Current Challenges Facing PFI/PPP Procurement

Andrew W MORLEY, and Duncan E W WAINSCOTT, United Kingdom

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SUMMARY

The Private Finance Initiative concept is constantly under close scrutiny from its opponents and detractors but, in the UK, official figures show that it has steadily outperformed the traditional procurement methods of the last century.

However, recent figures suggest that, of over 700 PFI infrastructure projects procured, 12% were delivered late (Source: HM Treasury) and 22% were over budget (Source: National Audit Office).

Therefore, whilst PFI may be one way forward for the provision of infrastructure in the emerging economies, and for the maintenance of it in mature economies, the associated risks must be identified and managed.

Poor performance might not have a major effect in a mature economy but the impact on a less developed or emerging economy could be severe. The project, in its formulation phase, could sit with a Client who is relatively inexperienced in the field. It is the Client's responsibility to short-list and appoint, via a robust pre-qualification procedure, advisors who can provide the appropriate Commercial Management expertise and experience.

In short, by properly resourcing a proposed project in its infancy all parties involved will be able to apply their particular expertise to develop the project and reduce the overall risk to its successful completion.

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1. INTRODUCTION

The abstract to this paper highlights the fact that although more complex and challenging Private Finance Initiative/Public Private Partnership projects are being entered into at an increasing rate, it is important to not forget those who are dipping their toes into such waters for the first time.

Recent figures published in the UK show that the majority of PFI/PPP projects procured are being delivered on time and within budget, and that the remainder (those which are being delivered late or over budget) are shown as being at an "acceptable" level.

The impact of these failures may cause only a minor ripple in the large waters which the more experienced swim in; however, to those who are just learning to tread water, the effect could be the difference between the success or failure of the PFI/PPP model in their economy.

The emerging economies need not be left behind to fend for themselves. Why should they, when there is already a wealth of knowledge about PFI available to them?

It would be so easy for those experienced in the PFI/PPP funding methods to turn a blind eye and carry on regardless…

All public procurement projects in UK Government are subject to Gateway reviews. Gateway reviews were instigated by the UK Office of Government Commerce (OGC) as a way of examining a programme or project at critical stages in its lifecycle to provide assurance that it can progress successfully to the next stage. The process is designed to lead to more effective delivery of benefits together with more predictable costs and outcomes. Gateway reviews are carried out by teams and/or individual professionals who are accredited by the OGC.

Therefore, the purpose of this paper is to help cement the ethos of spreading the knowledge on "Shaping the Change".

2. PLANNING THE PROJECT

It is quite clear that since the introduction of PFIs in 1992, overall procurement lengths are still excessive. This is, in part, expected as the nature of the projects proposed for PFI/PPP procurement continues to become more complex. However, there is no doubt that inadequate planning is a contributing factor.

In the first instance, the Client must decide whether or not the project is suitable for the PFI model of procurement (see Gateway Review 1 on page 8).

Level of Certainty

The main issue is how certain the public sector is about the nature of the infrastructure and services required. A high level of certainty would mean that the public sector knows with confidence the future service requirements at a detailed level. PFIs require a high level of public sector certainty with regards future service requirements because the services must be specified clearly and fully so that the public sector can then achieve the benefits of "whole-life" costing and strong performance incentives. If certainty is low, then the cost of risk transfer and future contractual change will increase.

Cost

Due to the cost of procurement, there is a rule-of-thumb financial threshold which the project needs to exceed before being considered for PFI. This threshold needs to be sufficiently high so that the procurement costs can be absorbed and is generally accepted as being £20m. If the project falls outside of the above criteria, then other methods of procurement such as traditional procurement need to be considered.

When a project within the European Community has been defined as suitable for the PFI/PPP procurement model, it is advertised in the Official Journal of the European Union (OJEU). From here, any prospective bidders can register their interest in the project. This public forum plays an essential part in this procurement model and emerging economies following the PFI/PPP route should consider replicating it.

The level of information included in the advertisement may vary, but can include the outline specification, information on the Client and a pre-qualification questionnaire. A well-drafted Output Specification is fundamental to developing a robust PFI contract. It is part of a process that is radically different to traditional procurement in that the emphasis is on service outputs and outcomes, the explicit allocation of risks, and the integration of design and construction with the operation of service facilities. In comparison, traditional procurement methodology is often an iterative process in which an outline of the capital project is drawn up and costed. Further iterations and costing revisions normally occur before a final scheme is agreed and the contract for development is let. Output Specifications encourage a focus on strategic needs rather than the history and detail of current provision. A well-drafted Output Specification allows new ideas about the design, construction and operation of PFI projects to flourish. Most critically, because this approach encourages bidders to develop the means to deliver the outputs within the context of a fixed, performance-related pricing mechanism, it focuses much more attention on project risks.

Producing an effective Output Specification involves the art of defining the end without specifying the means. "Outputs" clearly and comprehensively state what is required, and the standards to be achieved. How the outputs are to be achieved will form part of the bid.

Of course, the Bidders' preferred solution is for Clients to restrict the requirements on the bidder. However, this could lead to problems in maintaining competitive tendering.

The Challenge

By further developing the traditional research and forecasting techniques currently used in the industry, the public sector will become more adaptable to, and accommodating of, change in the Client's future service requirements. Whilst not in the public sector, the current Wembley Stadium saga highlights the need for such adaptability. Only by openly reviewing the successes and the failures encountered in previous projects can the public sector begin to make this movement. However, this is not a vehicle simply for self congratulation and public humiliation; it must have the primary objective of "Shaping the Change".

3. PRE-QUALIFICATION OF BIDDERS

Following the responses to the project's advertisement (in the OJEU or other forum), the list of prospective bidders will need to be reduced, leaving only those suitable to deliver the project. This pre-qualification process is designed to probe bidders' technical capability, capacity and financial strength in order to determine whether they are able to deliver a PFI scheme (see Gateway Review 2 on page 9).

Evaluation Methodology

It is expected that a PFI project will generate competitive interest from a wide variety of potential bidders. In order that evaluation resources are used to their best effect, it is necessary to approach the evaluation in two stages:

- a preliminary pre-qualification evaluation which aims to filter out obviously unsuitable candidates through a series of "hurdle" questions; and
- a detailed evaluation which involves the measured evaluation and scoring of responses.

Preliminary Evaluation

The preliminary evaluation is designed to determine whether or not bidders' responses comply with the Client's basic requirements. At a high level, the following elements are to be taken into account:

- eligibility;
- ability to undertake the project; and
- completeness of information.

Bidders are required to submit data in the specific formats, covering specified periods and in sufficient depth and detail. It is normal practice to alert bidders if their responses omit key data. The failure to provide information required in the right form and in the right depth after a reminder has been issued will merit rejection.

At preliminary evaluation a judgement has to be formed on each bidder's ability to deliver a project of the PFI scheme's magnitude and complexity. This judgement is based on an initial financial hurdle, coupled with a more qualitative examination of the bidder's structure. The financial hurdle assesses whether the bidders are sufficiently robust to be considered further. Examples of the criteria used are as follows:

- Turnover
  It is essential for the bidders to demonstrate that the PFI scheme would not dominate their businesses. Consequently, only those with a realistic chance of undertaking the project are passed.

- Credit Rating
  The pre-qualification questionnaire deliberately avoids asking bidders to submit their own credit ratings. It is better for the Client (in conjunction with its advisers) to seek ratings from one agency to ensure that the results are directly comparable.

In addition to objective financial measures, it is appropriate for the Client to consider the organisation of the bid. The absence of key members of the proposed project team at pre-qualification questionnaire stage (referred to as PQQ from hereon) would not necessarily merit exclusion if, in the judgement of the evaluation team, the candidate has a reasonable justification and can demonstrate a successful track record of completing similar transactions.

It is not intended for the preliminary evaluation to be the subject of a prescribed scoring methodology, as for the detailed evaluation. Pass/Fail questions must be unambiguous and financial thresholds will be set at levels appropriate for each project. Clients' legal and financial advisers will be able to provide examples of suitable approaches.

<u>Detailed Evaluation</u>

The detailed evaluation involves:

- evaluating and scoring bidder responses to a series of structured questions according to pre-defined criteria. Each question is weighted, and the weighted scores feed through into an overall quantitative assessment of:

  - technical capability (in terms of experience, working practices and structure)

  - capacity (in terms of expertise and availability) and

  - financial and economic standing.

- forming a general view based on the overall impression made by the bid, which also feeds through into the overall quantitative assessment.

The Pre-Qualification Questionnaire (PQQ)

The PQQ will be divided into sections which address the capacity, capability and financial background of the construction contractors, facilities operators and maintainers, lawyers, bankers, and accountants of the bidding consortium. Each of these sections will be evaluated and given a "weighting" according to the sections' importance to the project.

Certain questions in the PQQ will be allocated scores. The Client needs to evaluate the response to these questions according to how well they fit with the Clients' needs for the scheme. Any evaluation needs to incorporate both the amount of evidence provided (e.g. number of previous schemes) and the quality and relevance of that information.

In applying the scoring system the following need to be considered:

- For the most part, consortia consist of members who deliver particular aspects of the PFI project, e.g., a construction contractor, Operations & Maintenance contractor (or facilities management ("FM")) and so on. Exceptionally, the same company may provide both construction and FM. In this case, each element of the company needs to be scored separately in the PQQ so that its relative strengths can be evaluated in more detail;

- Often, consortia or large contractors will employ in-house legal or financial teams. These can be evaluated separately in terms of their experience in the relevant section of the PQQ;

- Often, within consortia, several members may contribute towards one role. This is commonly the case with facilities management services. Within each section, each consortium member needs to be evaluated separately. On aggregation, the total marks for that PQQ section are weighted to reflect the significance of each contributing member i.e. according to capital value for construction companies, or by annual service value for facilities management companies;

- Questions highlighted on the PQQ as "non-scoring" are to be excluded from the scoring process. The answers to these questions can be used to form the "overall impression" of the bid, as previously mentioned.

It is a matter for the Client and its advisers to set detailed expectations against which the substance of responses can be compared for each question. This will help ensure that Clients get what they need. However, some questions may require further guidance to assist in their interpretation, for example:

Conflicts

The significance of conflicts of interest needs to be considered in the light of a consortium's other responses. On occasion, a conflict may be such that it may be sufficient to exclude the consortium. In this instance, Clients need to ensure that they have obtained the views of their legal advisers,

Financial capacity

There are a variety of accounting methods and other analyses which can be performed on the data which the PQQ requests. Clients would be expected to utilise the expertise of their financial advisers in this area,

Insurance

Employer's liability insurance is a legal requirement (except for sole traders); this should be at least £5 million. Public liability insurance is also essential for any well-run business. Of course, the level of cover considered appropriate will be commensurate with the contract's value and significance and will, therefore, vary from project to project.

Employment

The PQQ requests analyses of total staff, staff engaged on PFI, etc. Bidders need to demonstrate their commitment to the project by having sufficient manpower and expertise available for the bid and the project delivery. Clients must satisfy themselves that bidders are in a position to provide that commitment,

Funding

Bidders are expected to set out whether they have selected a funding route, or if not, give details of their proposed funding route. The PQQ is designed to probe the bidder's commitment to securing best value in funding terms. Maximum marks will be awarded where the bidder is committed to holding a funding competition. Fewer marks are to be awarded where bidders do not demonstrate a clear process for the selection of a funding partner or partners. Fewer marks should also be awarded to bidders that are tied to particular lenders, with no competition. The least marks will be awarded where a bidder has no lender signed up and no commitment to holding a funding competition,

Litigation

The PQQ probes the possible impact of litigation against bidders' capacity to deliver. A recently set up consortium may have no outstanding litigation, but its members may have. Equally, an experienced consortium may have outstanding litigation whereas its individual members have none. Whilst information is required at both levels, Clients should take care not to double count litigation, i.e., the same case disclosed at both the consortium and member levels is to be counted once only,

References

The PQQ will request the names of client references to be supplied at consortium and Relevant Member levels (supply chain member or sub-contractor for example). Depending on the level of integration and the length of time that the consortium has been constituted, references may be duplicated between sections. Clients will score each reference provided in the section of the PQQ for which it is provided.

In implementing the scoring system and evaluating the results, the suitability of all bidders will become apparent. The recommended proposal will meet all the needs of the Client and the end user and offer the best value for money (VFM).

The Challenge

Pre-Qualification can be a long, drawn-out process. Procurement lengths are currently subject to close scrutiny in the UK; the aim being to reduce them. One way of achieving this is the standardisation of contract documents including the PQQ. If the Client's requirement is, say, a hospital then a standard "Hospital PQQ model" could be introduced to suit this particular type of project. Similar models could be produced for schools, roads and bridges, etc.

Once these standard models have been issued, returned and reviewed, the information can be retained for future projects. Any pre-qualified bidders can then be requested to provide updated financial data and company insurance information on a regular basis rather than requesting them to complete a full PQQ should a similar project arise in the future.

4. RISK MANAGEMENT

There are five OGC Gateway reviews which are implemented at specific stages of a project; three are pre-contract and two are centred on the service whilst in delivery:

Gateway Review 1 – Business Justification
Gateway Review 2 – Procurement Strategy
Gateway Review 3 – Investment Decision
Gateway Review 4 – Readiness for Service and,
Gateway Review 5 – Benefits Evaluation.

There is one other Gateway Review, Gate 0 (zero), which is intended to review certain processes throughout the life of the project. For example, Health & Safety and Quality Assurance procedures can be reviewed (independently) under Gate 0.

The Gateway reviews involved at pre-contract stage are Gates 1 to 3. The principles of OGC Gateway reviews are easily transferable and could be, with due recognition of, and any necessary adjustment for, local features, equally applicable to PFI/PPP projects outside the UK.

Gate 1 – Business Justification

The purpose of a Gate 1 review is to determine whether or not the project is suitable to be carried out under PFI. This review is implemented at the conception of the project.

By carrying out a Gate 1 review, the Client will be able to determine that, firstly, the project is feasible, both technically and commercially, and that the requirement specification is clear and unambiguous. The Client will also see whether or not the project is likely to generate sufficient interest in the current market for the project to go ahead.

At this stage in any project, only areas of obvious major risk will be known in any detail. These will be highlighted in Gate 1 and outline risk management plans can then be formed.

Any risks which are not identified at this stage and are, therefore, un-managed risks, will only escalate at a further stage in the project. Identify as much as possible now – if the risk is deemed small at this stage, it can be recorded and reviewed later. If the risk is not recorded, it may only manifest itself at the last minute and incur costs which, at one point, were avoidable.

Gate 2 – Procurement Strategy

The Gate 2 review is intended to review the procurement strategy before inviting proposals or tenders against the fully developed requirements specification, and is carried out in conjunction with the pre-qualification process, as detailed earlier in this paper. This review assesses the viability of the project and its potential for success.

Following the determination of the outline business case, a suitable and robust procurement strategy must be detailed. The Gate 2 review will determine that the project's plan is thoroughly detailed and is realistic. It will also determine whether or not funding is available for the project in its entirety. At this stage in the process, areas of specific financial risk will be identified, recorded and reviewed. These will be highlighted by the pre-qualification questionnaire issued to all prospective bidders before tender stage.

Gate 3 – Investment Decision

Whereas the Gateway 2 review determined the outline business case, the Gate 3 review covers all activity up to contract signature and focuses on determining that the solution is robust before delivery. It will confirm that the recommended proposal is appropriate before the contract is placed with the preferred bidder. The all-important principle of a PFI project is that the specified outputs will be delivered on time, within budget and provide value for money.

At this stage, the bidders will have provided both their commercial and technical proposals. A detailed risk assessment needs to be included with this information. The Client and the Gateway Review team must be satisfied that the bidders have given due consideration to all areas of risk, whether financial or technical. All risks will be highlighted as either Low, Medium or High (measured by severity against likelihood) and shown in table format for ease of understanding.

A procurement strategy was detailed at Gate 2 stage and it will be reviewed at Gate 3 stage to ensure that it is being adhered to.

The review also assesses whether the process to date has been well managed, that the appropriate processes are in place to achieve a successful outcome after the contract has been awarded, and that the Client and the preferred bidder have the capacity and ability to implement and manage the project.
Gate 4 (Readiness for Service) and Gate 5 (Benefits Evaluation) are both centred on post-contract tasks and, therefore, are not relevant to pre-qualification.

The Challenge

Again, standardisation is the key. Gateway Reviews have proved so successful in the UK, and also in Australia, that The Office of Government Commerce (UK) is currently developing the process with the aim of it being adopted by other EU countries. The implementation of the process will not happen overnight. The first step is education; those new to Gateway Reviews need to know how they operate, what their benefits are and when to introduce them. Those familiar to the process will be able to assist their neighbours by sharing their experiences, whether good or bad.

5. CONCLUSIONS

It is quite evident, and widely reported, that procurement timeframes are unnecessarily long. Contract standardisation being implemented in the UK will help reduce these timeframes. However, it would be optimistic to expect contract standardisation alone to solve this problem.

The standard and the understanding of Output Specifications is a major issue. An Output Specification, by defining outputs, also begins to define many of the risks that the bidders are being asked to take on. It is for the bidders to assemble the optimum means of delivering the results required. This is done at their own risk. If the facilities or services fail in some way, the Client cannot be held responsible as only the output has been specified, not the method of achieving the output.

It is wholly unrealistic to attempt to eliminate Risk from any project. However, by implementing Gateway-style reviews and a robust pre-qualification process, the Client is ensuring that all elements of risk are being identified, recorded and assessed and that they are reduced to a manageable level.

The pre-qualification process will eliminate any bidder whose financial, technical, or legal status is not suitable or may give cause for concern.

Now is the time for the industry to work together and to "spread the knowledge". When mistakes are made they can be recorded for others to review and learn the lessons of them. Unfortunately, in a society which is so quick to point the finger of blame, sweeping mistakes under the carpet seems to be the easier option. The industry needs to rise above this and address the problem head-on.

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BIOGRAPHICAL NOTE

Andrew Morley is Managing Director of CCM Associates Limited the commercial management/quantity surveying business he formed in 1987. He had previously worked as commercial manager for international contractors and chartered quantity surveyors in Europe, the Middle and Far East and Africa.

Much of his company's work in recent years has been the provision of technical and commercial services and advice to contractors bidding for PFI/PPP projects. The company also undertakes pre and post contract services for infrastructure projects procured by traditional forms of contract. It is his experience of both of these procurement methods that persuades him that, in most cases, the PFI/PPP route is to be preferred.

Andrew is a Fellow of the Institution of Civil Engineering Surveyors (ICES) and a Member of the Chartered Institute of Arbitrators. He is a past member of council of the ICES and has served on many of its committees. Currently he is ICES delegate to FIG Commission 10 and Chairman Elect of Commission 10.

Duncan Wainscott is an Assistant Quantity Surveyor with CCM Associates. Before joining CCM Associates, Duncan worked in both the UK and overseas for a leading Facilities Management provider to the Ministry of Defence. He has earlier career experience as an Architectural Technician working in building maintenance and management.

CONTACT

Andrew W Morley
CCM Associates Limited
89, Priory Road
Peterborough
PE3 9EE
Tel. +44 1733 892727
Fax. +44 1733 896475
Email: andrew.morley@ccmassociates.com