BUILDING A BETTER PARTNERSHIP

IAN COLYER OF PROCOM MANAGEMENT IDENTIFIES THE PROCUREMENT AND PROJECT MANAGEMENT ASPECTS IN ENSURING PUBLIC AND PRIVATE SECTOR SUCCESS IN PFI/PPP PROJECTS.

Project finance in the construction and service sectors has become extremely important since the Private Finance Initiative (PFI) concept was launched about 10 years ago and more latterly developed under the Public Private Partnership (PPP) banner. These encourage partnerships between the public and private sectors, involving the private sector in the provision and operation of assets that revert to the public sector at the end of a long-term agreement. It is the delivery of PFI/PPP projects to ensure value for money for central and local government and fair returns for shareholders that is the key to success. This requires effective procurement and project management at all stages in the project throughout the supply chain.

COMMITTED TO PFI. PFI has established itself over the past 10 years as a significant form of UK government procurement, with 516 projects either signed or at preferred bidder totalling £26bn worth of investment. It is used to procure a wide range of public services, including schools, hospitals, government accommodation, IT, transportation and infrastructure schemes. The current government is committed to expenditure of a further £11bn over the next three years and in addition the Strategic Rail Authority's recent plans identify the need for considerable private funding and investment in the rail infrastructure over the next 10 years.

There are a number of areas where effective procurement and project management skills can deliver PFI projects that are successful for both the public and private sectors. Most of them centre around the management of risk.

PRIVATE INVESTMENT. Public sector borrowing is reduced because of the change in the public sector procuring the construction, or provision of assets from the private sector and outsourcing services. The private sector now provides the finance for the long-term operation of these assets and this private investment in public sector services brings with it financial, managerial and technical expertise.

The private sector-formed special purpose vehicle (SPV) generally comprises a mix of operating and construction companies together with equity investors raising project finance and making repayments out of the income it generates from the revenue flows from that project over the period of the concession, typically 25 years. The shareholders of the SPV normally inject between 10% and 15% of equity into the project, attracting a higher return because it is at risk compared with the remaining project finance, giving an acceptable weighted average of capital. The senior debt lenders require recourse through parent company guarantees should the company or project fail, while the public sector relies on the contract provisions and the direct agreement with the SPV's lenders.

TRANSFER OF RISK. The procurement process needs to ensure that risk has been effectively transferred from the public sector to the private. While the government can usually secure finance at lower rates, it is the ability to transfer risk under PFI contracts that leads to better overall value for money. The assessment of whether a PFI solution will provide the best value for money requires appraisal of that solution against a public sector comparator (PSC) and generally this is the yardstick adopted by the public sector. The PSC compares the cost to the public sector in obtaining the outputs required from the private sector, to the costs of obtaining them by a non-PFI route. The comparison includes quantification of the proposed risk transfer to ensure the estimated cost of the risks retained by the public sector are incorporated into the analysis. Clearly, if the private sector is to assume risks more normally taken by the public sector, then these risks will need to be managed, and effective procurement and project skills will be critical in managing them.

STRUCTURING THE PROJECT. If risk is to be transferred to the private sector, it must be allocated to the party best placed to manage it. The interface between the technical, financial and legal aspects of the project is a key element of this. It is critical that the overall framework of the contractual documentation, reflecting the risk matrix and the commercial deal, is established prior to detailed negotiation of the contractual terms.

Team co-ordination and participation is critical here to ensure the correct interfaces between the public sector organisation, constructor, facilities management provider or operator, and the legal, financial, technical and insurance advisers so as to develop, negotiate and agree robust concession and supply chain agreements.

It is also important to use standard contract documentation and give clear and concise direction and instructions to avoid endless iterations of contract drafts.

AIMING FOR TRUE VALUE. Value for money can only be assessed by the public sector once a detailed business case has been developed and formal testing of the market has been completed, bids have been received and negotiations completed. Healthy competition is often the best guarantor of value for money.

The public sector often also uses mechanisms such as gain sharing, open book accounting and benchmarking to enable monitoring of value for money. Some projects have the right to share in refinancing benefits and the Office of Government Commerce (OGC) has recently prepared revised guidance recommending that contracts should give the public sector approval rights over refinancing and contain provisions on sharing gains, so dealing with change is a significant issue.

WHOLE LIFE COSTING. Injection of private sector experience, management expertise and innovation will not necessarily result in the lowest initial capital cost. Frequently, over the period of the contract, a higher initial investment can result in the lowest net present value when account is taken of integration and synergies between design, build and service operation, improved efficiency, operational and maintenance savings and the quality of service provided.

For this to be achieved, the public sector's realistic aspirations must be met while achieving the optimum balance between quality and cost, and it is vital for bidders not to sacrifice this concept and simply shoehorn their costs into a budget that will not meet the client's specification over the life of the contract. The opportunity for increasing demonstrable value is enhanced if the public sector client encourages innovation to achieve the required outputs.

In addition, serious consideration must be given to any scope for the more extensive exploitation of assets, including third-party and additional revenues from shared use of facilities and sale of redundant assets.

PARTNERSHIP APPROACH. Managing the relationship to secure successful partnerships was identified by the National Audit Office last year as being highly significant to achieving successful outcomes and is best achieved by the public and private sector organisations keeping their strict contractual and organisational relationships in perspective and approaching projects in a spirit of partnership. It is important for each party to understand the other's requirements and aspirations and for both to share a common vision of how to work together to achieve a mutually successful outcome. this is best done by regularly re-assessing relationships and ensuring that projects are delivering value for money.

A good partnership relationship is one where both sides are open, share information fully and work together to solve problems. It is not easy to secure this form of relationship and there are challenges in achieving this in PFI projects. Some projects have, for example, successfully achieved it by co-locating staff from the public and private sectors to improve communications and to identify and deal with problems more quickly.

Having personnel with the right blend of skills is critical to good project management. Overall attention is essential at an early stage in the procurement process to project management and developing relationships between the public sector and the selected SPV. This requires the right contractual framework, including allocating risks

'A GOOD PARTNERSHIP RELATIONSHIP IS ONE WHERE BOTH SIDES ARE OPEN, SHARE INFORMATION FULLY AND WORK TOGETHER TO SOLVE PROBLEMS'

appropriately, establishing clearly defined quality of service and value for money mechanisms and incorporating arrangements to deal with change.

CHANGE CONTROL. Change control provisions are essential in the project documentation because the long term nature of PFI projects means that contractual changes are inevitable during the life of the project. These may relate to the original specification, new services, additional works, design changes or performance measurement arrangements.

Alternatively, the public sector's priorities may change or other factors may arise, such as the opportunity to take advantage of improved technology.

Appropriate contractual procedures for dealing with change must be built into the contract and these need to ensure that value for money is maintained when contract changes occur. The importance of flexibility, both in the contract and the design of asset itself cannot be understated, since PFI is a long-term contract and must allow for future change in requirements.

PERFORMANCE. Performance monitoring is an essential aspect of PFI contracts, the long term nature of which require clearly defined performance levels and financial penalties to be levied for failure to meet these performance levels. It is important to devote a great deal of effort pre-financial close to create effective payment mechanisms to manage this relationship, as the PFI method of procurement has shifted the public sector's focus from the rigid specification of inputs to a concentration on critical outcomes that determine revenue levels.

It is clearly necessary to ensure that accurate and valid performance data is provided by the facilities management provider or operator. It is equally important that relationships do not suffer as a result of any impracticalities in operating the payment mechanism or the level of performance monitoring, and these aspects are best addressed at the outset.

LESSONS LEARNED. Finally, lessons learned from previous projects need to be disseminated quickly. The OGC has issued guidance on PFI project management and keeps this guidance up to date to reflect emerging developments and shared experiences of managing PFI contracts and relationships.

Further useful reading includes the OGC's best practice guidance *How Major Service Contracts Go Wrong* and the *Successful Delivery Skills Programme*. These highlight how important it is for the public sector and its private sector partners to manage proactively the complex relationship with service providers and their multiplicity of subcontractors. Note also that in future, the OGC's Gateway review process will be used to monitor how contracts are being managed and to identify areas where guidance needs updating.

For more useful and relevant information refer to www.ogc.gov.uk.

Ian Colyer is Chief Executive at Procom Management Ltd.
iancolyer@procomltd.co.uk
www.procomltd.co.uk