KPMG

Effectiveness of operational contracts in PFI

2007

KPMG LLP (UK)

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Contents

This survey plays its part in the assessment of the success of PFI

Foreword

We share a vision of a world in which public services requiring capital assets can be provided efficiently and effectively for the lowest cost compatible with the quality of service demanded. If these services are to be provided from the private sector, in partnership with local authorities or government agencies, our government - and other governments in turn - must be satisfied that this represents better value for money than the historic alternative of direct state delivery. Proving this is no small task.

As most of the recent industry surveys and individual contract evaluations have concluded there is a clear need for realistic benchmarking of the costs and quality of services being provided. This survey plays its part in the assessment of the success of PFI. It continues to focus on the delivery of contracted services - rather than the construction phase.

As this year's survey begins to establish itself as an important set of reference data for the industry, we have chosen to add a section to provide a summary of all UK PFI contracts in place at the end of 2006. Having established that base, we will in future include comment on those added year by year and on evident trends in the sector.

While not apparent from the survey, it is evident that the current style of rigorous competitive tendering for contracts under narrowly-defined PFI may not suit all types of service or all facilities. In many cases it is clear that both the suppliers of services and their public sector partners need more flexibility at least in the operational phase. Future surveys will address this area more specifically.

We hope this survey will help to inform the debate - all too easily hijacked by politically motivated and emotive soundbites - about how to deliver the best value for money public services.

Executive Summary

A number of themes arise from this year's survey. Once again, strong relationships are crucial to the profitability of contracts with new innovations and benchmarking starting to provide benefits to both the private and public sector.

There are still issues with contract accuracy and wording, but as well as needing to be tighter and easier to read they must give flexibility to the private sector to consistently "over deliver". Comment is also provided on soft services within health and education; a debate that is currently ongoing within the PFI marketplace.

Perennial issues such as the need for greater partnership and balanced responsibility, and future concerns such as cost control and costs of new regulations are also listed.

Basis

The survey is based on the responses of 93 contract managers in the private sector, across a range of PFI services.

Relationships

One of the central themes identified by our last report was the importance of the relationship between private and public sector partners. Our survey results showed a strong correlation between the health of that relationship and the overall performance of projects. So the first piece of good news is that relationships between contract managers appear to be in very good shape.

Operational performance

This year's survey suggests that most contracts are performing well, with nearly 10% more managers reporting very good results than last year. Once again, close communication with contracting parties and regular assessment of operations appear important.

Although a small number, less than 10% of respondents, felt that including soft services did not enable them to provide a better overall service, 67% of all managers considered that including them had had a beneficial effect.

Perennial problems continue to hamper some contracts, however, with a significant minority reporting profitability concerns.

Service Levels and deductions

94% of contracts are currently meeting their service level agreements and reported operational problems are generally resolved within the time allowed. 63% of contracts have incurred deductions.
Managers appear broadly happy with the monitoring of Service Level Agreements (SLAs) with the highest satisfaction ratings among those contracts monitored by the private consortium rather than by the public sector client. This may be a function of the way it is monitored. On balance it seems that deductions remain more of a sanction than an active management tool and their overall impact is minimal.

Innovation

Innovation has become an important driver behind contract performance improvements with 60% of respondents saying new ways of working have helped them over-deliver.

'With nearly 70% of managers referring to their contracts once a month or more, issues clearly remain'

In most cases, such enhancements have not meant an increase in costs. In some, it has resulted in cost savings. For the future success of PFI, it is important that contracts should be flexible enough to provide for, indeed encourage, innovation and to allow for the sharing of the benefits it brings to both parties.

Benchmarking

In 85% of cases the PFI contract includes requirements to undertake periodic benchmarking or market testing of services. In most cases the benchmarking or market testing process is explained clearly in the contract with the recommendation that it should happen between every three and seven years. So far though, only 13% (12 contracts) of the respondents have actually been through the process and the findings are not therefore sufficiently well based to either draw conclusions or influence policy. The limited evidence does suggest that it should be seen as an opportunity to make improvements to the contract. It is also becoming apparent that benchmarking can be as beneficial to the provider as to the public sector.

Contract wording

Last year, the wording of contracts was highlighted as an area for improvement. This year's survey shows the problem is still with us, even though the 14% of respondents who stated their contract always specified the exact nature and level of services required is 3% more than in 2005. With nearly 70% of managers referring to their contracts once a month or more, issues clearly remain.

Health and education comparison

The health and education sectors represent two-thirds of the contracts studied in our survey. They are both performing well. Contracts in both sectors are currently meeting Service Level Agreements in 90% of projects, 80% of contracts in each sector are profitable and 70% have been profitable in every year of operation. The reports of 'very good' performance are also up on last year. Both sectors have their concerns. The managers in the education sector are the most sceptical about the inclusion of soft services. Although 66% felt that including them provided a better service, all of those in the survey who thought that the inclusion of soft services did not provide a better result for the public sector were in education. This will only add to the current debate on their value for money and the exclusion of soft services from PFI contracts. Alternatively there may be a need to re-examine the procurement process to understand if the process itself constrains creation and delivery of effective solutions.

Risks and issues for the future

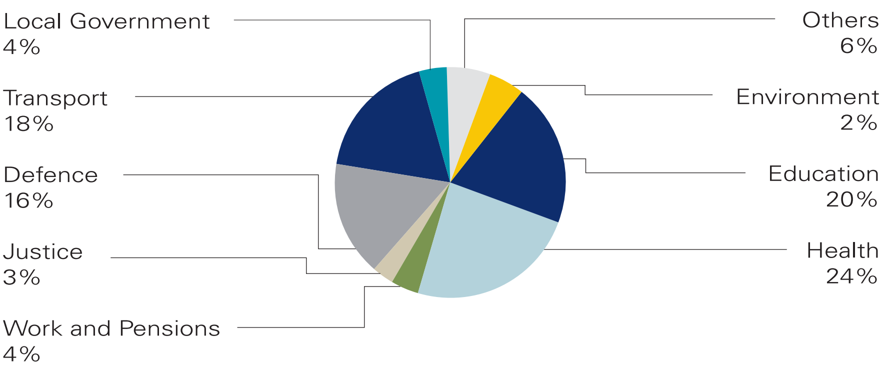
Most contractors appear confident in their current performance and positive about the future. Risk management appears under control, with 86% of managers reporting up-to-date risk profiles for their contracts. Issues that trouble contracts today, however, such as contractual misunderstandings and cost control remain the concerns for the future. The survey identifies a number of areas for future improvement.

Overview of the UK PFI marketplace

Since the first PFI contract, the construction of the QEII Bridge between Dartford and Thurrock in 1987, over £38bn in capital value has been contracted between public and private sectors. This excludes the 3 London Underground PPP contracts. Health has accounted for the highest amount of capital value with over £9.5bn of contracts signed. This is 25% of the capital value of UK PFI contracts. For the purposes of this analysis English, Scottish, Welsh and Northern Irish contracts are grouped together to make up the overall sector figures.

The top 10 projects by value are split between transport, defence, health and the DWP PRIME contract. Together they account for over £7bn in value (19% of total UK market); they are all listed below along with the London Underground PPP projects that have been excluded from this analysis.

Proportion of total PFI contract value by sector



Top 10 UK PFI projects by capital value

Sector	Project	Location	Year	Total Capital Value (£m)
Defence	Allenby/ Connaught	Aldershot, Salisbury Plain	2006	1257
Defence	Skynet 5	National	2003	1079
Health	Barts & the London NHS Trust	London	2006	1000
DWP	DWP - PRIME	National	1997	959
Health	University Hospital Birmingham NHS Trust	Birmingham	2006	627
Defence	Colchester	Colchester, Essex	2004	539
Health	Central Manchester, Children's & University Hospitals NHS Trust	Manchester	2004	512
Transport	M6 Toll Road	West Midlands	1992	485
Transport	London Underground Connect radio system	London	1999	468
Health	University College London Hospitals NHS Trust	London	2000	422

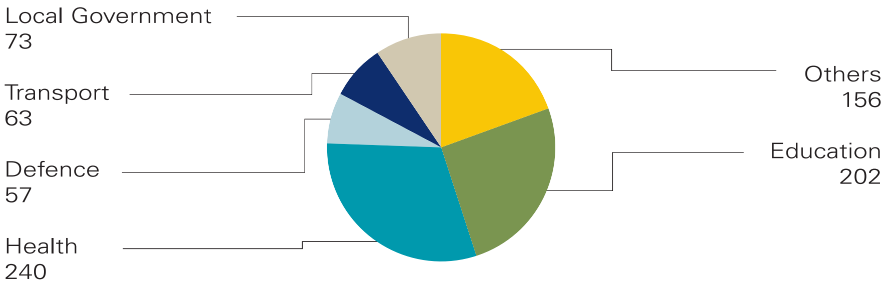
London Underground track contracts (excluded from analysis)

Sector	Project	Location	Year	Total Capital Value (£m)
Transport	London Underground Sub Service lines	London	2003	6180
Transport	London Underground Jubilee, Northern & Piccadilly Lines (JNP)	London	2002	5484
Transport	London Underground Bakerloo, Central & Victoria Lines (BCV)	London	2003	4597

Source: HM Treasury

As well as highest capital value the health sector accounts for the largest number of contracts with 240, 30% of the total number of projects carried out since 1987. It is closely followed by education with 202 and together they account for over 55% of the volume of UK PFI contracts.

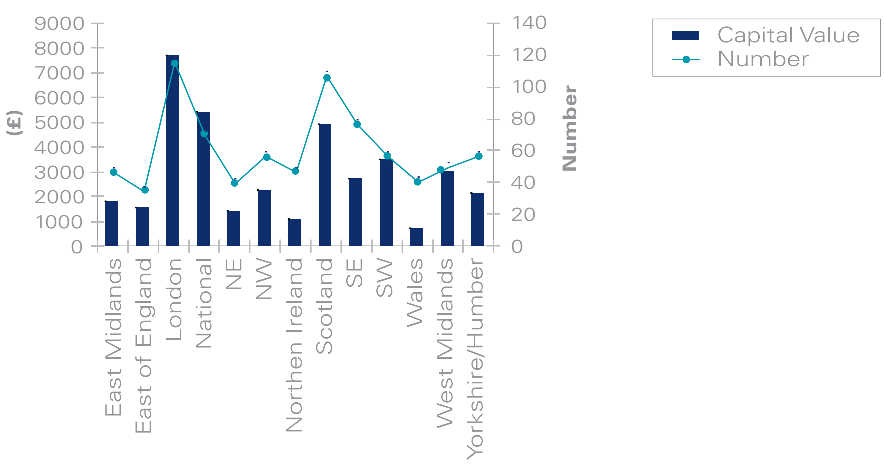
Number of PFI contracts by sector



If the regional distribution is analysed it is perhaps unsurprising that London accounts for the highest value and volume of signed contracts. It accounts for 116 with Scotland accounting for 99 and the South East of England 77. If 'national' contracts are excluded, Scotland also accounts for the second highest level of PFI spending by capital value. 46% of Scottish contracts are health related and 32% education. Together, they account for 78% of Scottish contracts by volume and just under 75% by contract value, which differs markedly from the overall UK picture of over 55% and 46% by volume and value respectively.

The overall trend in the current decade appears to be downward, at least in terms of numbers of contracts. Certain sectors, notably Health, are carefully appraising whether the traditional PFI model is still right for their area.

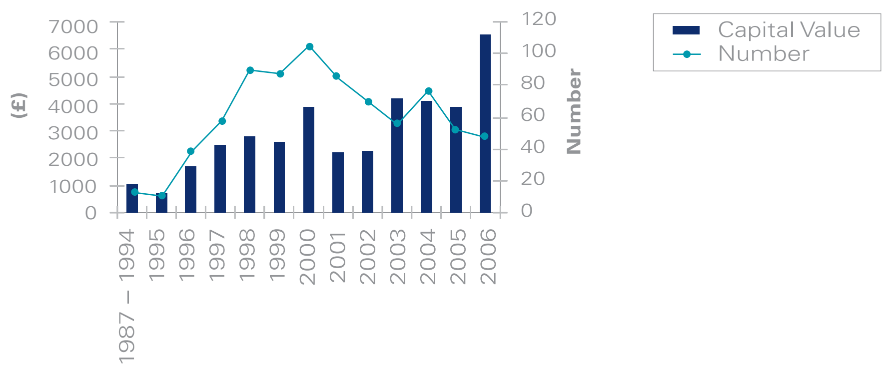
Contracts by region



Whilst 1987 was the year of the first PFI contract, there were only 13 up to and including 1994 totalling just over £1bn. Since 1995 there have been 778 contracts signed totalling over £38bn with the zenith being in 2000 with 106 PFI contracts agreed. 2006 was the peak year for contract value accounting for over £6.5bn.

We will wait to see what 2007 brings and will carry out this analysis next year to reflect changes and developments in this innovative marketplace. The overall trend in the current decade appears to be downward, at least in terms of numbers of contracts. Certain sectors, notably Health, are carefully appraising whether the traditional PFI model is still right for their area. We will also be monitoring the impact of the new BSF approach in Education

Contracts by year



Effectiveness of operational contracts in PFI

section

1 Relationships

Satisfaction with day-to-day working relationships appears to have improved from the already healthy state we observed last year. 24% of respondents consider them good and 56% very good. Only 5% noted poor relationships. This result is particularly significant since 23% of managers indicated that there was no effective, formal hand-over – a rise of 4% on last year. It also remains unusual for members of procurement teams to stay on beyond the bid stage. In only 24% of cases did a key member do so, and among those, under half (45%) stayed between 7 and 12 months albeit 36% stayed more than 18 months.

Our results show that when contract managers had remained in the team longer than a year, the contract they worked on scored consistently highly in terms of its operational relationships. There may not be an overall causal link here, although there may well be when it comes to the views of individual contract managers. Of managers who felt their relationship was poor, 60% had been in the job less than a year, while of the people who had been in the job between two and three years 68% said it was very good.

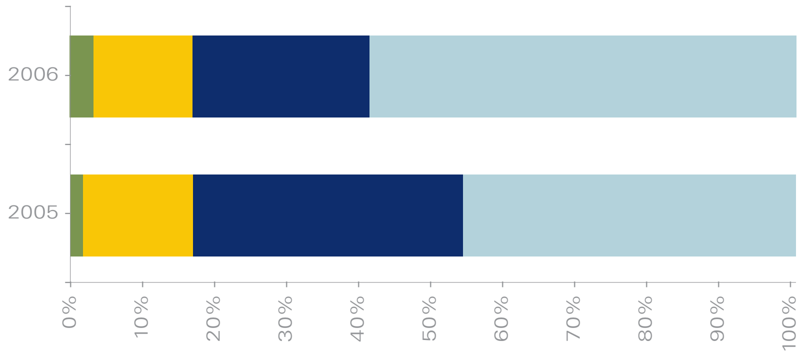
Communication

The longevity of these relationships may explain an interesting development from last year. Then, we found that managers working most closely often had the best working relationships. This does not seem to be the case this year. Although managers working in the same office overwhelmingly report 'very good' relationships, many of the contract management teams who responded to our survey were based on different sites (43%) – and 60% of them still reported 'very good' relationships.

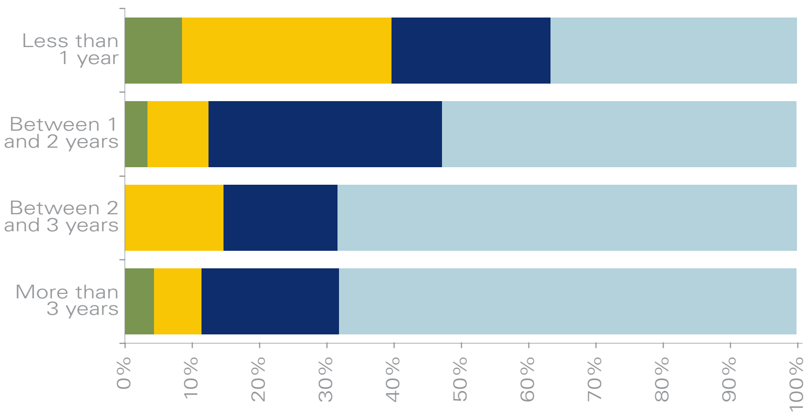
The key remains regular communication, with the highest satisfaction reports coming from teams that meet regularly – formally once a week (89% good or very good) or once a month (85% good or very good) as well as informally.

‘The key remains regular communication, with the highest satisfaction reports coming from teams that meet regularly ‘

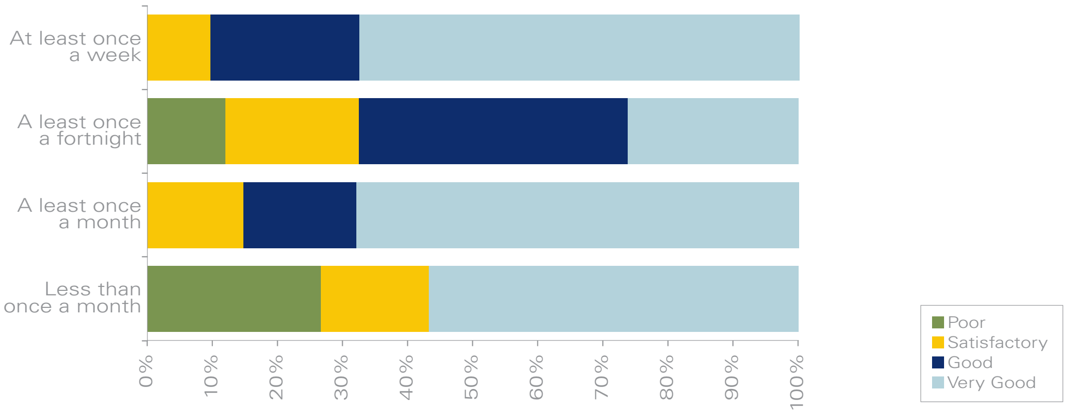
Quality of operational relationships between the public sector and private sector contact management teams



Quality of operational relationships between the public sector and private sector contact management teams and length of service of contact manager



Quality of operational relationships between the public sector and private sector contact management teams and frequency of formal meetings



section
2 Operational Performance

General quality

The percentage of respondents reporting a 'very good' overall performance of their contract has risen to 59%, compared to 49% in our 2005 report. An additional 36% thought their performance was 'good', while no one thought it was anything less than satisfactory. 83% said that the contract is currently delivering a positive annual profit on the services contract for the company.

Communication and performance assessment appear to be key factors in the success of contracts. Of the managers who met formally at least once a week, 72% felt the overall performance of the contract was very good, and only 6% 'satisfactory'. Of those who met informally on a daily basis, 80% reported 'very good' performance. It is also interesting to note that of the 24% of teams who had retained key members of procurement team, 77% reported very good performance.

' Communication and performance appear to be key factors in the success of contracts '

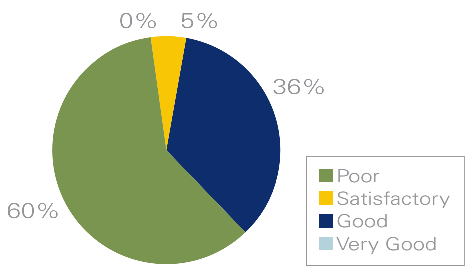
Most performance assessment was conducted monthly, although it is worth noting that every one of the 5% of managers who assessed performance weekly reported good or very good contract performance.

71% of hard services and 83% soft services contracts assess end user satisfaction. Surveys, 'mystery shopper' exercises and face-to-face feedback sessions are the most popular methods. Both hard and soft services are being delivered to an acceptable standard, either always or most of the time in more than 90% of cases.

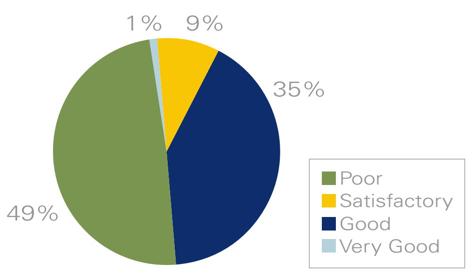
Soft services

82% of managers with contracts including soft services considered that they had had a beneficial effect. It seems it is the managers in the education sector that are most sceptical about their inclusion; although 66% of them felt that including soft services provided a better service, all 5 of them that felt that it did not were in the education sector.

Overall performance of the contract in terms of delivering the services stated in the PFI contract - 2006



Overall performance of the contract in terms of delivering the services stated in the PFI contract - 2005



Profitability

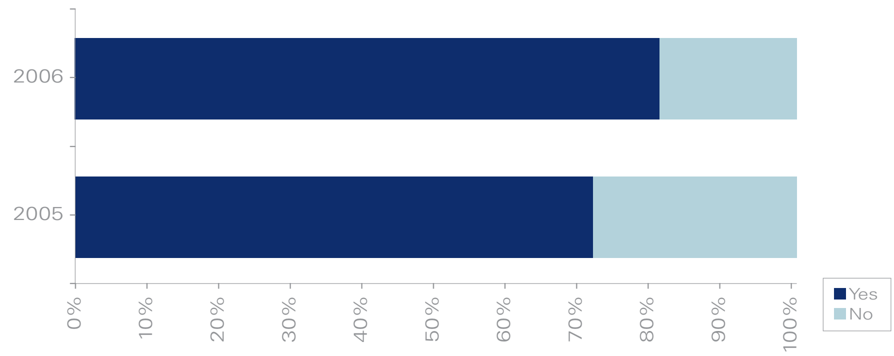
Most contracts are making money, with 83% delivering profits now and 70% having delivered positive profits every year of their operation. In 25% of these cases, those profits have been better than expected – and 3% reported as 'significantly better'. This may reflect the impact of the innovation that some managers were able to create. It is interesting to note that of the 12 contracts that were benchmarked, 9 of them led to price increases of between 0 and 10%.

There is a flip side to these figures that deserves attention though. 17% of contracts are not delivering profits and 38% are delivering less profits than expected, and almost 30% of these (11% overall) are delivering significantly less than expected. The most common reason cited was changes in client requirements while other reasons included third party revenue shortfalls, questions over build quality and TUPE issues leading to extra costs. The high volume and cost of repairs, poor costing and bid management as well as operational SPV servicing costs were other noted causes.

Only 24% said the profitability of their services contract had been impacted by changes in the financial circumstances of the public sector, with the main reasons being an increased focus on deductions and an inability to negotiate price increases. This may reflect the public sector being constrained in its spending and looking to save money on what should have been a fixed price commitment while at the same time seeking service level improvements.

Clearly this will make for a difficult series of discussions and the overall quality of relationships will be key to a satisfactory outcome.

Is the contract currently delivering a positive annual profit?



section
3 Contract Deductions

Service levels and deductions
When it comes to Service Level Agreements (SLA), the picture is similar to last year. Requirements are being met and deductions do not appear to be excessive. When problems have occurred, they have been resolved within the time allowed by the contract 'always' in 32% of cases, and 'most of the time' in 66%.

It is notable that of those that are monitored by the public sector client, only 44% reported very good relationships against 24% satisfactory or poor. Among those who used the private sector consortium SPV the 'very good' relationship percentage rises to 67%, against 22% satisfactory or poor.

In 53% of cases, the public sector has chosen to waive its right to impose deductions, although 39% of respondents have received deductions between one and five times. It appears that this right, however, remains more of a sanction than an active management tool. 34% of contracts have not been subjected to any performance or availability deductions, and of those that have, most have received just a handful – 51% less than ten and only 10% more than 50. Total deductions do not typically appear to represent any more than 0.5-1% of total revenues.

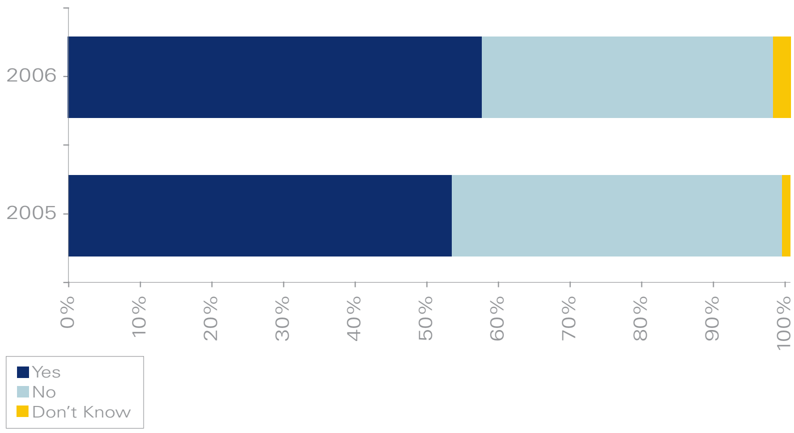
This suggests either:

a) high quality delivery; or
b) questionable contract management by the public sector; or
c) poorly designed payment mechanisms.

It is also possible, that in practice, the private sector suppliers work to 'over deliver' in some areas in order to be able to minimise the impact of deductions and to protect relationships.

The impact of deductions on relationships is therefore hard to gauge. 13% strongly agree, and 51% agree to some extent that the imposition of deductions damages the relationship with the public sector – but 79% of respondents recorded good or very good relationships with their corresponding management team. The discrepancy implicit in these conflicting results suggests that any damage done to the relationship is short lived.

Has the contract been subjected to any performance or availability deductions?



section

4 Innovation

Innovation and new ways of working have led to performance beyond that required by the contract ("over delivery") and generally this has not led to an increase in costs. Some innovations have resulted in cost savings. PFI contracts should allow for the development and use of innovative practices in order to generate benefits which can be shared between both parties.

There are many types of innovation being used to deliver contracts. Better and more thorough assessment methods were also cited as ways in which existing working practices were improved.

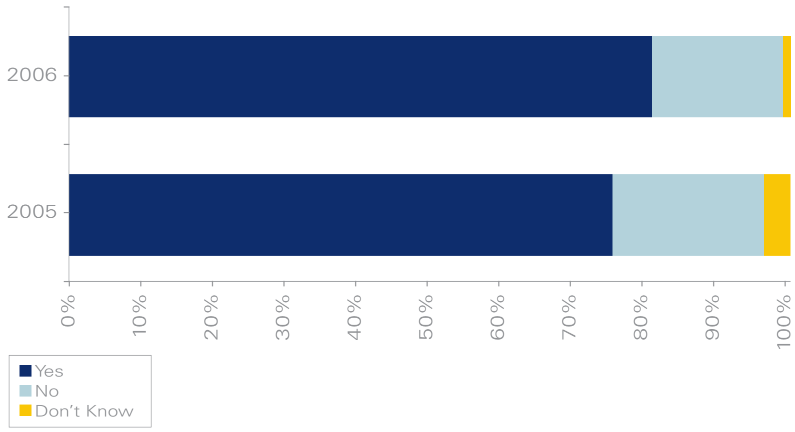
In only 19% of cases did this innovation lead to increases in service delivery costs, while 70% saw no change in the charge for the services they provided and 11% saw a decrease. Contract managers have cited a number of examples where the whole basis of the provision of the service has been rethought.

section

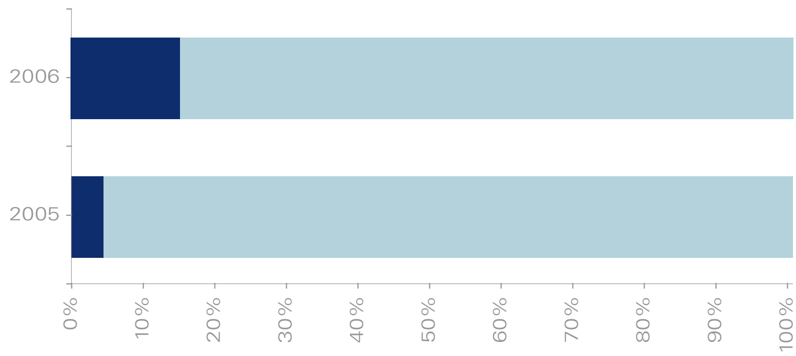
5 Benchmarking

‘ As a result of benchmarking, more prices rose than fell. In 75% of cases the overall price of services rose by up to 10% ’

Does the PFI contract include a requirement to undertake periodic benchmarking or market testing of services?



Have you undertaken a benchmarking/market testing exercise for this PFI contract?



Whilst most PFI contracts have a requirement for benchmarking or market testing, at the date of the survey relatively few had got to the time when this had become obligatory. At the time of our survey 87% of our respondents indicated that they had not undertaken a benchmarking exercise for their PFI contract. We have noted that of the 13% who had undertaken a benchmarking exercise, 75% reported positive profits in every year of operation since the contract.

As a result of benchmarking, more prices rose than fell. In 75% of cases the overall price of the services rose by up to 10%. The reasons behind these price changes ranged from pension costs and wage rates to changes in service specification and staff numbers.

Benchmarking did not tend to affect the relationship with the authority and in 33% of cases it actually improved it. As with last year's survey, most respondents think there will be a modest rise in the overall price of the service charged, with only 4% of managers expecting increases of more than 20%.

So, despite the concerns raised in last year's survey that benchmarking could be a significant relationship issue for both sides, the limited evidence suggests that it should not be feared, but rather seen as an opportunity for making improvements.

section

6 The PFI Contract

Contract clarity

The clarity of PFI contracts remains an important issue. 37% of managers surveyed refer to their contract at least once a week, 32% at least once a month and 24% at least once every three months 75% of those surveyed felt that it was reasonably accurate in the services it specified.

Last year, we considered the value of an easy read version of contracts. There seems to be no change in this area, with only 21% of managers having access to an easy read version. When asked what improvements they felt public sector PFI contract managers could benefit from, however, over 20% of respondents suggested clearer contracts. Our conclusion remains the same. Greater clarity on the page could reap benefits on the ground. Only 15% of contracts, for example, have experienced no variations, while 16% have seen over 100. Clearer contracts cannot guard against the most frequent cause of variation (capturing new requirements of the public sector client, 62%), but they can help reduce the 13% of problems caused by correcting mistakes in the original version.

Payment and dispute mechanisms

Another pressing problem appears to be with the payment mechanism. Around half of respondents agreed, either strongly (14%) or to some extent (36%) that the payment mechanism supported the effective management of the contract and yet 25% of respondents found it fairly difficult to use and 5% very difficult. 90% of payment mechanisms did not provide incentives to over-perform on the service levels specified in the contract. It is recognised that it is standard policy not to have incentives for over-performance as the public sector should set out what it needs and buy that. Clearly, as PFI develops we would hope that an incentive structure to reward over-performance (where it is agreed to be of value) should be built into the contracts.

There is more encouraging news with the dispute mechanism. Our survey results show this offers a good indication of the health of a contractual relationship and in 80% of cases it has not been used at all. Of these, 64% report a very good relationship and 67% a very good overall performance. 15% of contracts have used the mechanism between one and three times. It seems that where the dispute mechanism is resorted to regularly it has an adverse effect on relationships.

section
7 Health and Education

Performance

Satisfaction with performance has improved significantly since last year, with 71% of health sector contracts and 45% of education contracts reporting 'very good' performance. This compares with 56% and 31% respectively in the last survey. When it comes to operational relationships, the picture is similar in both health and education. 58% of educational contracts report very good relationships compared with 57% for health. Around 25% of contracts in each sector are reporting satisfactory or poor relationships.

Financial expectations have been different as well. For the survey overall 38% of managers said their profits had been worse than expected. In education and health specifically this poor profit performance rose to 48% and 41% of contracts respectively.

The biggest problems experienced in health and education were cutbacks in public funding and poor build quality; the latter being the responsibility of the winning consortium. There may be a case for a price adjustment between members of the consortium in such circumstances, but it should not affect the price paid by the public sector. An additional issue in health contracts was changes in client requirements.

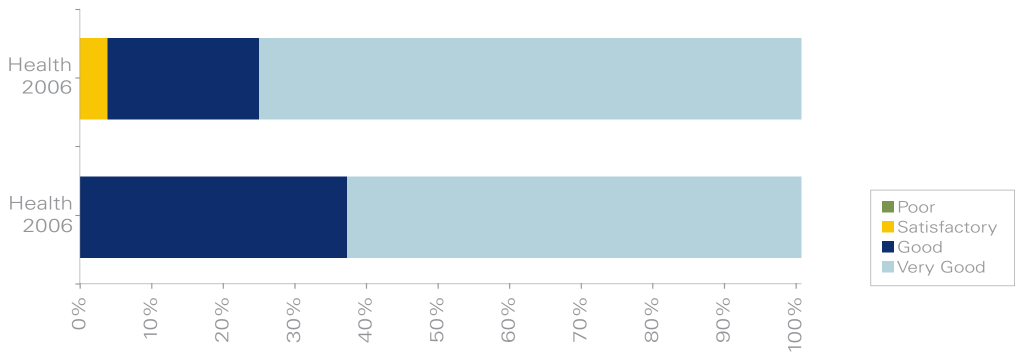
Deductions

Deductions are more common in education (74%) than in health (55%). When asked whether managers thought the imposition of deductions damaged relationships between private and public sectors teams, 75% of health managers agreed to some extent, compared to 55% of their counterparts in education.

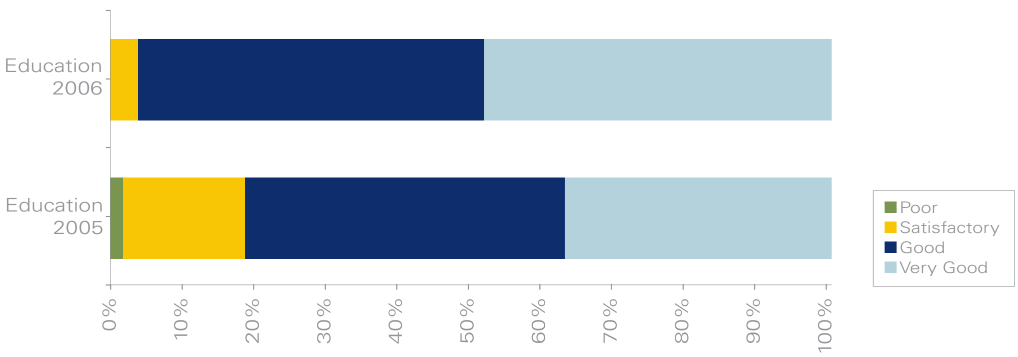
Risk

One potential issue is in the area of risk: 93% of health contracts report an up-to-date risk profile. This compares with 81% in education where 19% of managers feel there is no clear accountability for the management of risks.

Overall performance of the contract in terms of delivering the services stated in the PFI contract: Health Sector



Overall performance of the contract in terms of delivering the services stated in the PFI contract: Education Sector



Risk and the future

Risk

The vast majority of contracts (86%) have up-to-date risk profiles, with most managers ensuring key risks are reviewed at least once a month (42%) or every three months (30%). 87% feel there is clear accountability for the management of key risks and, understandably, those managers who feel there is not, report a much higher incidence of just satisfactory or poor relationships and performance.

Only 38% of companies conduct joint risk assessments with the public sector contract management team. The data suggests no particular correlation between working together and improved operational relationships or performance – but the persistence in working separately on such a fundamental issue may be a symptom of an enduring cultural gap.

Issues for the future

The number of managers who felt their public sector counterparts could benefit from additional help was only just over half. Their reasons, however, highlighted some of the perennial issues that surround PFI contracts. They included:

- developing a deeper understanding of legal constraints
- developing contractual boundaries (including having access to easy to read contracts)
- more balanced responsibility
- greater partnership
- developing a better knowledge of financial accounting
- developing a more commercial focus
- maintaining a more long-term focus
- retaining members of the management team

Looking to the future, there are a number of concerns:

- life-cycle issues such as investment and profitability
- cost control
- variation changes and contractual interpretation
- client culture change
- new regulations, especially the costs of environmental legislation.

Effects of the 2007 budget

The 2007 budget has legislated for £10.8bn future dealflow of PFI credits from 2008 to 2011, which demonstrates a commitment to the development of the PFI martketplace. HM Treasury have also announced plans to adopt IFRS for 2008/9. It remains to be seen what impact this change will have on the overall PFI pipeline.

Superficially, this looks like a decreased level of spending compared to £6bn in 2006. But if it relates only to the capital element of PFI spend, it looks more healthy.

Our Approach

section
8 Our Approach

‘ We believe the 93 projects covered in the survey represent a cross sample of almost 800 PFI projects active in the UK at the present time ’

This survey, jointly sponsored by KPMG and the Business Services Association (BSA) was conducted utilising a semi-structured online questionnaire between June and December 2006.

The link to the questionnaire was first distributed to project managers, within both BSA member organisations and other operators, on 26 June 2006. Two further email reminders were issued to the survey population over the course of the fieldwork period. By the closing date of 14 December 2006 we had received valid responses covering 93 PFI contracts.

The broad range of question areas included:
- the operational performance of PFI projects
- the nature and clarity of the contracts covering PFI projects
- the relationship between private and public sector contract management issues, challenges and possible lessons for future PFI contracts.

Our survey focuses on the private sector providers of PFI services. The PUK survey covered in HM Treasury's ‘Strengthening Long Term Partnerships’ report focuses on the views of public sector parties.

We believe the 93 projects covered in the survey represent a cross sample of the almost 800 PFI projects active in the UK at the present time. These projects are summarised in section 2.

The analysis of the PFI marketplace in the UK was carried out using data available from HM Treasury’s website. It has excluded the three London Underground PPP contracts.

In terms of statistical reliability we estimate that the sampling tolerances will vary between 5 and 10%.

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