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Good practice

Guide

This guide is intended for people in higher education institutions who are involved in procuring projects using the Private Finance Initiative (PFI). PFI is a method of procurement which seeks to achieve best value for money by focusing on the delivery of a service, rather than the acquisition of an asset.

Practical guide to PFI for higher education institutions

Revised February 2004

Contents

Executive summary	2	
Introduction	4	
Educational institutions and PFI	4	
Scope for PFI within the higher education sector	6	
Stage 1	Establishing the business need	9
Stage 2	Appraising the options – choosing a procurement route	9
Stage 3	The business case and the reference project – assessing value for money	10
Stage 4	Creating the project team – selecting advisers	14
Stage 5	Deciding tactics	15
Stage 6	The OJEU notice – inviting expressions of interest	16
Stage 7	Pre-qualification	20
Stage 8	Short-listing	20
Stage 9	Refining the original appraisal	21
Stage 10	The invitation to negotiate	21
Stage 11	Evaluation of bids	25
Stage 12	Selection of a preferred bidder, and negotiation to financial close	26
Stage 13	Awarding the contract	27
Stage 14	The contract management phase	28
Lessons learnt	29	
Annex A	Other published guidance	33
Annex B	Standard paragraphs for inclusion in advertisements of PFI projects in the Official Journal of the European Union (OJEU)	34
Glossary	35	

Note

This document was previously published as HEFCE 98/69. This version has been revised to reflect the development of PFI in the higher education sector. Its structure is based on the Treasury Taskforce 'Step by step guide to the PFI procurement process' – revised November 1999.

The PFI material developed by the Treasury Taskforce (1997-2000) is still valid and is available on the Office of Government Commerce PFI Network web-site at <http://pfi.ogc.gov.uk/>

Practical guide to PFI for higher education institutions

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Executive summary

Purpose

1. This guide is intended for people in higher education institutions who are involved in procuring projects using the Private Finance Initiative (PFI). PFI is a method of procurement which seeks to achieve best value for money by focusing on the delivery of a service, rather than the acquisition of an asset.

Key points

2. The first step in any procurement process must be to establish the viability of the project. The next stages are to establish whether the institution's legal position is compatible with PFI; whether the project is an appropriate subject for procurement by this method; and whether there will be sufficient interest in the private sector to justify an invitation to bidders.

3. A successful PFI procurement will lead the institution into a long-term contract with a commercial partner, requiring a high level of commitment on both sides. The contract will be worth much more than the value of the associated assets, and the procurement will place commensurate demands on management resources. It will also demand specialist expertise to ensure that the institution's interests are properly protected in the agreement. Unless institutions have sufficient experience in PFI, they will need to appoint outside advisers to assist them.

4. A particular feature of PFI procurement is the negotiations that precede contract award. These must be conducted so that they comply with EU regulations, and lead to a deal that is the best that the institution can achieve. Much will depend on agreeing an appropriate allocation of the risks associated with the project, and a pricing mechanism that provides the right incentives for the commercial partner.

5. Special considerations stem from the long-term nature of the relationship between the institution and its commercial partner. These must be recognised and addressed during the procurement process and before the contract is signed, to avoid difficulties in future years.

Action required

6. This report is for information and guidance.

Introduction

7. The Private Finance Initiative (PFI) is first and foremost a method of procurement which seeks to achieve best value for money. To do so it focuses on placing a contract for providing a service, rather than any particular asset. It is concerned with outputs, rather than how they are delivered. The other key characteristic of PFI is the apportionment of risks to whichever of the contracting parties is best able to manage them, so as to achieve best value for money. The scope for generating income from third parties is useful but not essential for a successful PFI solution.

8. The negotiation which leads to a deal is largely determined by the parties involved. PFI deals are likely to work best when both parties approach the process with as few preconditions as possible. This often means a willingness to challenge existing practices. Even if it is not possible to agree a final contract which reflects all the principles of PFI, institutions may find that there is still scope for achieving better value for money from deals which involve some form of public/private partnership. Much of the good practice recommended in this guide will still be applicable.

9. The Office of Government Commerce (OGC) makes available a number of publications giving detailed advice (listed at Annex A). This guide follows the structure of one in particular, the 'Step by step guide to the PFI procurement process – revised November 1999'.

10. This guide aims to supplement the advice already available, putting it in the context of higher education. It is targeted specifically at people in higher education institutions who have the task of turning PFI theory into practice.

11. The guide starts by reviewing the potential for PFI within an institution, and within the sector as a whole. It then describes the 14 key stages of the PFI process, from establishing the business need to managing the contract. For each stage it covers the methods that have worked, and the difficulties to be overcome. Finally, we have included a section which summarises the higher education sector's experience of PFI.

12. This guide is intended to help institutions manage PFI. It is not a substitute for the commercial, technical or legal advice which any institution considering PFI will need.

Educational institutions and PFI

Legal status

13. English higher education institutions are independent bodies and are part of the private sector. They do, however, receive large sums of public money, for which they are accountable to the Higher Education Funding Council for England (HEFCE) and ultimately to Parliament.

14. Institutions' powers are set out in their articles of governance. These can take many forms, from individual royal charters to model articles agreed with the Privy Council. Institutions must establish, early in any proposed PFI process, that their articles of governance give them the power to do what they wish. Each institution must also comply with any requirements of its financial memorandum with HEFCE. Negotiations

will be simpler if prospective private sector partners are aware of any constraints at an early stage in the PFI process.

15. Institutions are not required to explore PFI options. However, they do have an obligation to secure value for money and will therefore want to consider whether PFI is the best option for delivering the services they want. PFI in higher education should only proceed if it clearly delivers better value for money. It may also offer new opportunities for attracting private sector investment.

Procurement legislation

16. Although institutions are legally independent bodies, they are subject to EU procurement rules. These require advertising and open tendering for public procurement of products or services above a certain value. The regulations are described in detail in Stage 6 of this guide; they are likely to apply to most PFI projects.

17. Institutions are advised to take legal advice at the start of any PFI procurement process to ensure they comply with the relevant legislation. The cost of a legal challenge by a disgruntled unsuccessful supplier could be high, and could seriously delay the project.

Other legal constraints

18. The institution should be clear, at the start of the PFI process, about any legal or related matters which might affect the private sector's consideration of the risks and limitations attached to a PFI deal. Such matters might include the following:

- a. Internal constitutional arrangements which limit the institution's freedom to take certain actions.
- b. Constraints on the way the institution can deal with its land or property. For example, there are often limitations on the institution's power to dispose of gifts and bequests.
- c. Statutory planning, highway, environmental or similar constraints which might, for instance, restrict the way in which some other end user could develop the institution's buildings or land.
- d. Employment law such as the Transfer of Undertakings (Protection of Employment) Regulations 1981 (TUPE).

19. Institutions should consult with their legal advisers at an early stage.

Internal processes

20. The institution must be clear about its own formal processes to initiate and manage a PFI project, negotiate with prospective private sector partners and agree a PFI contract. In particular, both the institution and the bidders will need to understand from the start what the decision-taking and approval procedures are, so that they can plan the PFI process accordingly. Decisions must be made on many issues at the outset. It is important to avoid delay and to prevent the growth of ad hoc procedures once negotiations are under way.

Scope for PFI within the higher education sector

21. PFI offers the opportunity for institutions and potential commercial partners to take a fresh look at the basis on which services are provided. Private finance partners may be able to bring specialist expertise to a project, or provide a better allocation of risk. Either or both of these could deliver better value for money.

22. Which projects might be suitable for PFI will depend on the size of a project, in terms of monetary value, and the nature of the services to be provided.

Size of project

23. PFI potential may exist even in a very small value project, but it will not be viable if the costs of promoting it as a PFI project are too high to be borne by the institution or cannot be recovered by the commercial partner. Such a project would not pass the basic test of giving better value for money. An analysis of the early experience of PFI¹ indicates that PFI is unlikely to be an appropriate procurement route for projects involving a capital investment of less than £20 million.

24. In other sectors, such as local authority schools, it has proved possible to bundle projects together, to achieve an aggregate capital value which justifies a PFI approach. In the higher education sector such opportunities are likely to be rare, but institutions should remain alert to the possibility.

PFI potential

25. Before looking at specific areas of institutions' activity, it will be helpful to identify the general characteristics of a project which offers PFI potential.

Provision of a service

26. PFI is highly unlikely to show any advantages over a conventionally funded solution if the comparison is based on the provision of an asset alone. In many cases the cost of capital will be higher for the commercial partner than for an institution. PFI only has advantages if the project contains sufficient elements of service delivery, to give scope for the private sector to manage the balance between capital and operating costs.

Scope for risk transfer

27. The object is not to transfer all the project risks to the private sector, but rather to allocate them so that the commercial partner carries the risks that it can manage more efficiently than the institution.

Examples of such risks are:

- a. Design and construction. The most significant advantages come when private sector partners are responsible not just for the initial design and build of a facility, but also for its operation throughout the life of the project. They are then best placed to minimise the whole-life cost of the asset, including repair and maintenance costs, with payment linked to when the facility is available for use.

¹ 'PFI: meeting the investment challenge' (HM Treasury, July 2003).

b. Management and operating risk. The essence of this transfer is to relieve the institution of a task which the commercial partner may be better able to perform. The institution defines the standards of service which it requires; the commercial partner bears the risk of delivering within the price agreed. This also frees up the senior management of the institution to deal with its core activities of teaching and research.

c. Volume risk. Despite uncertainties over such variables as long-term income and student numbers, institutions have traditionally provided and managed all their assets and services, taking all the associated risks of changes in demand or usage. This policy means they cannot readily respond to increases in demand, or alter costs and prices in the face of changing requirements. A commercial partner may be able to reduce the total risk by adding an additional use to existing capacity, or by finding another use for the facilities when they are no longer required by the institution. Obviously scope for this sort of risk transfer is project specific: a commercial partner might find an alternative use for residential accommodation more easily in a city than in a campus university.

d. Technology risk. The higher education sector has usually acquired high technology research and laboratory equipment by outright purchase, using finance leasing or other forms of borrowing. Thereby it has accepted in full the risk of technological obsolescence. Such risk can be shared, or more efficiently managed, by entering into operating agreements with specialist commercial suppliers, who may also be able to lay the risks off against other commercial operations or absorb them within the total package. Such PFI arrangements also allow suppliers to take advantage of technological advances, and offer improvements to services.

Income from third parties

28. Some projects have potential for generating income from third parties, which may fall to the commercial partner or the institution, or be shared between them. However it is collected, it will be reflected in the overall cost of the project. The potential for a third-party income stream is not essential for a successful PFI project, and many projects have provided value for money without one.

Better value for money

29. The ultimate test is whether the project can provide the equivalent service more cheaply, or at a better quality, when delivered by PFI rather than a more conventional procurement route. In making this judgement, it is important to ensure that the comparison is a fair one. The costs of the conventional option must include a realistic pricing of all the services provided by the PFI solution, and must value the risks which are not being transferred.

Types of project

30. Whether or not the project is an appropriate candidate for PFI will depend to a large extent on whether the institution sees it as a non-core activity that others have the skills to deliver. This guide differentiates between core activities which are unquestionably concerned with the institution's central objectives of teaching and research, and other activities such as car parking which are undoubtedly non-core. Individual institutions may wish to establish on which side of the dividing line they place, for example, the provision of

student accommodation or careers advice. In simple terms, they are likely to consider non-core functions first for PFI, but would wish to retain full control and responsibility for core activities. Even within this, they should distinguish between the core activities such as teaching and research, and the non-core activity of providing the facilities for them.

Non-core activities

31. Examples of possible PFI deals involving non-core activities are given below. They have all been successfully considered for PFI in other sectors. All involve transferring some element of risk. Some also have the potential to generate income from third parties: for example, car parks and sports facilities will often have secondary uses when not required by the institution.

- a. Car parks. Transfer provision, management and maintenance, with an opportunity for income from secondary use. The institution avoids most of the costs for provision and management. The commercial partner takes income.
- b. Offices. Transfer provision, maintenance, building service management, and the right to use the assets at the end of the contract term. The institution occupies and pays for use by a regular single charge covering elements of availability, performance and, possibly, usage or demand. This charge reflects the fact that the commercial partner has rights as the end user.
- c. Catering. Transfer provision of facilities, maintenance, management and service delivery. The commercial partner takes the income.
- d. Entertainment, sports and leisure facilities. Transfer all aspects of provision, with protected minority user rights for the institution. The institution or individuals pay for use; the commercial partner assumes full liability. The institution might take a profit share.
- e. Commercial services. The commercial partner makes all provision, with opportunities to sell on franchises and occupational leases. The institution provides the site and receives some income, but the commercial partner meets all costs.
- f. Residential accommodation. The commercial partner assumes responsibility for management and maintenance of existing facilities, and for future provision. Income is shared with the institution.
- g. Conference facilities. A joint venture provided, managed and marketed for both partners. The institution retains rights for academic conferences, but all income goes to the joint venture, with profits distributed in accordance with the amount of investment and risk-taking.
- h. Combined heat and power. The commercial partner takes responsibility for delivering electrical supplies and heat energy, and possibly also for the maintenance of the distribution system. Opportunities may exist for extending the supply to third party customers, with the institution sharing the benefit of any economies of scale achieved.

Core activities

32. PFI contracts in support of core activities are most likely to be found in providing the directly associated facilities. In principle there is little to differentiate them from non-core activities, except there may be less opportunity to transfer volume or usage risk to the commercial partner. The specialist nature of some buildings may also make it more difficult, though not impossible, to transfer risks associated with end-use or residual value.

33. It is likely therefore that facilities in support of core activities will be procured by 'design, build, finance and operate' (DBFO) deals, in which the private sector partner is reimbursed by a regular single charge covering elements of availability, performance and, possibly, usage or demand. Such deals can provide teaching, laboratory, lecture and office space, and also access to facilities such as research equipment. The stress is on paying for access to, and use of, the facilities, rather than acquiring them as an asset: the deal is framed to provide laboratory space, for example, rather than to build laboratories.

Stage 1 Establishing the business need

34. The starting point for any institution is to examine all its activities and assets systematically in the context of its strategic estates and investment plans. The aim is first to establish its business needs. It can then consider in outline how these needs might best be met, and identify those areas where the principles of PFI could be applied. Given the diversity of an institution's activities, it would be surprising if such an exercise did not reveal some areas with the potential for PFI.

35. This process will enable an institution to take a corporate view and reach a broad judgement about the future balance between methods of procuring facilities to support its operations.

36. In carrying out this examination, the institution might consider the following:

- does it need to incur the costs and risks of acquiring and holding land, buildings and equipment in the future?
- what is the scope for transferring some or all of the existing stock of land, buildings and equipment to a commercial partner?
- what facilities are needed in the future, specified in terms of outputs and services?
- what is the scope for transferring non-core activities to a commercial partner, and generating income from these facilities?
- what risks should the institution retain, bearing in mind its past record in managing them? How will it manage them?

Stage 2 Appraising the options – choosing a procurement route

37. The general characteristics of a project which offers PFI potential have already been discussed, in paragraphs 25-33. To test whether PFI is relevant, the following questions should be asked:

- a. Can the requirement be expressed in terms of a service?

- b. Are there providers other than the institution?
- c. If there are, could provision by another supplier offer better or at least equivalent value for money? Definitions of value for money, and how to establish a base measure for it, are addressed in Stage 3.
- d. If so, can the associated risks be managed at lower cost, more effectively and with greater expertise over the lifetime of the facility?

38. If the answer to all these questions is yes, then PFI is relevant and the institution should proceed to a more detailed project appraisal.

Stage 3 The business case and the reference project – assessing value for money

39. PFI will not turn a bad project into a good one. At the very least, there must be a project which is a better option than doing nothing. This project can then be tested for a range of procurement routes, to establish which offers best value for money. The PFI process exposes the project to bidders at an early stage, and they too will have to be convinced that it is viable – a particularly searching form of peer review. Therefore, the institution must carry out a detailed project appraisal.

40. Authoritative guidance on project appraisal is given in the Treasury publication 'The Green Book: appraisal and evaluation in central government' (HM Treasury, 2003). This should be followed where projects involving public funding are being considered. Further guidance is given in our own guide 'Investment decision making – a guide to good practice' (HEFCE 2003/17).

41. However, most projects in the higher education sector will not involve direct public funding, so the comparison will be between procurement options funded by the institution or by commercial sources, or a PFI solution. In such cases the requirements of the Green Book can be moderated in the following ways:

- a. The institution need only consider costs and benefits to the institution; the wider costs and benefits to the economy are not relevant.
- b. The public sector comparator is not relevant; the relevant comparator is the conventional procurement option which offers best value for money.

42. The Green Book emphasises the importance of making an explicit analysis of risks in any appraisal. It is necessary to value the risks being transferred or retained, to ensure the options are compared on a consistent basis. The basis of valuing risk should include:

- the costs should the event occur
- the probability of the event occurring.

43. Risks which are retained should be included in the investment appraisal of the conventional procurement option, to balance the costs of the PFI option which will include the costs of the risks being transferred. Further advice on the treatment of risks in an appraisal is given in Annex C of HEFCE 2003/17, available on the web only at www.hefce.ac.uk under Publications.

Developing a base for evaluating the PFI deal

44. A PFI solution should not cost the institution more than a conventional procurement route would have done, when considered on a comparable basis, and taking into account the same outputs and risks transferred.

45. If PFI were a simple matter of comparing the costs for providing a standard building, for example, then this comparison would cause little difficulty. However the inherent flexibility of PFI may result in a different project solution, making direct comparison impossible. The PFI solution is also likely to involve regular service payments for the facility and a range of services, provided as part of the contract. The comparison therefore needs to be over the life of the contract and to reflect all the elements in it.

46. This is achieved by comparing the net present values produced by discounting the cash flow from the PFI option and a conventionally procured comparator (CPC). The option with the lower net present cost should be the preferred one, unless there are strong non-financial considerations.

Costing the comparator

47. The starting point for the CPC is to identify all the costs and benefits to the institution if it were to provide by conventional means the full range of services delivered by the PFI contract. This will include the cost of assets such as buildings or equipment procured conventionally, as well as the whole life operating costs of those services, and any external income. The CPC must also include the costs of all the risks being retained by the institution.

48. Where a similar but conventionally funded project is not possible, the institution should carry out a systematic financial comparison with the realistic alternative options. This may mean going back to the base case 'do nothing' option, or looking at achieving the same objectives in a quite different way.

Risk

49. The costing of the CPC must make full provision for all the risks which the PFI project might transfer to commercial partners, and which they will incorporate in their bid. In a conventionally procured solution, the institution may be bearing not just the risks associated with delivering the capital assets, such as cost and time overruns, but also all the risks that might affect the operating costs in the longer term. These include maintenance of the assets, cost of utilities, wages, technological obsolescence and residual value. All these elements must be included in the comparator if a fair evaluation is to be made.

Reviewing the costs

50. Comparative costs should be regularly reviewed. The net present value for a conventionally procured solution can be calculated at the start of the project, but it is highly unlikely that the final version of the same calculation can be made for the PFI option until very late in the procurement process. Indeed it may not be possible to do so until the parties have agreed what is to be provided and what is to be paid.

51. Both institutions and bidders must realise that despite all attempts to minimise the risk of abortive costs and lost time, even at this late stage the PFI deal may not proceed because the cost exceeds the cost of conventional procurement. Throughout the negotiation both parties will need to review progress regularly to minimise this risk, and the CPC must be updated and kept in line with the PFI option. Early experiences of this situation in National Health Service PFI deals have made the commercial sector understandably cautious.

Affordability

52. In addition to testing whether a project offers value for money, a separate and equally important test is whether it is affordable within projected cash flows over the whole life of the project. Institutions must be aware that private sector providers will make explicit provision in their price for the risks they agree to bear. This may make a private sector solution look less affordable if the institution has not made a similar cash provision for the risks it will bear when constructing the CPC.

Confirming commitment

53. Institutions should not embark on a PFI process unless there is a realistic chance of success. An unsuccessful attempt at PFI will not only involve both institution and bidders in nugatory expenditure, but will also damage the credibility of the higher education sector in the eyes of potential PFI providers. Paragraphs 30-33 described the type of projects that are likely to be suitable for PFI, and the tests that institutions should apply before proceeding to the procurement stage. At this point institutions should review whether it is appropriate to go ahead. In particular, they should:

- confirm they are committed to undertaking the procurement, assuming that the bidders can meet the specification and it is affordable
- assess whether they can state their requirements in terms of outputs
- evaluate whether there is scope for risk transfer
- seek confirmation that the project is 'bankable' in PFI terms, in other words that it can be structured to attract private sector investment.

One of the ways an institution can reinforce its commitment is to sound out the market to see whether the private sector will be interested in undertaking the project.

Market sounding – soft testing for PFI viability

54. Following the initial appraisal of a project and before embarking on the PFI procurement route, institutions may well decide to sound out the market to confirm their judgement about the project's potential. This is known as soft testing. It is a valuable tool where:

- the institution wants to make certain that full PFI procurement is justified
- the scope of the project is unclear
- there is uncertainty about the PFI market for the project
- some, but not full, PFI testing is required to gain approval for an investment.

55. This stage should generally take place before establishing a project team and recruiting advisers, since that is where it fits logically into the PFI sequence. However, institutions may wish to review their

commitment to undertaking the project by some other means if the soft test indicates that PFI is not appropriate. If they are determined to press ahead by some other procurement route, then they should already be thinking about establishing a project team. There may be advantages in recruiting at least a lead adviser, who can help to formulate the soft test and prepare the documentation, and who may also provide a useful introduction to the relevant market.

Conducting a soft test

56. Soft testing involves canvassing the PFI viability of a project to selected commercial organisations which the institution or its advisers think are likely to be interested. The soft test seeks to confirm that interest, with or without additional comment. Soft testing is a consultation rather than a procurement process, and is conducted without prejudice to any later procurement procedure. Normally it can be accomplished within three months.

57. The procedure is straightforward. Once a project with PFI potential has been identified, the institution should prepare a briefing pack describing the institution itself, its market and the nature of the project in output terms. It must avoid describing the project in terms of a detailed design specification, but rather indicate its needs, and hence the outputs it wants to achieve from the project. For instance, in the case of buildings, the institution should state what the space is to be used for, rather than what it should look like.

58. The briefing pack is then circulated to a range of commercial organisations which, in the judgement of the institution and its advisers, are likely to be interested in the project. Specialist service providers, facilities managers and funders should all be approached, and of course projects involving building work will be of interest to the construction and development industry. Normally institutions can ask for a response within three to four weeks. Analysis of the responses will assist the institution by:

- a. Clarifying the institution's thinking about a project. In their written or verbal responses to the briefing pack it is common for commercial organisations to indicate, albeit in general terms, how the shape or scope of the project, or its outcomes, could be adjusted to favour PFI. For instance they might propose incorporating other aspects of facilities management, or offering a longer interest in the land.
- b. Establishing and evaluating the commercial sector's general interest in the project. The briefing pack can also invite the commercial organisations to confirm specifically whether they would be interested in pursuing the project through a formal procurement process.
- c. Determining and setting up the appropriate procurement process. The scale of interest will enable the institution to determine how the project might best be procured: for example, whether to follow a PFI route through the EU negotiated process, or some other route such as a standard fixed price design and build contract.

59. If the level and strength of commercial interest suggest that PFI can confidently be pursued, the institution will then need to address the details of conducting the PFI procurement process in the most effective way.

Stage 4 Creating the project team – selecting advisers

60. The scope for an institution to secure value for money and transfer risk will partly be determined by the commercial opportunities in the project and its ability to present these opportunities to prospective bidders. This requires a willingness to consider alternative and innovative propositions put forward by commercial organisations. It also calls for good project management. The PFI process is demanding: all the normal project pressures will be there, plus the need to deal with a number of bidders simultaneously. In particular, bidders will expect a realistic timetable to be established, and will look to the institution's project team to abide by it.

61. Once the PFI process is under way, the institution will find that a great deal of management time is spent on supporting the process, defining requirements in detail, maintaining the dialogue with bidders, selecting a preferred bidder and making sure that the institution's interests are properly safeguarded in the contract. The private sector's higher cost of capital, and impatience to turn opportunity into profit, lead to the selection of fast track design and build methods, and a tremendous desire, once the project has been proved worthwhile, to get the contract agreed. If bidders feel that the institution does not match their commitment they are unlikely to continue.

62. The institution must decide exactly who within its organisation is authorised to deal on its behalf, and the extent to which this negotiating power will be delegated to members of the project team and its advisers. The workload involved in establishing the institution's requirements and negotiating a solution will merit a full-time project manager in all but the smallest project; in the larger projects they will require significant clerical and administrative support. It is also important to clarify the extent of the project manager's authority, and the individual or corporate body to whom they report and from whom their authority is derived. This may be the governing body of the institution, or a specific project board or committee established for the purpose.

Selecting advisers

63. Much of the detail of the PFI process will be new territory to the institution and its project manager, and they will be unwise to venture there without appropriate guidance. This guide, and advice from HEFCE, can help to set them on the right path. However, the intensity and detail of the PFI process mean that further specific professional advice will almost always be required, in the following areas.

- a. Commercial and financial. The institution will benefit from someone who can guide it through the PFI process, advising how to structure its requirements to give the best scope for achieving value for money. Such a person will also be able to give specific advice on issues such as risk transfer, pricing structure, project finance and evaluating value for money.
- b. Legal. The institution will be committed to a contract for a considerable period, which could have a significant effect on its activities. It is vital that its interests are protected. The best way to do this is to involve legal advisers with specific PFI expertise from an early stage. Although their initial role will be small, early involvement will ensure that they will have a sound understanding of the institution's requirements by the time they need to influence the details of the developing agreement.
- c. Technical. The institution itself may have the necessary expertise to evaluate the technical details of bidders' proposals. However specialists in architecture or property may be needed to

evaluate aspects of a project that involves a new building or renovating an existing one, for instance: and IT specialists can help define and evaluate a project with a significant information technology content. In some cases this role can be combined with others where, for example, the commercial adviser also has IT expertise.

64. It is helpful to identify at an early stage who will fulfil the role of lead adviser. The lead adviser will play the principal part in structuring the whole PFI process, and may also provide project management support. For instance, they can take much of the load in drafting and publishing a briefing pack, the information memorandum, and the invitation to negotiate, and can act as a first point of contact for bidders. However, developing the basic output requirement of the project is one task that the institution alone must tackle. It cannot be delegated.

65. The Treasury Taskforce Technical Note No. 3 'How to appoint and manage advisers to PFI projects' is a useful source. It is essential to test the extent of advisers' PFI expertise. In this context their genuine experience and knowledge of PFI is just as valuable as their specialist professional expertise. Advisers should always be appointed by competition unless there are exceptional reasons to the contrary. Cost targets for the advisers' fees should be set at an early stage. Institutions should ask advisers to quote capped fees for identifiable tasks or stages of the project, rather than hourly or daily rates. It may be useful to explore whether costs can be reduced by paying advisers, at least in part, by 'success fees'.

66. Reputable advisers will do much to enhance the credibility and standing of the project in the PFI marketplace. Although many entrepreneurs, construction companies and consultants are seeking to put together PFI contracts in education, the funds will have to be raised from banks and other investors. The reputation of the institution's advisers will be an important factor. In each case there will be a credit or investment committee that needs to be convinced, and they are rather different from the audience for which the institution's estates strategies and strategic plans have been developed. Potential difficulties will need to be handled skilfully, and advisers with PFI experience have a role in arguing the strength of the institution's position within the higher education sector and the soundness of its proposed project.

67. Engaging advisers may appear expensive. However, institutions should bear in mind that:

a. PFI is not the only procurement method which may involve paying for outside advice. Even a conventional building project will require a project adviser in its early stages, and a client project manager to act on the institution's behalf.

b. The value of a PFI contract is based on the delivery of services over a long period. It is likely to be several times the cost of the assets involved, and it is this overall cost which must be the yardstick when evaluating the expense of the procurement process.

Stage 5 Deciding tactics

68. Before it initiates the procurement process, the institution must decide how to handle the response. In the pre-qualification stage it may have to select a short list from sometimes as many as 30 bidders. The number on the short list needs to be large enough to foster innovative competition while still giving the bidders sufficient prospect of success to encourage them to compete. It should also allow for the possibility that at least one of the bidders might pull out mid-way.

69. If some further selection is to take place, such as the preliminary project submission described below, then a target of about six bidders would be reasonable. If all short-listed bidders are to enter into full negotiations then at least two, and preferably three, is a sensible number for the short list, with a maximum of four. If more than four are involved in full negotiations they will be discouraged from committing the time and resources needed to support a bid. This would also impose greater demands on the institution's project team and its advisers.

70. A further refinement is to split the negotiating stage into two phases, and to weed out the short list gradually so that only two or possibly three bidders work up fully priced bids. However, this process must be made clear in the initial information memorandum. Typically this option has the advantage of allowing a slightly longer short list at the outset, and possibly a less closely defined statement of requirements for the first phase, providing more opportunity to gather innovative proposals. A further short-listing process can then take place, with the last few bidders working up their proposals in greater detail in the second phase. The first phase must define the deal in sufficient detail to cover all the key issues which might subsequently affect value for money and risk transfer. This is because the second phase gives the institution much less scope to exploit the competitive tension between bidders in negotiating details.

71. Bidders will look for a clearly defined timetable, and will naturally want to see one which reduces the number of bidders early, and proceeds as quickly as possible to selection of a preferred bidder, to minimise their risks and financial exposure. On the other hand, the institution's interests may be better served by keeping all three or four short-listed bidders involved in the process for as long as possible. This will help to maintain competitive tension, though it will involve more effort from the institution and its advisers.

72. The best compromise will be achieved by minimising the overall length of the bidding process and the negotiating phase, consistent with allowing enough time for an optimum solution to emerge. The institution should have defined its output specification, and prepared the bidding documents, before it initiates the procurement process. Bidders will quickly become disillusioned, and lose confidence in the project, if they are kept waiting while the institution stops to sort its ideas out.

Stage 6 The OJEU notice – inviting expressions of interest

73. Institutions are required to observe EU rules on the procurement of assets and services, so it is worth considering in general terms those rules that affect PFI procurement.

74. A PFI procurement process that is subject to the EU rules is likely to take one of two contractual forms, for works or services; it is unlikely to fall under the rules for supplies. Each has a threshold project value, above which the opportunity must be advertised in a specified way in the Official Journal of the European Union (OJEU). The current financial thresholds are available on the OGC web-site.

Interpretation

75. Although many deals will include a significant works element, a genuine PFI project is likely to be a service contract, primarily concerned with providing services or facilities. However, the classification will depend upon the proportions of the various elements; for example, a works contract may also incorporate elements of facilities management. Institutions will need to take legal advice on this issue to be sure the

project is properly described. In many cases the exact balance between works and service elements will not become clear until some way through the negotiation process, and in the initial stages it may be sensible to advertise under both services and works categories.

76. Care is needed in assessing the value of projects to see if they fall above or below the relevant thresholds. If during subsequent negotiations the institution wishes to extend the project to include additional services or a further phase of capital development, the extra costs will have to be added to the original, and the total value may then exceed the threshold. This could force the institution to halt the procurement process while it advertises the project in accordance with the EU regulations. Similar considerations apply if the scope of the project changes significantly, in either direction, after the advertisement is placed.

77. Other reasons may also make it advisable to pursue the OJEU route for projects below the threshold.

a. Uncertainty about the costs of the proposed project can create the potential for alternative solutions which then exceed the threshold. The institution might then have to decline a proposed solution even though it would have yielded greatest value and risk transfer.

b. The marketability of the project is enhanced by using the EU procurement rules to emphasise to the commercial sector the fair and open approach of the institution.

c. If a commercial organisation challenges the procurement process the cost could be quite high and the challenge could delay the project.

d. The timescales imposed on the awarding authority by the EU rules are minimum requirements. They specify allowing at least 37 days for bidders to respond. Institutions may wish to observe this timescale anyway, regardless of the procurement route selected, to ensure that they obtain high quality and well considered submissions.

e. The perceived advantages to the institution of pursuing a tendering process free of the EU rules may be illusory. The opportunity to explore commercial sector schemes in detail, before the short-listing phase, is in practice limited by both competitive forces and the expense incurred by the commercial sector in developing proposals.

f. The EU rules do not prevent the institution, if it wishes, from inviting selected organisations to express interest in the project, so long as it does so after the advertisement is published.

Tender procedures

78. Having decided to embark on an EU procurement process and place an OJEU advertisement, the institution must decide on the tender procedure to be adopted: open, restricted or negotiated.

79. In an open procedure, all respondents are invited to tender, and there is no substantive negotiation. It is thus most appropriate for procuring straightforward supplies rather than PFI projects. The restricted procedure allows the awarding authority to select a limited number of bidders but allows only limited scope for negotiation.

80. Both of the above procedures work best where inputs and outputs are clearly defined from the start. In PFI, where this is not normally the case, the negotiated procedure is generally more suitable. This allows the awarding authority to select a limited number of bidders and allows for negotiation from there up to the final contracts.

81. Further information on the use of the negotiated procedure is available in the Treasury Taskforce Technical Note No. 2 'How to follow EC procurement procedure and advertise in the OJEC'. (When this note was published, the full title of the journal was the 'Official Journal of the European Community'.) However, institutions should be aware that a revised EU directive is anticipated in 2004. This is likely to include provision for a new process of competitive dialogue relevant to the negotiation of PFI contracts. The advice in the following paragraphs is based on the use of the existing negotiated procedure.

82. All EU procurement processes involve placing the appropriate advertisement in the OJEU and then applying objective pre-specified selection criteria. Institutions should follow the Treasury guidelines on including standard paragraphs in the advertisement, which are reproduced as Annex B. In each case the contract must be awarded to the tender with the lowest price, or 'with the most economically advantageous offer' in the language of the EU rules.

83. In the case of the negotiated procedure, initial selection criteria will relate to the respondents' technical or financial capacity, but not be specific to the project. Those thereby selected to negotiate will be evaluated, on the basis of their tenders, as to who can provide 'the most economically advantageous offer', or the best value for money and transfer of risk in the terms of the PFI project.

84. The initial advertised invitation and the supply of more detailed information mark the start of a formal procurement process designed to ensure fair competition. All qualification and proposal criteria must be transparent and equally accessible to all parties. Decisions must be taken strictly in accordance with stated criteria which must therefore be carefully thought through beforehand, to ensure that the institution's objectives will be met. Once the evaluation criteria have been published, they cannot be altered in any way.

Advertising the opportunity

85. Drafting the advertisement in broad output terms gives the greatest flexibility in determining the nature of possible bidders, either consortia or individual. Careful drafting will ensure that the institution and its advisers retain the option to develop partnerships which give the institution scope to exploit strategic opportunities. Too specific a statement of requirements may deter some potential bidders, and may restrict the opportunity to consider innovative suggestions put forward during the competition.

86. The requirement to advertise in the OJEU has already been discussed (paragraphs 73-77). Depending on the chosen procurement process, the institution may also advertise in other government journals and in the press. For smaller projects especially, trade journals such as 'The Builder' can prove useful.

The information memorandum

87. The institution should issue an information memorandum. This must be ready when the OJEU advertisement is published, since it will be the basis upon which commercial organisations express interest

in being selected to tender. If the project has been soft-tested using a briefing pack, the information memorandum can be a slightly amended version of that document (paragraphs 56-57).

88. The information memorandum should set out the following:

- the background to the project
- the institution, its market and the nature of the opportunity
- a summary of the institution's requirements, in terms of outputs
- details of any existing facilities, and an indication of whether and how they might be used to meet future requirements
- a summary of the PFI principles as they apply to this opportunity
- an indication of any work done on a conventionally procured alternative, and whether this work will be made available to bidders
- an indication of the funding sources which the institution will use to pay for the project.

89. With PFI, the relationship between an institution and a commercial partner is much longer term than with conventional procurement, so the commercial partners will probably need to know far more about the nature, financial soundness and long-term continuity of the institution's business in order to assess risk. The institution should have a clear statement of these matters and may need to show development plans and revenue projections over the medium term.

90. The project should be described in terms of desired outcomes, parameters, performance standards and basic control requirements. For the commercial sector to respond creatively the project description must be seen as a framework rather than a straitjacket.

91. There is no need for detailed building specifications; only an indication of the purposes the buildings must serve. At the same time the commercial sector needs to know what it cannot do in and around the project. This offers far more freedom to consider commercial activity and alternative uses than laying down what is permitted. Bidders will also need to know what basic controls the institution will want to exert to ensure that its core objectives are met.

92. The information memorandum should indicate the qualifying requirements for commercial organisations wishing to express interest. This gives the institution a framework for ensuring the adequacy of its potential partners, and helps it to draw up a short list. The institution should include a series of questions at the end of the information memorandum concerning the financial, technical and commercial standing of bidders as described in the pre-qualification and short-listing criteria detailed below (paragraph 94). It should also state any additional criteria it might apply, such as the project criteria below (paragraph 97), and the number of organisations it intends to invite to the next stage.

93. The EU rules lay down a minimum of 37 days, from the day the advertisement is despatched for publication in the OJEU, for 'expressions of interest' to be returned. A shorter period is available under the accelerated procedure, but the institution would have to be subject to severe time pressures to justify this.

Stage 7 Pre-qualification

Basic qualifying criteria

94. The institution needs to establish relevant criteria to ensure that bidders are all capable of doing the job. These qualifying criteria should include basic information about their business, and specific information about familiarity with the sector, the substance of the project and PFI.

- a. General and financial information:
 - the bidder's details
 - the bidder's audited financial statements for the last three years
 - details of any pending or threatened or other legal proceedings
 - bank reference.
- b. Technical and commercial capability:
 - details of projects undertaken within PFI
 - the experience of the bidder's legal and financial advisers in advising on PFI
 - experience of managing DBFO projects, facilities management and the assumption of other risks such as residual value, volume or capacity
 - other experience, alone or as part of a consortium, within or outside PFI
 - project management and project funding experience.
- c. Understanding of PFI and the higher education sector:
 - knowledge of the PFI regime in higher education
 - details of projects undertaken within the higher or further education sectors in the UK and if relevant in the EU
 - details of any other work in the education sector.

95. EU regulations require that only basic qualifying criteria can be used for initial selection. To ensure that the criteria are applied fairly, a brief written appraisal should be made of each submission.

Stage 8 Short-listing

The role of a preliminary project submission

96. In many cases applying the basic qualifying criteria will reduce the number of bidders to the target, and the institution can move directly to the invitation to negotiate. It may however be appropriate, subject to legal advice, to explore those basic criteria against a bidder's views of the project. As part of the expression of interest, the institution may therefore wish to invite commercial organisations to make a preliminary project submission in response to the information memorandum. This can help the institution to refine the list of bidders who have met basic criteria, and produce the short list to be invited to tender or negotiate.

97. The institution is not seeking detailed views, but an indication of the bidders' view of the project and their approach to it, to show compliance with the basic criteria described above, having regard to the

institution's needs, the educational context and PFI. As such, the institution should invite commercial organisations to explain their:

- understanding of the application of PFI, including risk transfer and value for money
- capability to meet the timetable and handle the project
- approach to design
- approach to developing a partnership with the institution's management
- understanding of the institution's output specification
- ability to provide funding.

98. The process of short-listing will often involve a discussion between commercial organisations and a selection committee comprising the institution and its advisers. At that stage the institution can only take into account basic qualifying criteria, using in some cases the preliminary project submission and any further information which organisations wish to supply. All interviewed organisations must be evaluated by reference to the same framework, and the number selected must be in accordance with the institution's previously stated intentions.

Stage 9 Refining the original appraisal

99. The original project appraisal will have been based on assumptions about what the market can deliver and the extent to which risk can be transferred. A feature of PFI is that these assumptions can be refined during the process. Within the limits established by the original OJEU advertisement, the negotiated procedure allows the project solution to be developed by consultation between the institution and the bidders.

100. Even at this stage, the responses to the invitation for expressions of interest, and discussions with prospective bidders, will help the institution refine its ideas about what the project can deliver, and may prompt changes to the output specifications. These should be reflected in the CPC.

101. The institution should be prepared to revisit its original appraisal, to confirm that the decision to proceed with PFI remains valid. Bidders will look to the institution to re-affirm its commitment to the project, and its affordability, to give them confidence that their bids will represent a realistic solution to the problem.

Stage 10 The invitation to negotiate

102. Once a short list has been selected, the institution will need to set out a detailed framework within which the commercial organisations can make their offers. This is normally done with a formal document known as an invitation to negotiate. It is advisable to develop the invitation to negotiate while awaiting expressions of interest.

103. Precisely what will be covered will vary considerably from project to project, and will depend upon the judgements of the institution and its legal, financial, technical and PFI advisers. However, institutions should bear in mind that:

a. The outcome of the invitation to negotiate will be offers which the institution must evaluate and which should lead to the basis of a contract. The document must therefore be as comprehensive as possible.

b. This is a PFI project. Therefore, however detailed the invitation may be on the points which it needs to cover, institutions must give commercial organisations as much flexibility as possible to respond creatively.

104. The institution and its advisers are likely to want to include in this document:

- a description of the institution, its markets and competitors
- a description of the opportunity
- an output specification
- an outline contract specification
- a description of the assessment framework, the performance standards and how these link to the payment mechanism.

The institution, its markets and competitors

105. Although much of this will already have been covered in the information memorandum, more detail may now be required to convince bidders to enter into partnership with the institution. For example, it may be wise to add more detail about the management and organisational structure of the institution, or the educational activities of particular relevance to the opportunity.

The opportunity

106. The institution will need to determine the scale and nature of the facilities and services to be provided by the successful bidder. It should also describe the site and, where relevant, existing services. The portfolio of services and facilities will determine the scope for demonstrating value for money and transfer of risk. At the same time, the institution will need to set out areas of sensitivity, both culturally and operationally, regarding the commercial provision of services, together with any control mechanisms it wishes to exert in order to protect its usage.

An output specification

107. Having defined the services to be provided and the associated PFI parameters of value for money and the transfer of risk, the output specification is the key yardstick against which bidders demonstrate the value for money and the transfer of risk inherent in their proposal. The institution will probably need to consult with other service providers as well as PFI advisers in preparing this specification.

108. Typically, the output specification should include information on:

- broad functional content
- key service relationships, to define how the elements of service delivery interact and which need to be near each other
- key design requirements

- indicative schedules of equipment
- the site and any limitations on the building footprint
- information technology requirements
- student access requirements
- service specifications
- quality standards.

109. A project plan will be required, setting out key milestones, components, approvals, design, construction, commissioning and occupation. A statement of the timing and value of payments will also be required, against a fully considered development control plan.

Outline contract specification

110. The institution, with its legal advisers, will need to provide bidders with at least an outline of the proposed contractual framework. It is worth exploring whether any relevant model contract terms and conditions exist, either in generic form or from a previous similar project. The contractual framework will need to cover the following:

- nature of contracting body
- the contractual relationship
- length of contract, breaks, triggers and renewal clauses
- liabilities of parties to the contract
- terms under which facilities and services will be provided
- performance standards
- the structure, method of operation and funding of the bidder
- transfer of assets
- break points at which there may be a requirement to market test services
- income sharing arrangements
- payment arrangements
- step-in rights for the institution, allowing it to take over service provision if the supplier gets into difficulties
- step-in rights for the funders, allowing them to substitute another service provider if the supplier defaults
- default and termination provisions.

111. In most PFI deals the control, ownership or management of assets or services will be in the hands of a commercial organisation. Commercial organisations will be concerned, when assessing their risks, to satisfy themselves about the long-term reliability of the institution as a partner. Likewise, the institution will want to be assured that it is protected against risks to its services which may arise from the default or failure of a commercial organisation. How an institution will protect its services will depend on the circumstances and the advice it receives. In general, the risks an institution faces are likely to include:

- failure to deliver to time
- failure to perform to specification or achieve performance standards
- insolvency
- take-over or corporate restructuring.

112. Each could affect the services which the institution needs to provide to sustain its core business. It is possible to protect the institution's position using measures such as:

- financial penalties for delay and default in delivery
- financial penalties for failures in service quality
- structural protection from defaults by the individual members of a consortium, by interposing a PFI company or 'special purpose vehicle', which guarantees overall performance of the consortium.

The assessment framework

113. As part of the output specification discussed above (paragraphs 107-109), a comprehensive list of schedules will be included for the bidders to complete. The institution and its advisers can then develop a framework to evaluate the tender bids against a number of factors, to compare value for money and transfer of risk. These factors might include:

- how well proposals conform to the tender conditions
- net present values from investment appraisal of options
- payment methods
- planning and design issues
- services to be managed by the bidder
- contractual details, issues and structure
- qualitative assessment of which proposals best meet the institution's objectives and required performance standards
- extent of risk transfer.

Negotiation with bidders

114. The key elements of the contract should be established at the negotiating stage while the bidders are still very much aware that they are in competition. Maintaining momentum is important. As soon as the process is allowed to falter there is a danger that enthusiasm will wane. This may lead to bidders withdrawing, or at the very least putting in less effort, and is likely to reduce the quality of the contract available to the institution. The key ingredients for success are commitment from the institution's senior management, adequate resources and sticking to an achievable timetable.

115. The EU procurement regulations apply equally to this stage of the process. They must be followed in detail to ensure that no challenge can be made later by a dissatisfied bidder. Once bidders have received the invitation to negotiate, they cannot be dropped from the process until they have had an opportunity to present their proposals. From this point on, the institution may only remove bidders from the process on the basis of the quality of their proposal, not on the basis of some aspect, such as the structure of a consortium, which was defined at the pre-qualification stage. It will of course be difficult to assess the quality of the proposal unless a reasonable level of detail has been provided.

116. The institution and its advisers must develop a clear understanding of the outputs that a bidder will be asked to provide, supported by robust and appropriate contractual arrangements. Using standard forms to

draw out specific responses to information requirements – financial, qualitative and quantitative – will help in the evaluation phase as well as minimising any gaps in the information.

117. It is inevitable and desirable that there will be a number of meetings with each of the bidders during the negotiation stage, sometimes collectively but more likely individually. It is essential to remember throughout that the process is governed by EU procurement rules, so all bidders need to have a level playing field. Thus if any information or amendment is given to one then it must be given to all. However, the institution must also be careful to protect the commercial confidentiality of each bid.

118. With these principles in mind, the procurement process will be smoother if the institution or its advisers:

- seek clarification from bidders on outstanding issues, to ensure early identification of problem areas
- provide feedback to the bidders on the acceptability of their proposed scheme
- clarify the institution's understanding of the scope for negotiation, especially in areas where a bidder might generate income streams from additional services to a third party.

Stage 11 Evaluation of bids

119. The institution will then have to evaluate the PFI bids. The details of the evaluation process can be developed in parallel with the negotiations, but it is important that the principles are established at a very early stage, before the invitation to negotiate is published. This is because the evaluation must be based on an objective assessment of how well the bids meet the stated requirements. In an EU procurement process, the institution has to award the contract on the basis of the lowest price or 'the most economically advantageous offer'. It will therefore choose as a preferred bidder the one which appears to offer the best value for money.

120. To set out a clear audit trail for recommending a preferred bidder, the institution and its advisers must undertake a comprehensive evaluation of the fully priced bids. This is likely to comprise:

- a commercial evaluation of the proposed partner
- an evaluation of how well the proposal meets the output specification
- financial, economic and strategic evaluations of the proposal
- an evaluation of the degree to which value for money and transfer of risk are demonstrated
- a check on the financial robustness of the bid.

It will be easier to evaluate the financial sensitivities of bids if bidders are required to submit a copy of their financial model in electronic form.

Financial appraisal of the proposal

121. The financial appraisal should help the institution to assess how the tender submissions compare with the conventionally procured option. It should include the following elements:

- appraisal of capital and operating costs to ensure that they give value for money and transfer risk, by using data generated from other similar projects or recognised good practice

- a qualitative comparison of performance and facilities
- the net present value of the options, compared on a consistent basis, including the transfer of risk
- a sensitivity analysis showing the impact of changes in key variables.

Evaluation of risk transfer

122. Submissions must be evaluated against each other and the CPC for the transfer of risk. All risks should be documented and analysed, so that they can be cross-referred to the eventual legal agreement. Risks might usefully be grouped under headings which match the elements of a payment mechanism.

- Availability risks. These are risks which affect whether the facilities can be used. In building terms: is it watertight and weatherproof, are the basic utilities available, and does it meet health and safety legislation?
- Performance risks. These relate to the service delivery element of the proposed contract. Failure to deliver to the specified performance level would lead the supplier to incur a financial penalty.
- Demand risks. These only apply where demand is expected to be variable, and parties to the proposed contract are prepared to see this reflected in the payment mechanism.
- Residual value risks are also significant. They relate to the state and usefulness of the facilities at the end of the contract period. Although they cannot be associated with any particular element of the payment mechanism, they will certainly influence the overall payment structure.

123. The private sector partners should specify where they feel they are better placed to manage risks on behalf of the institution, and to reflect this in the proposed contract price.

Evaluation of value for money

124. In assessing best value for money, other contributing factors will be taken into account, such as:

- additional business development potential
- generating alternative uses for the facilities
- additional positive benefits for the institution.

Stage 12 Selection of a preferred bidder – negotiation to financial close

Commercial evaluation of the proposed partner

125. As the institution is proposing to develop a medium- or long-term relationship with a commercial partner, possibly including the transfer of sensitive services previously provided in-house, it is essential to ensure that the successful bidder can provide the scale and nature of services required. To this end the institution should check the commercial standing of the bidder in more detail than at the pre-qualifying stage.

126. This might involve:

- undertaking additional due diligence on lead companies and consortium members to ensure financial security
- testing the ability of the bidder or the bidder's sub-contractor(s) to provide services as specified
- where bids are conditional on raising finance, seeking independent confirmation that this is likely to be achievable.

Negotiation to financial close

127. Following the identification of a preferred partner, the institution and its advisers will need to work through what are often complex and extensive negotiations in order to frame the offer as an agreement or series of agreements which together make up the PFI contract. Experience in health sector projects has shown it is best to keep the time between appointing a preferred bidder and financial close as short as possible. This means that substantive issues must be resolved before the preferred bidder is appointed. Institutions must work to a disciplined timetable. They must know what outputs they are seeking and how flexible they can be in negotiations.

Stage 13 Contract award

128. At the stage when the contract is to be awarded, attention is likely to focus on how the various elements of the PFI offer can be transferred into a project agreement. This should set out the nature of the relationship between the institution and the preferred bidder, who may establish a 'special purpose vehicle' as a contractual company. The resulting legal contract builds on the outline contract specification established in Stage 10, and will include the following.

- a. The circumstances under which the institution can use the facilities. It might have exclusive use throughout the contract term, or the right to a guaranteed level of access which reduces over time. Alternatively, it may compete in the market for use of the facilities. Where the institution has primacy, the agreement will cover the circumstances under which the supplier can exploit spare capacity.
- b. The construction and development of the facilities. This covers the arrangements under which the supplier has access to the institution's land or premises to carry out construction; the freedom the supplier has to use initiative in the development; and any constraints on the style, scope or scale of development which the institution may wish to impose. It should also cover issues such as the ownership of the completed facilities, and how they will be disposed of at the end of the contract term.
- c. The associated services provided by the private sector. This should include the methods of service delivery and the performance standards that the supplier will be required to maintain. It should also specify what freedom the supplier has to offer these services, or others, to a third party.
- d. Details of the payment mechanism. This explains how the payments are related to the availability of facilities, and the way in which penalties are imposed when service delivery is below standard.

e. Ownership and reversionary interests. These specify what happens to the facilities at the end of the contract.

129. Once a contract has been agreed, the institution will need to complete the formalities of the EU procurement process by placing a contract award notice in the OJEU.

Stage 14 Contract management

130. Both parties to the contract will have to live with it, and with each other, for a considerable period. The negotiation procedure gives a valuable opportunity to explore the intangible aspects of such a relationship, in parallel with establishing the details of the proposed contract. It is important that the institution's preferred bidder is also seen as a compatible partner. While the institution should not inhibit the supplier's ability to manage the service delivery as the contract requires, nevertheless it should be an active and intelligent customer.

131. At a very early stage, the institution must establish the team that it will use to manage the contract. Both parties should understand how the contractual relationship will be maintained. It is helpful if the institution nominates a single point of contact for all dealings related to the contract. This must be clear to the institution's staff just as much as to the supplier's. Relationships with the supplier will be much easier if it is made clear from the outset who is authorised to represent the institution on all matters related to the contract.

132. If the contract involves providing new or refurbished buildings, a problem may arise in the very early stages during the construction phase. The institution must remember that it is party to a contract to deliver specified outputs. Any temptation to interfere in the method of building delivery, and particularly in aspects of building design, must be fiercely resisted. Such interference in matters that are properly the province of the contractor runs quite contrary to the philosophy of PFI. If the institution seeks to influence such details, it must expect to be charged extra for the privilege. In the worst case it will find that it has effectively taken the design and construction risks back from the supplier.

133. Nevertheless the construction phase marks the start of the contractual relationship, and can set the tone for the nature of the partnership. It is perfectly reasonable to structure the contract so that the institution can monitor the progress towards contract delivery, and provide feedback. If the institution detects that the nature of the facilities being supplied will lead to operating difficulties for the supplier, then it is entirely reasonable to point this out. The institution will also wish to be in a position where it can detect early signs of the supplier having difficulty in setting up the facilities. In the extreme, should the supplier fall seriously behind programme, the institution will wish to invoke the contractual remedies which will place the supplier in default and allow the institution to make other arrangements to deliver the contract.

134. Details of how contract delivery is to be monitored will be established during negotiations, and must be closely linked to the payment mechanism. The institution must therefore have sufficient access to performance data so that it can monitor performance effectively. However, the main effort of data collection and performance monitoring should fall on the contractor. Indeed, the nature of some PFI contracts, particularly for delivering information technology services, means that data on aspects such as volume of use can only be collected by the service provider. It is reasonable to expect the service provider to have the

appropriate quality assurance systems in place, to verify the standard of their operations. The institution should then aim for a hands-off approach to the details of contract delivery.

135. Where a contract involves the commercial partner taking on the performance and management of existing services, members of the institution's staff will probably be transferred to become employees of the contractor. Their interests will be protected by TUPE legislation, and the contractor will have incorporated the associated risks into his bid. If the institution wants to influence their conditions of employment thereafter, then this must be expressly provided for in the contract. However, on a positive note, experience indicates that specialist staff in particular welcome the opportunity to transfer to an employer who may be able to offer wider career prospects.

136. Towards the end of the contract, there should be provision for a joint approach to contract termination. Obviously, if the institution intends to terminate the contract completely, it will have little interest in what happens to the facilities thereafter. However, if there is an option to extend the contract or re-tender the service provision, or if the facilities will revert to the institution or it has an option to buy them, then the material state of the facilities and their maintenance will be of direct concern. If the commercial partner takes on the residual value risk, it will be in their interest to ensure the facilities are maintained to an acceptable standard throughout the contract.

137. Institution and supplier will gain little by having a combative relationship. However, it is perfectly reasonable for the institution to expect the supplier's performance to meet the contract requirements. Indeed the payment mechanism should provide the incentive for just that level of service delivery. Where performance falls below standard, an early dialogue establishing a programme for rectification will be more valuable than just relying on the penalty payment system. A mechanism for solving problems and resolving disputes should be part of the working relationship. Contractual penalties are there as a last resort, but their use indicates that the collaborative relationship between institution and commercial partner is wanting. Termination of the contract is unsatisfactory for both sides.

Lessons learnt

138. This guide has been revised to share with the rest of the sector our developing knowledge of PFI and PPP and the experience of recent projects. Other lessons emerge from the experience of pathfinder projects, not only the successful ones but also those that set off down the PFI route and, for one reason or another, did not result in a signed deal. Much of this experience has been published as case studies; a list of those currently available is at Annex A. The rest of this section addresses some common themes.

Different deal structures

139. The preceding sections of this guide have assumed a deal which fits into the classic PFI mould, distinguished by three key features:

- a. The contract is for the delivery of a service over a period of time, not just the initial provision of an asset.
- b. The contract allocates the various risks to the party best able to manage them, so as to achieve best value for money.

- c. The risk allocation is reflected in the payment mechanism.

140. However, the wider concept of Public Private Partnership (PPP) embraces many variants. At one extreme lies the service or works concession. In the EU procurement context, a concession is a contract where the consideration consists either solely in the right to exploit the works or services, or in that right together with payment. Note that works concessions fall within the scope of the EU procurement directives, but service concessions do not.

141. A concession might exist where an institution agreed that a private sector provider would build student residential accommodation, but that the involvement of the institution would be minimal and the private sector would derive all its income from its position as landlord to the student occupants. Such an arrangement is only one step removed from a hall of residence built entirely as a private sector speculative venture.

142. Towards the other extreme are projects which follow the DBFO pattern, but stop short of a payment mechanism that transfers risk, using some sort of fixed or indexed sum without any explicit penalties for under-performance. Such deals might come about where the funders are unwilling to take on risks that they see as outside their control, for instance where the private sector provides student accommodation on a site where the level of occupancy is controlled by the institution.

Types of project

143. Many of the PFI and PPP projects in the sector have involved the provision of student residences, and a growing number of private sector providers are emerging. The deals are attractive to the private sector because the revenue stream can be clearly defined and the risks are well understood. The nature of the deals varies widely. Some follow the conventional DBFO route, with the institution paying a private sector bidder to deliver a service, and with the relationship between landlord and student tenant managed by the university or college. However, we are also seeing a growing appetite in the private sector to take on the volume risk as well, particularly in metropolitan areas, and develop halls of residence which are operated largely independently from the institutions.

144. Not all the deals have involved buildings. One group of case studies covers projects for telecommunications, a management information system, and combined heat and power.

145. But so far we have seen fewer deals which provide teaching or research facilities. They present additional difficulties:

- a. The way the higher education sector is funded makes it difficult for the private sector to identify the specific revenue streams that support this sort of project.
- b. The scope for service delivery is limited.
- c. It is not easy for a private sector operator to offer an affordable solution if they have to develop an infrastructure to manage just one or a small number of buildings on a campus, when the university's in-house operation can offer an alternative at marginal cost. To make such a project

viable, the institution needs to offer the private sector the opportunity to take on a substantial tranche of service delivery.

Size of project

146. Many of the early PFI and PPP projects in higher education were small. At the outset, we were reluctant to set a lower limit for the deals that we supported, since to do so would curtail the opportunities to seek value for money. But from an early stage it was clear that the smaller deals exacerbate one of the perceived problems with PFI: it is seen as a very complicated and expensive process to acquire an asset. To some extent this attitude comes from looking only at the cost of the underlying asset – which may be, for example, a building costing £10 million. But a true PFI contract focuses on the procurement of a service, and the contract may be worth several times as much as the building itself. This is the yardstick against which to measure the effort involved in closing the deal.

147. However, the spread of deals outside the sector has provided a larger database from which to evaluate the appropriate use of PFI as a procurement process. The current recommendation from the Treasury² is that PFI is not an appropriate procurement route for projects involving assets worth less than £20 million.

Output specification

148. Thinking in terms of outputs rather than inputs presents a difficulty for those used to more conventional procurement specifications. It is all too easy for institutions to specify what they want in terms of what they are doing now to live with the problem, rather than setting out the problem so that the private sector can help them solve it. There is also a tendency to over-specify, denying the private sector the opportunity to innovate. Institutions must realise that if they specify in too much detail how the private sector is to solve the problem, then they undermine the potential for transferring risk.

149. Institutions must recognise that it takes some time to generate an output specification, and give themselves time to get it right. This means involving the users at an early stage, and getting them thinking in the right terms. Institutions must also watch out for the possible implications: they must undertake a reality check to ensure that their specification can be met within the physical constraints of the site, and in a way that they can afford.

Project appraisal

150. One of the key features of any project is an initial appraisal, to establish that the project is viable and affordable. PFI is no different. One of its key features is that it requires the client to answer the key questions about a project at an early stage. These answers are then subjected to a very critical form of peer review, as soon as the client offers the project as a contract opportunity to the private sector bidders. Clients have to make sure that the project makes sense for them, and that they will be able to afford it. But they also need to be confident that it can be structured to represent a real commercial opportunity for the private sector.

² 'PFI: meeting the investment challenge', HM Treasury, July 2003.

151. This means that institutions also have to be fairly sure that the funders of the deal are going to be in agreement. Institutions must establish what the commercial aspects of the deal will be, before committing to one of the bidders. There is a real risk that institutions may think they have come to an understanding with the bidders, only to have the whole negotiations opened up again when the bidders introduce their funders to the negotiating table. The project's financial backers are a key influence, since it is ultimately they who will determine the price from their perception of the risks involved.

Risk and affordability

152. Understanding risk is the key. Institutions will seek a private sector bidder who can manage some of the risks more efficiently than they can, and who is prepared to reflect that efficiency in the price. But institutions must understand that bidders are going to make an explicit provision in the price for the risks they are taking on. Previously the institution may have been accepting these risks itself, but not pricing them. So institutions must make an appropriate adjustment when they evaluate competing bids.

153. A recent report³ identified that one of the most significant limiting factors in the sector's adoption of PPP and PFI is risk identification and valuation. Institutions are not giving enough credence to risk determination and mitigation, and are therefore often only considering value for money in cash terms and not taking into account the value of risk transfer. We have published further advice on appraising risk in Annex C to 'Investment decision making: a guide to good practice' (HEFCE 2003/17, available on the web at www.hefce.ac.uk under Publications).

154. Recognising the cost of risks, and the value of risk transfer, may have implications for affordability. The price of a PFI contract may appear more expensive than the comparative cost of conventional procurement, if the risks inherent in conventional procurement have not been properly costed.

³ 'Review of HEFCE's PFI and PPP activity' KPMG, September 2002 (available on the web at www.hefce.ac.uk under Finance/PPP and PFI).

Annex A

Other published guidance

1. The Treasury Taskforce (1997-2000) produced a number of documents which provide advice on best practice drawn from practical experience of PFI projects. This material, which is still valid, includes:

- 'Step by step guide to the PFI procurement process – revised November 1998'
- Policy statement 2 'Public sector comparators and value for money – February 1998'
- Policy statement 4 'PFI projects: disclosure of information and consultation with staff and other interested parties'
- Technical Note 2 'How to follow EC procurement procedure and advertise in the OJEC'
- Technical Note 3 'How to appoint and manage advisers to PFI projects'.

2. Treasury Taskforce documents and other PFI material are available on the OGC's PFI Network site at <http://pfi.ogc.gov.uk>

3. HEFCE has published a number of case studies – some in hard copy, others as web-based documents. All are available on the web at www.hefce.ac.uk under Finance/PPP and PFI:

- 'PFI case studies' (HEFCE 98/71)
- 'The re-development of the Cruciform Building' (HEFCE 99/43)
- 'Student accommodation projects – a guide to PFI contracts' (HEFCE 00/47)
- 'PFI case studies – projects for technical support services' (HEFCE 02/05)
- Case study: Nottingham Trent University – Hotel, gymnasium and conference facilities
- Case study: Oxford Brookes University – design, build and management of 750 en-suite bedrooms
- Case study: University of Hertfordshire – sports and residences project.

4. Institutions may also wish to refer to 'Investment decision making: a guide to good practice' (HEFCE 2003/17).

5. A guidance note from the Treasury's former Central Unit on Procurement is still available: 'Introduction to the EC procurement rules' – Guidance Note No. 51. This note and current EC procurement thresholds are available on the OGC's web-site at <http://ogc.gov.uk>, under Procurement Policy and EC Rules.

Annex B

Standard paragraphs for inclusion in advertisements of PFI projects in the Official Journal of the European Union (OJEU)

For Prior Information Notices (PINs)

The key words to be used in the 'Other information' section are as follows:

'Potential suppliers who wish to register an interest in this requirement may now do so and will, in return, receive a short prospectus outlining the nature of the project and its scope. Suppliers should note that this requirement is considered suitable for the application of the UK Government's Private Finance Initiative (PFI) sometimes called Public Private Partnerships (PPP).

For Negotiated Procedure Notices

Again the key words are to be used in the 'Other Information' section, and are as follows:

'This requirement is considered suitable for the application of the UK Government's Private Finance Initiative (PFI) sometimes called Public Private Partnerships (PPP). Service providers who respond to this requirement will ultimately be required to make firm proposals for funding the project in accordance with this initiative. The contracting authority reserves the right not to award a contract.'

Variants

Variant bids will be permissible, provided the contracting authority agrees that the core requirements will be met.

It is still official policy to decide the appropriate procurement regime on a case by case basis, although practice has shown that the negotiated procedure is almost universally adopted for PFI projects.

Glossary

CPC	Conventionally procured comparator. This is the project that the institution would have to undertake, in the absence of a PFI solution, to achieve the same output
DBFO	Design, build, finance and operate. A specific form of PFI project
Due diligence	The investigative process that funders undertake before investing in a project
HEFCE	Higher Education Funding Council for England
OGC	Office of Government Commerce
OJEU	The Official Journal of the European Union, in which contract opportunities are advertised
PFI	Private Finance Initiative
PPP	Public Private Partnership
Residual value	The value of the assets associated with the project at the end of the contract
Step-in rights	The rights of the institution to rectify a problem by taking over responsibility for provision of the service. It can also refer to the situation where the funder has a direct agreement with the institution whereby the funder can substitute another service provider if the supplier defaults
Special purpose vehicle	A company set up by a consortium specifically to bid for and operate a particular contract
TUPE	The Transfer of Undertakings (Protection of Employment) Regulations 1981