

Value Testing PFI Projects: The Danger Zones

Part 1: Procedural Dangers

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“Value testing” is the bane of authorities’, SPVs’ and service providers’ lives. At Jones Day we recently witnessed this first hand when we advised a project company in relation to a lengthy and complex market test which, unusually, resulted in the replacement of the incumbent provider of the market-tested services with a new service provider.

While some projects may well go through the process unscathed, for most there are procedural, contractual, legal and practical issues which potentially have “disaster” written all over them if the value test process is not understood and managed properly. Given the nature and value of PFI contracts, this process needs to be taken seriously in order to avoid the “danger zones” such as challenges to the process, missing the value test date, not obtaining the relevant consents and failing to achieve value for money.

In the first of a series on value testing we look at what value testing is, how and when the process should be commenced and the pitfalls to be aware of. *Part 2: Practical Dangers* will cover market testing in practice and *Part 3: Dangers of Dispute* will examine the contract award stage, the aftermath and avoiding disputes.

What is Value Testing?

As PFI contracts typically run for a 25-30 year term, there needs to be some mechanism in the contracts to allow the cost and quality of the “soft” services (those not requiring significant capital expenditure such as catering, cleaning, portering, security) to be value tested in order to ensure that the soft services remain value for money during the contract term.

Value testing in PFI is generally achieved through benchmarking and/or market testing (although other means of value testing may be appropriate). Benchmarking is where the provider of the soft services compares its or its subcontractors’ costs of providing the services against the market price of equivalent services. This may lead to an adjustment in the price of the soft services. Market testing, on the other hand, is where the project company re-tenders the soft services to the open market which may result in a replacement of the provider of some or all of the soft services by the preferred tenderer.

You may be wondering why value testing has only over recent years become something of a hot topic. The reason is that it is common for PFI contracts to provide for value testing every 5 – 10 years (10 – 14 years in prison PFIs) with a longer initial period before the first exercise. As such, it is only now that PFIs are starting to go through the value test process and are realising the difficulties that come can with it.

The Process

The process of value testing recommended in the Standard Form PFI Contract (Standardisation of PFI Contracts, Version 4) is market testing (rather than the previously preferred benchmarking method) due to the perceived advantages of greater transparency and competition to achieve best value for money. However, the process will, particularly in relation to early PFI Projects prior to standardisation, ultimately depend on the value test provisions in the contract, subject to deviation from those provisions by consent of all parties.

The value test process is usually the responsibility of, and run by, the project company. The key is to plan, and plan early. As will become clear in this series, there can be a lot to do during this process and more often than not, time is grossly underestimated. The average duration of the value testing exercise reported by Partnerships UK in its *Value Tested Projects Report* is 12 months for the accommodation and health sectors and just under 10 months for the education sector. However, if service variations are required and/or any difficulties are envisaged (such as an uncooperative incumbent soft services provider) it would be sensible to allow even more time than this in order to ensure that the Value Test Date is met.

Benchmarking

One of the major drawbacks of benchmarking is the lack of detail on the benchmarking process found in many (particularly the early) contracts. Difficulties have tended to arise where it is unclear which services, or elements of services, are to be benchmarked; what they are to be benchmarked against (this is a fundamental problem where there are no benchmark partners available, as was the case in the *Bournemouth PFI Library Project* which was the first PFI library to undertake this process and comparisons could not accurately be made); and what the fall back position is if benchmarking is not suitable or the benchmarked price is not accepted by the Authority?

If the provisions are not clear or detailed enough, agree them at the outset to ensure, firstly, that there is no argument over the validity or applicability of the benchmarked results (particularly where the Authority does not have the right to audit the benchmarked data) and, secondly, you have a “Plan B” in order to avoid a stalemate situation where a benchmark price is not agreed but there are no other prescribed means of value testing. Such transparency should increase the chances of accurate and usable benchmark data being obtained, and therefore a greater chance of a benchmark price being agreed.

Market Testing

If there has been an unsuccessful benchmarking or the value test process in the contract provides for market testing only, the key to a successful market test is for the Project Company to constitute a market test team at the outset, involving representatives of the Authority authorised to make decisions, representatives of the project company and, if required, a technical adviser, and to devise a detailed market test plan with key milestones, including the Value Test Date as the longstop date.

Fair and Transparent Procurement Process

Although market tests are not subject to the public procurement rules, the process must still facilitate competition by being rigorous, equitable, transparent and allow for detailed feedback to be provided to unsuccessful bidders. With bid costs being significant on the larger contracts, if there is any scope for challenge on the grounds of unfairness, a lack of transparency or a perceived conflict of interest, the project company and the Authority could be exposed to a significant claim from a “disgruntled” bidder. By way of example, Bristol City Council was recently faced with the threat of a challenge by DC Leisure Management in relation to alleged flaws in the procurement process relating to a PFI project to construct a new £21 million leisure centre in Bristol. The issue was that DC Leisure’s proposal to build a ten lane swimming pool was rejected during the tender process, but the same proposal by the successful bidder was accepted. It is understood that the matter was settled by Bristol City Council paying DC Leisure the sum of £800,000 in an out of court settlement.

Conflicts of Interest

The Project Company must also be alive to conflicts of interest which could put the fairness of the procurement process at risk. Where, as is common, the incumbent service provider, its shareholders or its

principal operating sub-contractor is associated with the Project Company and intends to take part in the market test, the Project Company must ensure that safeguards are in place to exclude those who are, or are potentially, conflicted from some or all of the market test process. In these circumstances, the Project Company and the Authority should consider jointly appointing an Independent Tender Process Manager to independently oversee the process to ensure no conflicts of interest arise.

The Timetable

Market tests are an excellent opportunity to undertake a full contract and service review, taking into account the adequacy of the operational contract up until that date. In order to be able to set a realistic timetable, the Project Company in conjunction with the Authority should establish whether:

- the services are to be market tested as a bulk or individually;
- any variations are to be made to the market test services;
- the variations will affect the payment mechanism and /or the risk profile;
- there will be any additional services or services removed (including whether any services are to be provided “in-house”);
- there are any existing (undocumented) variations which need to be “caught up” in the contract documents;
- contractual amendments are required due to changes in statute;
- any contractual clarification is required;
- any practical on-site issues need reflecting in the contract documents;
- consents need to be obtained from funders and/or shareholders; and
- the Authority can afford its “wish list”.

Once the above is established via market test meetings, the Project Company needs to adequately resource the market test and decide whether external advisors are required (this is advised if there are large or numerous variations and /or there are changes to the payment mechanism and /or the risk profile).

The practical issues of effecting variations, contract amendments, obtaining consents, reviewing tenders, selecting the preferred bidder, dealing with interface issues and disputes will be covered in the next Parts of this Value Testing series.

Practical Tips

- When benchmarking, specify what services are to be benchmarked and what they are to be benchmarked against (i.e. set out the data sources). The more detailed the provision, the more use the results are likely to be, increasing the chances of agreeing a benchmarked price.
- Ensure that the market test process is carried out in a fair, competitive, transparent and non-discriminatory way in order to avoid the risk of a challenge from “disgruntled” bidders.
- Introduce adequate safeguards to deal with any potential conflicts of interest.
- The Project Company should manage resources by constituting a market test team with authority to make decisions.
- Scope out the requirements of the market test and set a realistic timetable.
- Ensure that the Authority can afford its “wish list” to avoid unnecessary work being undertaken which would put the time table at risk.
- Make funders and / or shareholders aware of the market test and the time line to get stakeholder “buy-in” and the necessary consents.