Guidance on variations to PFI contracts and schemes

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Guidance on variations to PFI contracts and schemes

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Contents

Executive summary

This document provides guidance on which variations should be submitted to the Department of Health (DH) for approval. It sets out the delegated limits that apply, and provides advice on the contents of a variation business case. It considers variations at every stage of a project, including procurement, and sets out the approval process.

It applies to PFI schemes that have previously been approved by DH. Where a scheme was below the DH delegated limit and approved by the Strategic Health Authority (SHA), the SHA should deal with the variation in the light of this guidance. It has been informed by the National Audit Office (NAO) report, *Making changes in Operational PFI* Projects, published on 17th January 2008, and HM Treasury Operational Task Note 3, Variations Protocol for Operational Projects, issued December 2007.

It should be read in conjunction with 'Best Practice guidance on variations', produced by the Department's Private Finance Unit (PFU), which has been written from the commercial perspective to inform the application of schedule 22 of the Standard Contract for NHS PFI schemes and is also published today alongside this guidance on the DH website.

Introduction

Who this guidance is for

1. NHS Trusts, PCTs and project teams dealing with PFI projects, particularly those schemes under construction or operational. It is also useful for schemes in procurement as there are measures which can be put in place prior to PFI contract signature which will make subsequent variations easier to handle.

2. Variations are, of course, just as likely to occur in publicly funded schemes. However, there is a different situation here as there is no standing or incumbent concession partner. Trusts with publicly funded schemes may still find material of interest in this guidance and, if they consider that any of the requirements apply to their schemes, they should in the first place consult their SHA.

What does this guidance cover

3. This document provides guidance on which variations should be submitted to DH for approval. It sets out the delegated limits that apply, and provides advice on the contents of a variation business case. It considers variations at every stage of a project, including procurement, and sets out the approval process.

4. It applies to PFI schemes that have previously been approved by DH. Where a scheme was below the DH delegated limit and approved by the SHA, the SHA should deal with the variation in the light of this guidance.

5. It has been informed by the NAO report, *Making changes in Operational PFI* Projects, published on 17th January 2008, and HM Treasury Operational Task Note 3, Variations Protocol for Operational Projects, issued December 2007. It should also be read in conjunction with the DH PFU Best Practice guidance on variations, written from the commercial perspective to inform the application of schedule 22 of the Standard Contract for NHS PFI schemes (also available on DH website).

Guidance on variations

6. DH recognises that, as change is inevitable during a project's lifetime, so also are variations, both large and small, from a range of causes both internal and external. What DH is concerned to ensure is that variations are only undertaken when it is appropriate to do so, especially those with an impact on capacity or costs where any such must be robustly justified. Variations at any stage of a project should be carried out with due regard for the EU Procurement Directives, affordability and value for money. On the specific issues of procurement and value for money, DH would also expect to see more variations, especially the larger sort, tested through a business case to see if they could be the subject of independent procurements. That is, that incorporation into the PFI contract should not be automatic, and, for any proposed variation above the OJEU threshold, consideration of an independent procurement should be an option considered in the decision-making process and the business case.

7. DH is particularly keen to avoid variations that arise from insufficiently developed thinking about, and signup to, a project's scope, specification and processes at an early stage. This is something DH wishes to emphasise: the more a project is thought through prior to procurement and financial close, the less likely it is that variations will be unanticipated or arise from other than external causes (eg, technological change, or policy or service change). The requirement for such thinking around scope and specifications is increasing now, with the impact of Competitive Dialogue (CD) and the Appointment of Preferred Bidder Business Case (ABC) approval process.

DH's role in variations – why DH is involved

8. There are three main reasons why DH will be part of the approval process for some PFI variations. They are:

   i) any variation risks moving a PFI scheme outside the parameters upon which it was approved at ABC (or financial close, for pre-CD procurements);

   ii) DH issues the Deed of Safeguard, so any variation which sets up a requirement for a revised Deed must have DH approval in order for the revised Deed to be issued. Conversely, a variation that was not approved could invalidate the Deed for the whole scheme; and

   iii) a variation may impact on the risks and liabilities that could fall to DH if its obligations were triggered in accordance with the terms of the Deed.

9. DH therefore has a role, and some variations must have DH approval. But DH does not have to be involved in all variation approvals; there must be an element of selection, and this is addressed in the section below on Delegated Limits. Trusts and PCTs should however be aware of the risk of invalidating the Deed if a variation should be implemented that impacts significantly on the scheme but which has not had DH approval.

What constitutes a variation

10. Fundamentally, a variation is any change, however minor, from the scope, services provided, design, legal and financial position approved at contract signature (as some limited change may occur post-Appointment, contract signature is the best point at which positions may be regarded as 'fixed'). They can range from a decision to install a different type of light bulb, through changes to soft FM services as a result of benchmarking, to adding a new unit or service. They are also inevitable: all projects will experience change during construction and operation that may affect the contract and its schedules. Smaller variations will be handled via change requests. Larger variations will usually be recognised as requiring approval at least at the level of the Project Board, and more likely by an external body, eg, the Trust or PCT Board. DH approval is unlikely to be necessary for any variation below the level of Trust or PCT Board approval.

11. Variations themselves will vary in size, and one useful set of definitions is that of 'low', 'medium' and 'high' value variations as defined in the HM Treasury Operational Task Note 3. The NHS SF3 defines small works as being of value £1,000 or less, while HM Treasury gives £10,000. A Trust or PCT can decide to increase the SF3 Small Works threshold if

they wish, but DH would recommend using the HM Treasury ‘low value’ definition as a maximum.

12. One particular issue is that of handling variations that are made up of a number of small works that arise during and just after construction. These can to some extent be anticipated through an allowance for contingencies; this, if approved as part of the ABC/FBC, should be reconciled against the actual costs incurred at Trust Board level – further approval is not necessary. Where small works exceed any contingency budget these are best handled, in non-FT Trusts, via regular reports to the Trust Board. All Trusts should ensure that Trust governance is properly handled. If the value of the small works reaches the threshold set in paragraph 16 iii) below, then the SHA should be involved. If there is no impact on the scheme risk profile, PFI debt or liabilities, *and* the amount is made up entirely of small works, then approval can be handled at SHA level. SHAs must ensure that vfm has been signed off by a QS.

13. If the threshold is passed, and there is an impact on the risk profile, PFI debt, or liabilities, then approval must be sought from the centre. A Trust in this position should seek CIB’s approval. Any expenditure that has already been incurred when DH’s Capital Investment Branch (CIB) approval is sought should be included in the case as a sunk cost, in order to provide the full picture to CIB. The case should also include a full audit trail from the position approved at FBC, up to the variation.

DH delegated limits

14. The delegated limit for variations used to be simply £2m capital value or 2% of the project’s capital cost; whichever was the *less*. In practice, this was found not to work very well, being opaque to the nature of the variation. The criteria for deciding whether DH should also approve a variation have therefore been changed to include qualitative tests as well as a financial threshold. This is to ensure, as far as possible, that DH approval has to be sought only when it is appropriate.

15. Foundation Trusts should refer to the delegated limits that are set out within their Deeds of Safeguard.

16. For Trusts or PCTs that are not yet FTs, SHA and DH approval is required where the variation has the following effect:

    i) for projects where the real (ie, uninflated) annual Unitary Charge, for Trusts with Unitary Charges greater than £10 million per year, increases or decreases by 10% or more from the Unitary Charge payable in the first twelve months after service commencement. For Trusts with annual Unitary Charges of less than £10 million per year, the applicable percentage is 5%;

    ii) increasing the PFI contract termination liabilities;

    iii) if a refinancing is carried out; and

    iv) if the capital value of any single variation exceeds £5m or 5% of the project’s original capital value.

17. For those Trusts or PCTs to whom the PFI review process was applied, no variation should cause them to exceed the envelope which was set for them at the outcome of the review.

18. These variation tests and limits apply no matter how the variation itself is funded. A build variation may be funded outside the PFI via borrowing (or public capital), but may still impact on the Unitary Charge, eg, if soft services are extended to a new unit, or on termination liabilities. (If a variation of some kind is funded outside the PFI, and has no impact on the points listed in paragraph 15 above, then this guidance does not apply.)

19. All other variations should be approved by the Trust, PCT or the SHA as appropriate (based on whether the Trust is an FT or not).

20. As variations can occur over the whole life of a project, the ‘clock’ for the financial limits will be reset after every DH approval of a variation, so that any subsequent variation only triggers DH approval if it again meets the criteria. If a small variation is what trips over the threshold in the first place, then the situation should be discussed with DH CIB to decide what variation is approved, depending on whether there have been one or two large variations that are appropriate for DH approval or a series of smaller variations that are more apt to SHA approval.

21. If there is any uncertainty about whether a given variation, or set of variations, should be approved by DH, then Trusts and PCTs should consult the SHA or DH CIB as appropriate.

22. The attached *Annex A* sets out the format and content of a variation case.

Funding variations

23. The Trust must consider and decide upon the most appropriate route for funding variations. Known post-contract variations should have their funding agreed prior to contract signature; Trusts otherwise should consider what would be a sensible contingency figure for small works (see paragraph 11 above), and for unexpected events. Whatever funding is decided upon should be included in the FBC/ABC so that the amount, application and funding can be considered in the round.

24. In considering funding, the lead will probably be taken from the existing funding mechanism for the scheme. A bond funded scheme may have already built in a variation bond facility, or it may be possible to subsequently agree one. For bank financed schemes, the banks may simply increase the debt level; in these cases, there may well be additional interest or other hedging products required. In any event, the impact on termination liabilities should be considered, with financial adviser input. Trusts with variations that require additional funding from the PFI company should contact the PFU to discuss.

25. Should a variation arise for which no previous funding has been earmarked, then the vfm of any proposed funding must be considered, and advice sought from the Trust’s/PCTs financial advisers.

Handling variations and variation issues at different stages of a project

26. DH advice is to take a conservative approach to accepting any variation. This approach should include even small works during construction as these can mount up to quite surprising totals. Again, this underlines the value of careful and thorough scoping beforehand. DH's concern here is particularly with the risk of poor vfm, and this can be mitigated by preparation before contract signature. For example, if Trusts follow the Design Development Protocol and Competitive Dialogue (CD) guidance, the design should be more fully developed and prepared prior to financial close such that the risk of small works during construction should be minimised. Equally it is important to manage the expectations of end users during the design process, so that again changes are minimised during construction. (See also para 29.)

27. Trusts should look at agreeing unit rates and even draft or outline schedules for likely variation work pre contract signature in order to ensure as much price predictability and stability as possible. See also section on *Initial Estimate Protocol* in the linked PFU Variations guidance.

28. Trusts should involve their advisers – technical, legal and financial – on large variations (that should certainly include those attracting DH approval) and adviser input may also be valuable or necessary on smaller variations, eg, those above the OJEU threshold, or others depending on type and the issues raised.

Pre contract signature

29. Strictly speaking, a change in scope at this stage is not a variation, but it does carry some of the same risks of poor vfm. Compliance with the CD process is expected to reduce changes in scope, especially once the preferred bidder has been appointed as ABC approval may lapse, or the CD itself may be overturned, if significant changes are proposed after that stage. Therefore, what should be focused on prior to contract signature is ensuring that appropriate measures are in place to deal with later variations.

30. There are four key elements to this. These are:

    i) handling any changes that are known to be necessary after contract signature, but which cannot be incorporated into the project earlier. These should have been signalled early on in the procurement process, that is, at OJEU stage, in order not to jeopardise the Dialogue. As far as possible, the work on these (eg, design, pricing) should be done before contract signature. They should be as much a part of the project planning as any other aspect of the scheme, and should also form part of the FBC/ABC. If this is done, then the most that might be necessary after contract signature is a supplement to the FBC/ABC to confirm the final arrangements;

ii) agreeing the processes for handling changes to the project. This goes wider than agreeing change requests since it must encompass the possibility of changes that range from very small to very large;

iii) agreeing where possible unit prices to assist with pricing any unexpected variations or small works. These should be set out in a schedule, and may include both physical items (eg, doors, shelves, a standard room) and lifecycle, soft FM and insurance implications; and

iv) identifying the means of funding both anticipated and unexpected variations. This is discussed in more detail in the next paragraph.

During construction

31. This can be a tempting period in that it can seem easy to make additions or changes while the main building is underway, but the risk of poor vfm is very high because of the time pressure and lack of competition. However, it does have the advantage that the risk of having to undo building, or change it, is less – thus making the variation potentially less costly. Another risk is that of the private sector provider viewing a variation as a delay event, and so delaying – at Trust risk – the whole project. And a further risk is that of breaching EU procurement regulations – this may be particularly acute during construction, but, as noted above, this should be a consideration whenever a variation is considered. A Trust must therefore give careful consideration of these risks to a variation that arises during construction, including an explanation of why it has arisen, eg, why the need was not foreseen during procurement.

32. Should an unexpected variation nevertheless arise during this period, eg, from an unforeseen change in law, the Trust should avoid the temptation to take any kind of a short cut in considering design, funding, vfm and legal issues – this would risk problems later on. The risks outlined in paragraph 24 should also be considered.

During operation

33. A project with a 30-year life span is bound to experience changes, some of which will result in a variation being requested. As advised in previous sections, Trust must focus on the issues of value for money, financial implications and legal consequences. The delegated limits outlined above must be applied, and the business case format in *Annex A*.

Conclusion

34. The most sensible approach that a Trust can take to variations is to ensure that as much preparation as possible is put into place for any that do arise. Trusts should also rigorously consider alternative means of procurement, and do all that is necessary to ensure good pricing and value for money.

Annex A

Format and content of variation business case.

A variation business case (VBC) is in effect a supplement to an FBC (or Confirming Business Case – CBC – under Competitive Dialogue) but is expected to be simpler. It should use the 5-case model, putting service and design issues into the Management Case section. It should also update key tables from the FBC or CBC as agreed with the DH CIB reviewer, eg, key funding and affordability tables.

The content of each of the five cases should then be:

Strategic – what the variation(s) are for, and why, and, in summary, what the key design, legal and financial implications are

Economic – this will vary depending on the variation. It should include an appraisal of (a) delivery options (eg, the ways in which a new service could be delivered, or a problem solved) and (b) of procurement routes. If the variation is a build that is integral to an already-approved new building, then only (a) may be possible, and the focus then should be on ascertaining vfm via benchmarking, unit rates and QS assurance

Financial – this should cover both affordability and funding, if the funding is affected. Affordability must be shown in the context of the whole Trust financial position, and the PFI review threshold should be rebased and checked. Funding should be carefully considered to ensure the best vfm of any changes made. For larger variations, the Trust should consider running a funding competition – advice from PFU should be sought

Commercial – the amount of detail here will depend on the procurement method. The procurement regulation position should be set out and, if a variation is above the EU procurement threshold but is not being procured independently, then the Trust must include legal advice confirming that what they propose to do is within the EU procurement directives. Any drafting relating to the variation should be included, and any impact on SF3 positions should be identified

Management – the detail of design or service changes should be outlined here. Benefits delivery should be covered, and the risk log updated with any risk management issues being discussed. How the project is being managed should be explained, and any impact from the variation should be set out.