT	4	1998	
National Assembly for Wales				
Pontypridd and Rhondda NHS Trust	Royal Glamorgan Hospital Staff Residence	3	1999	Y
National Assembly for Wales	A55	112	1998	
Gwent Healthcare NHS Trust	Chepstow Community Hospital	8	1998	Y
National Assembly for Wales	Neville Hall Endoscopy and Day Surgery Unit	2.8	1998	
National Assembly for Wales	OSIRIS	48.4	1996	Y
Cardiff and Vale NHS Trust	University Hospital Wales - Car Park	10	1996	Y

NOTE

1. Values given are the project capital values.
2. 'Y' indicates that a response from the authority was received. An asterisk indicates that a response from the contractor was also received.

Appendix 3

Points to be considered in the implementation of key learning points

Paragraph 24 of the Executive Summary to this report sets out six recommendations for managing the relationship to secure a successful partnership in PFI projects. We have set out below suggested points to be considered in putting the recommendations into practice.

Recommendation A: *Authorities and contractors should always seek to understand each other's businesses and establish a partnership approach to each of their PFI projects based on a common vision of how they will work together to achieve a successful outcome to the project.*

Points to be considered

- Authorities should discuss with all bidders for a PFI project what the authority and bidders would seek to achieve from the project.
- Authorities should take steps to understand the business culture of bidders for a PFI project. This may include visiting the bidders' organisations or speaking with parties who have previously worked with the bidders. They should likewise encourage the bidders to understand the culture of the authority.
- In addition to agreeing appropriate contractual terms, authorities should develop with their preferred bidder a partnership plan which will set out the key principles of how they will work together to achieve a successful outcome to the project.

Recommendation B: *Authorities must give attention at an early stage in the procurement process of a PFI project to contract management issues and how their relationship with the selected PFI contractor will be developed.*

Points to be considered

- The consideration of contract management issues must be built into the timetable for developing PFI projects.
- Authorities should make all bidders for a PFI project aware of the key performance criteria on which payments for the required service will be based.
- All other material aspects relating to how the contract will be managed should be agreed and documented before a PFI contract is let.

Recommendation C: *Authorities need always to consider when developing a PFI contract the factors which may require changes to the contract after it has been let. The authorities' priorities may change or other factors may arise such as the opportunity to take advantage of improved technology. Appropriate contractual procedures for dealing with change should be built into the contract.*

Points to be considered

- At an early stage in the procurement authorities should fully review all factors which could give rise to the need for a change to the PFI contract after it has been let. This should particularly focus on factors which could lead to an expansion or contraction of the required service, the extent to which change has previously been a feature of this particular area of the authority's activities and the likelihood of new forms of service delivery emerging during the contract period.
- The authority should discuss with all bidders their attitude to dealing with changes that may impact on the PFI contract after it has been let.
- Authorities should develop appropriate mechanisms for dealing with change in their PFI contracts. These should include arrangements which deal with how new services will be priced and which will enable authorities to receive value for money for these services.

Recommendation D: *During the procurement stage authorities must develop a staffing and training plan to ensure that they have staff with the right skills and experience to manage the contract after it has been let and to build a good working relationship with the contractor.*

Points to be considered

- Authorities should identify the number of staff required, and the skills they will need, to manage a PFI contract after it has been let. In making this assessment, they may find it helpful to speak to other authorities with experience of the post-contract phase of a PFI project. Required skills are likely to include general commercial awareness and specific detailed knowledge of the project.

- Particular attention should be paid to staffing levels and skills needed in the early years of the contract when risks will be greater while the service is being introduced and working relationships with the contractor are being developed.
- Authorities should clearly identify whether staff who have been involved with the procurement and contract negotiations will be continuing to work on the project after the contract has been let. Where staff continuity is not possible arrangements should be put in place for bringing in new staff and making them familiar with the project and the contract terms.

Recommendation E: *Authorities should regularly re-assess their relationships with contractors, and the value for money their projects are delivering, to identify ways in which relationships can be improved.*

Points to be considered

- Authorities should periodically take time to assess the strengths and weaknesses of their relationships with their PFI contractors and should engage their contractors in a dialogue on how, from both their perspectives, the relationship can be improved.
- During the life of a PFI contract authorities should regularly step back and evaluate if value for money is still being achieved. Further thought will be needed on how value for money in PFI projects should be assessed after contracts have been let. This should take account of performance, pricing and user satisfaction. Where the extent of value for money which the project is expected to deliver has changed since contract letting the reasons for this should be identified.
- The results of these evaluations should be used by senior management of the authority to inform decisions about action which may be necessary on the project which has been assessed and action which may be necessary in respect of other current and planned PFI projects.

Recommendation F: *The Office of Government Commerce should take forward its plans to consider further guidance on contract management issues and should consider facilitating opportunities for staff from different authorities to share experiences of managing PFI contracts and relationships with PFI contractors.*

Points to be considered

- The Office of Government Commerce should take forward its plans to ensure that existing guidance is kept up to date to reflect developing experience among departments in managing PFI deals. In particular, it should consider the adequacy of guidance on topics identified by departments in responding to our survey: contract management, performance measurement, payment mechanisms, change procedures, legal issues and achieving and maintaining value for money.
- Regular meetings of PFI contract managers from across government and the private sector will be helpful so that experiences can be shared and further training provided. The Office of Government Commerce should consider facilitating this process.
- There may also be scope within departments, and across government, for lessons on contract management to be shared by the use of electronic mail or the Internet.

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