

UK MoD: Raising its Game as a PFI Customer

by Kathy Makin

Kathy Makin is Director of Widening Smart Acquisition, UK Ministry of Defence. Here she looks at the problems inherent in the Private Finance Initiative and ways to overcome them.

This article examines not only the reality of why the Private Finance Initiative (PFI) is a valuable procurement tool for the Ministry of Defence (MoD), but also the reality of the unique features and difficulties of PFI and the need for the Department to raise its game as a PFI customer, in co-operation with industry.

Readers will be familiar with the pressures to which the defence budget is subject: the Government purse is finite; there are competing priorities elsewhere in Government; and technological advance does not come cheap to procure or maintain. At the same time, social changes and demographic factors mean that, even at lower overall Armed Force levels, recruiting and retention continue to pose a challenge. Thus, in addition to the requirement for first-class equipment for our Service personnel, there is also a need to provide a modern, high-quality working and living environment for them and their families. Against this background, MoD needs to get the best value for money out of every penny of the expenditure.

PFI helps in a number of ways. Our experience so far suggests that PFIs are averaging about 10 per cent less than the cost of conventional procurement in spite of the additional costs of borrowing inherent in third-party finance. But value for money, not price, is the main criterion. By focusing on the service required and expressing this in output terms, we encourage industry to

contribute its own expertise and skills, promoting innovation, quality and the use of best practice and modern standards. PFI automatically involves a 'whole-life' approach to projects and, especially in the accommodation and infrastructure field, stops MoD indulging in its tendency to short-termism, for example in the form of 'saving' on maintenance costs. It can represent an excellent means of renewing accommodation and infrastructure and getting user-friendly products and services in tune with today's expectations.

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In the equipment field, selection of PFI can similarly make use of industry expertise in other customer sectors and can (as do some non-equipment PFIs) offer scope for third-party revenue and the flexibility to allocate risk to the party best placed to manage it. In both the equipment and non-equipment sectors, the allocation of design and construction risk to the supplier, and the fact that payment begins to be made only when the service starts to be provided, reduces the risk of delays; and the pay and performance mechanisms built into each contract are geared to incentivising and driving delivery of a good-quality service. The role of the banks in performing Due Diligence also helps make for a soundly based project.

MoD's PFI programme already includes 47 signed deals which have involved some £4bn of private sector investment, and there are another 36 PFI projects in procurement or under consideration with potential for further such investment worth £12bn. Unitary payments under PFIs account for about six per cent of the annual defence programme. Projects have included living and technical accommodation; academic accommodation and training (e.g. aircrew simulator training); water and sewage; satellite communications; and a number of equipment-based projects which take PFI close to the front line, e.g. Heavy Equipment Transporter; Strategic Sea Lift (RoRo ferries); Field Electrical Power Supplies; and Strategic Tanker Aircraft.

Of course, the scope for PFIs in the equipment area is necessarily limited, even though the concept of Sponsored Reserves has helped us to take PFIs closer to the front line than would otherwise have been the case. PFI is based on the provision of a whole service including manning and, intuitively, there are limits to the type of equipments which are suitable for PFI. Thus we do not expect that PFIs will account for more than about 10 per cent of the equipment acquisition programme.

Turning to my second reality, it has to be admitted that PFI is challenging and demanding of staff skills. Projects are highly complex, and they are based on Special Purpose Vehicles (SPVs), formed of two or more constituent companies especially for the purpose, and of which MoD may have no prior experience as an entity as opposed to its experience of the SPV's constituent

parts. PFI projects involve complex financial arrangements usually including third-party financing. MoD project teams undertaking PFIs – as well as central supporting staffs – need high skill levels and there is almost invariably a need for external legal and financial advice. The length of contracts means that we have to be very sure about the requirement and its enduring nature since, while there is likely to be flexibility for expansion of the scope of some projects, there is unlikely to be much scope for reduction in the requirement except at considerable nugatory cost. Furthermore, the timescale for placing contracts tends to give opportunities for second thoughts about project scope and for outside events to supervene.

Other more specific factors potentially leading to difficulty or complexity (and this is more of a personal selection than a comprehensive list) are: the need to be clear as early as possible about likely balance sheet treatment, given that any surprise judgements by the National Audit Office may render the capital cost of projects unaffordable; the fact that bids have to be compared not just against one another but against a Public Sector Comparator (PSC) to be sure they represent Value for Money¹; the complexity of payment and performance-monitoring mechanisms (though there may well be read-across between projects); and last, but not least, the complexity of the potential transfer of staff and posts and decisions on the use of Sponsored Reserves.

Nor of course is it only for MoD that PFI poses challenges. For industry,

there is the requirement to form SPVs and get third-party finance; there are bid costs and staff management issues arising either from long competitions or from the time taken to reach financial close; industry itself may have skill shortages, especially where it is taking on new roles hitherto performed by MoD; and – in the sectors outside the traditional defence industries – there is the fact that there may be plenty of work to be had elsewhere, with less aggro.

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It is against this background that MoD has acknowledged the reality of the need to do better as a customer of PFI projects, and has recognised that a large element in achieving this is effective consultation with industry about what can be improved, and how. We have called this the ‘Smarter PFI’ initiative. The first step was a written consultation exercise with industry last summer which we conducted on an industrial sector basis, followed by a workshop in the autumn with industry and other external stakeholders including trade associations and external advisers.

A draft action plan was issued in December 2003 and it is planned to issue a finalised action plan in March 2004 followed by a further industry event in May. This will still be very much a living document and the action plan will be a progressive and exploratory one, with some items

being initially for study rather than immediate implementation.

The issues identified in our consultation were numerous, but centred on some major core themes. There were issues about project flow (projects bunching together rather than being spaced apart, making it difficult in resource terms for potential suppliers to bid for all of them) and, for similar reasons, concerns about the lack of visibility of the forward programme. There were concerns about requirement setting and about changes in project scoping as a result of failure to set boundaries around and between projects at a sufficiently early stage. There was a belief that too many projects have not achieved sufficient maturity at the Initial Gate and OJEC advert stage, thus misusing industry’s time in the competitive process. There were issues about the approvals process, which is seen by industry as unwieldy and time-consuming, and about funding issues, where there is concern that affordability issues are not sorted out early enough. There were views that competition is prolonged inappropriately, for example through a series of Best and Final Offers, and that the PSC is used as a stick to drive bids down inappropriately. There were concerns about the use of ‘convergence’ during the competitive phase (i.e. how much value does it add in more straightforward projects?) and about the length of time from selection of the preferred bidder to financial close. There were concerns about the skills and experience levels of IPTs and about IPT empowerment versus the existence or otherwise of authoritative sources of central advice and policy direction; and also about project ‘ownership’ and the scope for

inappropriately belated input from the 'second' customer, especially in non-equipment projects.

Not all of these themes were unique to PFI, and the Smarter PFI initiative thus needs to keep closely in touch with wider work in the Department to improve the implementation of Smart Acquisition following the MoD/Defence Industrial Council Senior Acquisition Forum last autumn and the Chief of Defence Procurement's stocktake of Smart Acquisition in the Defence Procurement Agency (DPA).

The draft action plan we issued in December included a commentary on a number of strands of work in the Department, which we think will contribute to addressing the issues raised in the Smarter PFI consultations. One of these is the steps being taken by MoD to embrace various Office of Government Commerce (OGC) initiatives such as the concept of appointing Senior Responsible Owners (SROs) for projects, which as the name implies should help to ensure that projects are 'owned' effectively at senior levels by staff who will be accountable for making sure that major issues are tackled at an appropriate stage; that projects and the implications of projects are viewed holistically, where necessary, across all lines of development; and that peer review of projects is carried out at critical points in the life of a project.

These in turn will feed into current work on 'Smarter Approvals' since one element will be to link the approvals process more effectively to broader mechanisms for project governance.

The Broadening agenda under which my Directorate is tasked with improving and extending the implementation of Smart Acquisition in the non-equipment areas will also make a contribution to improving PFI acquisition in the estates and infrastructure areas. We are seeking improved contact with industry: for example, in the Broader arena, through a specially formed Joint Broadening Group chaired jointly by Norman Rose of the Business Services Association and Mike Cooper, the project Manager of the Allenby/Connaught project. We are considering how the central PFI organisation in MoD can be strengthened (Defence Management Consultancy Services are currently conducting a review of my Directorate and the PFI/PPP focal points in DPA, the Defence Logistic Organisation and Defence Estates); and we are looking at the possibility of an inwards secondment from Partnerships UK. The question of integrated Project Team (IPT) experience, skills, continuity and reward is being addressed on a pan-acquisition basis.

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The current work to tackle what has been recognised as over-programming across the whole MoD programme will have a beneficial impact in terms of achieving greater certainty on the affordability of projects, even if this means that some aspirations go by the board. There is also work in hand generally to improve forward programming and planning coherence across the Department, in particular to

improve planning across lines of development and to achieve a longer forward look in the non-equipment areas.

Specifically on the PFI front, we are in dialogue with Treasury about means of assessing value for money in PFIs and Treasury's proposals for changing how the PSC is used, although the bespoke nature of many MoD PFIs makes us cautious about the risks of selecting PFI as the procurement route at too early a stage. We aim to achieve more systematic Post Project Evaluation and dissemination both of lessons learned and of best practice. We are considering the creation of a database of PFI practitioners. We propose to review certain specific PFI processes and guidance, and to consider being more prescriptive about some aspects where there is currently scope for discretion. And my Directorate will also be considering any recommendations from an audit, currently underway, under our sponsorship by Defence Internal Audit which is examining a sample of signed PFI deals.

So there is a lot going on. To sum up, PFI for MoD is a highly useful element of the acquisition programme. It poses its own unique challenges, as well as some that are common to other acquisition. We are keen to remain engaged with industry in identifying and tackling them. ■

NOTES

1. Although the proposals in the Treasury paper *PFI: Meeting the Investment Challenge* may change the way the PSC is used, requiring an earlier quantitative assessment of the PFI-ability of programmes and projects and then leaving value for money to emerge from competition, a proposal about which MoD has reservations because of the bespoke nature of many defence projects.