

Interface

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The newsletter of Manches Projects Group

CUTTING THE COST OF PFI



A review of possible savings to be made in operational PFI projects.

The 2010 Spending Review identified PFI projects as one of many areas where Government should work to achieve cost savings to meet the need to reduce public spending. Draft guidance on how to achieve this was issued in January 2011, and the final form of that guidance was published on 19th July 2011 titled "Making savings in operational PFI projects". This publication is available at http://www.hm-treasury.gov.uk/d/iuk_making_savings.pdf

Earlier this year, reviews were undertaken of four operational PFI projects:

- Queen's Hospital, Romford (selected as representative of accommodation type PFI contracts);
- MOD Main Building Redevelopment;
- Corsham Development Project; and
- Welbeck Defence Sixth Form College.

It is estimated that public sector spending on PFI contracts in 2011-12 will exceed £8 billion.

As a result of the reviews, the Treasury has calculated that £1.5 billion can be saved across the 495 operational PFI projects in England with savings opportunities of around 5% on annual unitary charges. These savings can then be recycled back into frontline services by the contracting authorities. The new guidance now takes account of the practical experience gained whilst undertaking these pilot reviews.

The guidance recommends that all contracting authorities with operational PFI contracts instigate a contract savings review and sets out various actions to be taken by, and areas of consideration for, PFI contract managers and contracting authorities if not yet already undertaken. Although written for a public sector audience, it is also useful for private sector financial investors and contractors to consider the content of the guidance.

Key Approaches for achieving operational savings

The guidance sets out three key areas, confirmed by the pilot projects as the main route to operational savings:

- effective management of existing terms;
- optimising use of asset capacity (and mitigating costs of surplus capacity);
- reviewing the specification of soft services (and ensuring value is tested properly, and the public sector applies consistent standard and only pays for what it needs).

Having set these aims, the document contains more detailed guidance on how to pursue them.

Getting the most out of the existing contract

As a first step, before considering amending a contract, the guidance suggests that the contracting authorities ensure that they have a good understanding of the contractual terms and are, by effectively managing their contracts, getting the most out of them in their current form. Areas for review include:

- The contract, including the contracted services and payment mechanism. Do the existing contract provisions reflect any variations that have arisen and are the existing contract provisions being applied effectively?
- The actual asset usage levels and current service requirements; and
- Data on the current cost effectiveness of service unit cost pricing compared with suitable benchmarks.

Considerations pre contract amendment

If, having addressed the contract efficiency, contracting authorities decide that changes to a contract are necessary, the guidance notes that the implications of any contract amendment must be considered and fully understood.

- **Cost of Change.** Any savings made must not be outweighed by the cost of implementing change. Costs could include legal, technical and financial advisory fees, survey costs and financial modelling costs for the contracting authority, PFI provider and lenders.
- **Procurement Law Issues.** Will there be any procurement law implications if the contract is amended? Material variations to an existing contract may amount to a "new" contract being entered into; in which case the contract would need to be retendered.
- **Value for Money.** Appendix A of the guidance gives some brief pointers to the public sector as to how to protect Value for Money (VfM), including a list of measurers that are not recommended because they generally prejudice VfM.
- **Transparency and Information.** If the contract predates SoPC4, it is unlikely to contain robust cost transparency provisions. Without these it will be difficult for contracting authorities to ascertain the real project costs and to determine the VfM of implementing any changes. Similarly the change mechanism in older contracts is likely to be unwieldy and complicated. For pre SoPC4 contracts, the guidance suggests parties agree to follow the Infrastructure UK Operational Taskforce guidance sample protocol to improve the management of variations. The Treasury is currently working with investors, subcontractors and lenders to prepare a voluntary code of conduct on operational saving matters to address cost transparency and change mechanism in pre SoPC4 contracts.

Departmental PFU measures

The guidance identifies certain enabling measures that departmental PFUs should consider making available to contracting authorities, if not already doing so, prior to any contract amendment.

- **Contract cost data.** Facilitating cost data collection for sector services under PFI contracts and making it available to contracting authorities in an easily accessible form.
- **Contracting authority contact.** Maintaining lists of contract managers to be made available within a sector or amongst common service providers, allowing contract managers to make each other aware of any relevant negotiations and share best practice.
- **Standard form drafting.** In addition to the generic SoPC4 drafting most sectors have sector specific contracts. Any contracting authority considering amending their contract should check with their departmental PFU what the current standard provisions are in respect of the amendments being considered.

Potential project savings

The guidance sets out a number of areas in which contracting authorities could consider making changes. Careful consideration will be needed, however, as what would amount to cost saving under one project might actually incur greater costs under another.

- **Insurance provisions.** Under the draft guidance insurance was cited as a potential area for cost savings. However, for a variety of reasons, for the majority of PFI contracts this will not be the case.
- **Encouraging decreased energy consumption and maximising energy purchasing volumes.** Contracting authorities are being encouraged to monitor their energy consumption and to consider ways to reduce energy use. If the authority has greater buying and negotiating strength than the PFI provider, and is not already doing so, cost savings could be made by the authority purchasing the power directly but authorities will of course need to consider any transfer of CRC liabilities as part of the acquisition.
- **Optimising the use of PFI assets.** Areas for consideration include rationalising overall estates, subletting space to other public or private sector tenants, increasing occupational density thereby creating space for other functions or mothballing unused space. However not all contracts will allow the contracting authorities to pursue these options and, even if they are allowed under the contract, they may not represent VfM.
- **Review service specification.** Contracting authorities should review service specifications if they feel that they are incurring costs for unnecessary services. Possible cost savings could include reducing decorating frequency or reducing overnight lighting costs by changing to daytime cleaning. However, any variation must not undermine the project's main objectives.
- **Removal/re-scoping of ancillary services.** In certain circumstances the removal or re-scoping of ancillary services may represent VfM e.g. where the service is no longer required or an alternative service provider offers better VfM and the contract does not include value testing provisions. However, the converse is also true and there may be circumstances where the service is being provided at below market price.
- **Interface.** In some circumstances it may be cost effective to remove a service from the contract and arrange for it to be delivered separately. This option will only apply to certain sectors (it would not be appropriate in a closed environment such as a prison) and, a clear interface/risk matrix would need to be established.

- **Alignment of value testing exercises.** It may be more cost effective for a contracting authority with more than one PFI contract or a group of authorities, where the services to be value tested are similar to align value testing exercises. However, changing the timing of the value testing exercise may require lender consent and deferring the testing and changing the contract is likely to incur costs. Any cost savings would, therefore, need to exceed these outlays.
- **Taking back change in law risk.** Contracting authorities could re-evaluate the VfM of requiring the PFI provider to share the risk of capital costs of general changes of law during the project's operational phase. Taking the risk back into the public sector in its entirety may be more cost effective but the ramifications of this on other aspects of the contract must be carefully considered.

Conclusion

For all parties involved in operational PFI contracts, the Spending Review cost reduction aims present a huge challenge. The operational phase of a project is of immense value to project vehicle investors, FM providers and lenders, and any well-run project will already have been worked hard by these parties to maximise profitability. Savings to the public sector may occasionally still be achievable through genuine "win-win" efficiency improvements, but in most cases it is likely that negotiation with the private sector parties will include dealing with issues which directly affect turnover, profitability or cover ratios. In that context, the Treasury's proposed code of conduct on operational savings matters will be an essential piece of the jigsaw, and no-one should underestimate the potential complexity and cost of negotiating contract terms.

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