ICT SERVICES AGREEMENT SCHEDULES

SCHEDULE 7.5

FINANCIAL MODEL

CONTENTS

Section A

Product Description

1. PRODUCT

ICT Services Agreement - schedule 7.5 (Financial Model)

2. PURPOSE OF PRODUCT

To detail the provisions applicable to the Financial Model and the associated provisions on open book accounting. In particular it will specify how the Financial Model will be held, how it can be changed and a description of the types of thing it should contain for change control purposes.

3. COMPOSITION

- Content and Construction of the Financial Model
- Visibility through the Financial Model
- Custody of the Financial Model
- Updates to the Financial Model
- Disputes

4. DERIVATION

- Authority requirements
- Bidders proposal

5. RELATED CLAUSES AND SCHEDULES

Clauses: 24 (Audits), 26 (Charge Control), 55 (Termination)

Schedules: 2.6 (Continuous Improvement)

7.1 (Charges and Invoicing)

7.3 (Value for Money Provisions)

7.4 (Financial Distress)

8.1 (Governance)

6. ALLOCATION

- Standard schedule for Authority to submit to bidders for agreement

- The excel spreadsheet making up the Financial Model will be agreed during the development/negotiation stage of the procurement. A hard copy of the final form of the Financial Model (or extracts from it) as at the Effective Date should be printed out and attached at the Appendix to this schedule. A "soft" copy should also be included within the Agreement so as to reflect the dynamic nature of the Financial Model. A sample financial model is provided as part of the Model ICT Services Agreement which is intended to be added to the Appendix to the schedule. It includes dummy figures which should be ignored. It is provided as an example only and detailed and detailed financial advice should be taken in relation to the content and structure of the financial model. Please also note that:

- As it is a high level model it does not include cost input sheets (e.g. for development). A populated model would also need to be supported by a data book.

- It may need further sheet (e.g. termination).

- Further detail may be needed in relation to transparency (e.g. risk and contingency).

7. QUALITY/REVIEW

Authority expertise: procurement/commercial, financial, legal.

Section B

Guidance

1. INTRODUCTION

The purpose of the schedule is to detail the Financial Model that has been developed by the Contractor prior to the Agreement being awarded. The Financial Model should demonstrate the budgeted items of initial set-up and ongoing delivery costs and assumed profitability. It is crucial that any Financial Model is properly scrutinised on behalf of the Authority by a qualified financial expert.

The Financial Model will be used to calculate compensation for the Contractor where the Authority voluntarily terminates or the Contractor terminates for breach by the Authority; to support gain sharing and to assist in the estimation of the proper cost of change control.

Guidance Note 1 (Key Commercial Principles), section 1 - 11 (Financial Distress) and Guidance Note 2 (Payment, Affordability and Asset Ownership) should be consulted when considering this schedule.

2. FINANCIAL MODEL CONTENT

The Financial Model shall contain information identifying inputs against recognisable outputs (ie the cost against the service obtained), a contingency risk matrix identifying all contingencies and risks relevant to the provision of the Services and an assumptions book detailing all assumptions made or relied upon in developing, updating and amending the Financial Model.

3. UPDATES TO FINANCIAL MODEL

The schedule shall state the methodology and procedure for updating the Financial Model.

4. CONTEXT

The level of complexity of the financial model will depend on the complexity of the services. Less complex projects may not require as complex a structure for the financial model as described here.

The Contractor should provide a full priced bid for the service as set out in Authority bid documentation (including the draft contract and payment mechanism). The Contractor should also include full prices for any variant bids and mandatory options as appropriate.

The price stated in respect of the service and any variant bids should be the output of a full comprehensive financial model of the bid. The financial model should be provided in fully functional electronic form with the Contractor's response to the Authority's bid documents.

5. BASELINE AUTHORITY POSITION

The Authority should ensure that the Contractor develops a financial model that is fit for purpose. Evidence of such fitness for purpose within the model would include the following features:

- Inputs, calculations and outputs are clearly segregated and where possible are stated on separate worksheets;
- There are no circularities or circular references;
- Inputs, calculations, formulas or outputs are not hidden, protected or obscured;
- Any macros used are transparent.

The model should be accompanied by a data book setting out, in full, all of the source inputs and assumptions provided by the Contractor. Inputs should be stated at an appropriate level of detail in a logical and accessible fashion to permit independent verification. The data book information should be capable of easy reconciliation to the model inputs and the data book may provide a greater degree of analysis of inputs than might be visible in the model. The Contractor may also wish to consider the data book as a medium for the recording of model operating instructions, user guides and any relevant supplementary information that is included.

The overall flow of data in financial models should be from inputs, to calculations, to outputs. The contractor should ensure that model worksheets are laid out in a clear and logical manner. With respect to the calculations sheet, the Contractor should follow the general rule that any particular row should only contain a single formula. Formulas should not contain a mixture of inputs and calculations. Ideally, column labelling should be consistent between model worksheets.

The key outputs from the model should be the project cash flow (that shows the timing and relationship between the planned costs and the revenue the Contractor expects to receive) and a profit and loss statement for each year of the project. Where more than one service line is being delivered under the contract, these outputs should be analysed, where possible, on a service line basis.

The model should calculate the revenues from the Authority by the operation of the payment mechanism based upon the assumptions set out in the data book and the set of prices quoted by the Contractor. These calculations should show the application of every price in the payment mechanism to its relevant Milestone Date, in the case of Milestone Payments, or unit of usage, availability, capacity or other payment unit in the case of the Service Charge. These calculations should also model the operation of the service credit regime showing the impact of the regime for an assumed level of service performance.

The model should be capable of undertaking sensitivity analysis to allow the Authority to understand the impact of upside and downside scenarios on the payments to be made and the Contractor’s return. Such sensitivities should include (but should not be limited to) the impact of:

- Changes in volumes or other cost drivers;
- Project delay;
- Cost increases;
- Service credit deductions;
- Changes in the balance of amounts between Milestone Payments and Service Charges;
- Use of Phase Payments (if applicable).

All Contractor cost assumptions may be stated in the financial model at the major category level, provided that the level of detail in the supporting data book is sufficient to enable verification of individual cost assumptions. Cost category totals stated in the data book should appear as identifiable model inputs. The model should include details of (but should not be limited to) the following cost categories:

- Staff costs;
- Hardware and software costs;
- Application support or maintenance;
- Live operations costs;

- Planned technology refresh or upgrade;
- Third party and novated contract costs.

The Authority should also ensure that the Contractor states and has clearly shown in the model:

- Any assumed overhead costs;
- Any assumed contingency costs;
- Any assumed risks (e.g. performance of a third party) expressed in cost terms or included in the Contractor's return;
- The Contractor's return.

6. THE CONTRACTOR'S RETURN

Guidance Note 2 (Payment, Affordability and asset Ownership) explains that a key principle of the payment mechanism and the use of Milestone Payments and a Service Charge is to transfer a sufficient level of performance risk to the Contractor and ensure that the Contractor is incentivised to provide a good quality service during the operational stage by having part of the Contractor's return at risk during that stage. In order to ensure this principle is adopted in the Contract, the Authority needs to understand the structure of the Contractor's pricing as demonstrated in the financial model. The Authority will also need to carry out "downside" sensitivity testing to understand the impact of delays and/or the performance regime on the Contractor's return.

Through a review and analysis of the financial model the Authority needs to ensure that:

- The Milestone Payments are covering no more than the Contractor's initial up front design, development and equipment investment costs ;
- The Contractor's overall project return is achieved through Milestone Payments made after ATP by the Authority and/or through the Service Charges; [1]
- The Service Charge will also cover the Contractor's operating costs.

[1] It is expected that in most projects the Contractor's return will be achieved through Milestone Payments between ATP and CPP and the Service Charges.

In order to ensure that the Contractor's pricing structure follows these principles, the Authority should carefully review the declared cost structure proposed by the Contractor to ensure that costs are reasonable given the proposed solution and do not contain any hidden elements of profit. Where appropriate, the Authority should benchmark the Contractor's declared costs (for example through a benchmarking organisation or through a benchmark club with other public sector bodies), to gain this level of assurance.

The Contractor's return will be measured by either:

- Forecast profit mark up which is profit calculated as a percentage of cost
- Forecast profit margin which is profit calculated as a percentage of price.

Typically for a development the Contractor will set its prices and expected revenue through the financial model as follows:

(A) Forecast Direct Costs (development manpower, bought in equipment, subcontract costs)

+

(B) Forecast Overhead (usually a standard corporate % rate, the amount calculated by applying the rate to A)

+

(C)) Actual Contingency capped at the level of the Forecast Contingency (usually a "bid" % rate, the amount calculated by applying the rate to A+B). Inclusion of Contingency is dependent on the type of project, the certainty of the Authority requirement etc

+

(D) Return or Profit (usually a "bid" % rate, the amount calculated by applying rate to A+B+C to set a Profit mark up, or by setting the overall price to achieve an amount above A+B+C that, when divided by the overall price, would provide a percentage equivalent to the Contractor's requisite Profit margin).

Prices for the operating period will be set as above but should exclude (C).

The Authority should seek to ensure that Direct Costs (A) are, as far as possible, direct input costs and do not include any margin or mark up. Staff costs should not be Contractor full scale rates (as used on a time and materials assignment) but should relate to the direct cost of employment.

Subcontract costs within (A) are likely to include margin, but generally sub-contractor applied overheads and return should not exceed that set by the prime Contractor. But services provided by associated companies, affiliates or related parties to the prime Contractor, should not include any mark up or margin and the Authority should take steps to ensure that the prime Contractor is not including such “internal” company or group mark-ups, margins or overheads in (A).

Under (A), the Authority should seek to obtain full visibility and understanding of bought in costs so as to avoid double counting or payment of margin or mark-up. Where possible, the Authority should seek from the prime Contractor an undertaking that bought in goods and services from unrelated third parties are provided to the Authority at the same cost as provided to the prime Contractor itself (that is, the unrelated third party costs are passed through to the Authority without additional mark-up or margin being applied by the prime Contractor), or at a lower rate of mark up or margin than the corporate rate applied at (B) and (D).

The Authority should also ensure that notional amounts for taxation or corporate internal financing should not be included in the cost and pricing structure set out above as these should be treated by the Contractor at corporate or group level not at project level.

Understandably, Contractors will seek to ensure that investment costs are recovered as quickly as possible through Milestone Payments from the Authority, and that the project will begin to “pay back” as soon as possible in cash-flow terms. Nevertheless, the Authority should ensure that the Contractor is pricing to achieve a return over the whole life of the project (that is, the Contract duration) rather than loading its profit into the early part of the contract.

[***Guidance: The Authority should ensure that it understands any investment analysis the Contractor will have made in bidding for the Contract (that is the cash flow analysis the Contractor will have undertaken of investment costs versus the revenue it will receive through the Milestone Payments).[2] The Contractor will probably undertake a cash flow***

[2] The Contractor will probably undertake a cash flow analysis to determine the Net Present Value (NPV) of the investment costs and their recovery through payments made by the Authority. The Contractor will bid in proposed revenues from Authority payments so as to achieve an Internal Rate of Return (IRR) on the investment. IRR is defined mathematically as the discount rate which, when applied to the net cash flow over the investment period (cash outflows and then cash inflows) results in a net present value of zero.
IRR calculations are highly sensitive to the timing of cash flows and the IRR calculation is best applied where a project produces a negative cash outflow in the beginning followed by positive cash inflows in later years. Cash

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A mid life technology refresh or upgrade that was not planned (and hence priced) at the outset of the Contract should be handled through the Change Control Procedure. The Authority should pay for the refresh or upgrade through Milestone Payments agreed at the time of the Change although some adjustment to the Service Charges may also be required if the refresh or upgrade results in a change to the on-going service. The Contractor's return relating to the refresh or upgrade will be recovered through the Service Charge, and a CPP relating to the point at which it has been demonstrated that the refresh or upgrade has been successfully implemented. All Milestone Payments relating to the refresh or upgrade will remain recoverable until the relevant CPP.

7. THE BASE CASE

The Base Case is the financial model and set of financial parameters that underpin the Contractor’s price when the Contract is signed. For instance, the Base Case should include the Contractor’s applied corporate overhead and forecast return for the project. In the event of a Change, the financial model that underpins the Contractor’s price after the Change should contain the same financial parameters in the Base Case unless the risk profile of the project has radically changed. That is, if the Contractor is bearing more risk after the Change, its

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forecast return may, by agreement with the Authority, be allowed to increase. If the Contractor is bearing less risk after the Change, its forecast return may be lower.

In the event of termination, reference should be made to the Base Case to determine forecast costs and Contractor return.

8. OBJECTIVE OF THE FINANCIAL MODEL

The objective of the financial model is to provide the Authority and its advisers with full transparency as to the manner in which any bid prices have been derived and should have the required level of functionality and information to support bid prices. The financial model should ultimately form a schedule to the project agreement. Consequently the Authority should seek to review all aspects of the model assumptions, data inputs, calculations and outputs and should expect the Contractor to provide reasonable assistance in this regard.

The model should support the Contractor's pricing and allow the Authority to understand the Contractor's pricing. Broadly speaking, the Authority should be seeking to ensure that the financial analysis supporting that Contractor's prices is complete, robust, accurate and valid and properly reflects the Authority's requirement and the Contractor's proposed solution.

Section C

Proforma/example schedule

9. INTRODUCTION

9.1 This schedule details the requirements for the Financial Model that is to be supplied by the Contractor to enable the Authority to identify how the Contractor calculates the Charges. The Charges shall be calculated in accordance with the provisions stated in Schedule 7.1 (Charging and Invoicing) and shall be calculated such that all payments made prior to ATP will be exclusive of profit.

9.2 The Contractor and the Authority will both retain copies of the Financial Model in hard and soft copy and the Contractor shall provide the Authority with updates to the Financial Model in accordance with the provisions of this schedule.

9.3 The Financial Model shall be used together with the rates set out in schedule 7.1 (Charges and Invoicing) as a basis for considering any changes to the Charges under schedule 8.2 (Change Control Procedure) and for such other purposes as are specifically indicated in this Agreement.

10. CONTENT AND CONSTRUCTION OF THE FINANCIAL MODEL

10.1 The Financial Model shall:

10.1.1 provide sufficient detail for the Authority to have visibility of all the costs to be incurred by the Contractor and of the Charges to be paid in respect of the provision of the Services;

[Guidance: The Authority should consider whether it requires additional protection around the accuracy of the Financial Model e.g. inclusion of warranties as to its correctness and completeness. Consideration should also be given as to whether to include controls on borrowing against the revenue stream from the Agreement.]

10.1.2 be constructed:

10.1.2.1 in relation to Milestone Payments on a [monthly/quarterly] basis;

10.1.2.2 in relation to Service Charges on an annual basis;

10.1.3 quote all monetary values in pounds Sterling;

10.1.4 quote all costs as exclusive of any VAT;

10.1.5 provide visibility of the input costs for providing the Services throughout the Term, excluding mark-up, which shall include without limitation at least the following:

10.1.5.1 Labour broken down by each job title (e.g. project manager), with the number of days and daily rate shown for each job title. Labour shall also be broken down and sub-totalled by the major phases of the project;

10.1.5.2 Hardware and software costs;

10.1.5.3 Depreciation policy applicable to Assets (including software and hardware);

10.1.5.4 Licence costs;

10.1.5.5 Sub-contractor costs;

10.1.5.6 Accommodation costs (if applicable);

10.1.5.7 Overheads / mark-ups separately identified and their calculation explained;

10.1.5.8 Pricing of risk fully explained and the quantification supported by a risk matrix;

10.1.5.9 Financing costs (if applicable) showing the interest rate and calculation and the need to apply financing explained; and

10.1.5.10 Other miscellaneous costs.

10.1.6 provide a reasonably skilled and experienced individual with a full analysis of the Contractor's capital and operating costs and the assumptions used to develop and modify the Charges set out in schedule 7.1 (Charges and Invoicing);

10.1.7 quote all costs, prices and revenues based on current prices;

10.1.8 describe any indexation assumptions relating to input costs;

10.1.9 be constructed in a format and using a software tool as specified by the Authority;

10.1.10 not have any parts which are hidden, protected, locked or made otherwise inaccessible or obscured to review or alteration;

10.1.11 be laid out in a clear and logical manner. The overall flow of information in the Financial Model shall flow from inputs, to calculations, to outputs, with the final output being in tables. Any formulae in the Financial Model shall not contain a mixture of inputs and calculations. Any column labelling in the Financial Model shall be consistent between worksheets;

10.1.12 shall include a cash flow statement that shows the timing and relationship between the planned costs and the revenue which the Contractor expects to receive;

10.1.13 clearly show the calculation of any financing charges associated with outstanding balances (between costs incurred and revenue received); and

10.1.14 provide visibility of profit (and the calculation of profit) both as a value and as a percentage and show the Project Internal Rate of Return.

10.2 The Contractor shall, if requested by the Authority, provide (or procure the provision of) the above level of information in relation to the costs and expenses to be incurred by any of its Sub-contractors or third party suppliers.

11. VISIBILITY THROUGH THE FINANCIAL MODEL

11.1 Upon request of the Authority the Contractor shall promptly provide to the Authority details of the elements used to make up any Charges.

11.2 The Contractor shall provide to the Authority the following information in relation to the Charges:

11.2.1 The Contractor's total fixed price for the Services and/or Deliverables;

11.2.2 The margin included in that total fixed price;

11.2.3 A list of the agreed prices against each manpower grade in the Financial Model;

11.2.4 A list of the costs underpinning those prices for each manpower grade in the Financial Model, being the price less the margin;

11.2.5 A summary of the costs broken down against each Service and/or Deliverable;

11.2.6 Details of any other manpower costs, not already included in these rates, for all activities to be undertaken;

11.2.7 Explanation of any underlying assumptions regarding:

11.2.7.1overtime rates;

11.2.7.2standard hours;

11.2.7.3accommodation charges; and

11.2.7.4discounts applied;

11.2.8 A resource estimating model to support the Charges/Changes if applicable;

11.2.9 A breakdown of manpower resources by the number and type of Contractor's staff (including any Sub-contractors) required for each Deliverable and/or Service and free of any contingency. This should also apply to third party costs;

11.2.10 [The total price of Deliverables broken down by volume, unit cost and margin;]

11.2.11 Any additional activities, costs and, risks that may impact the Authority and which are not already covered by the Charges;

11.2.12 An explanation of the type and value of risk associated with the provision of Services, including the amount of money attributable to each risk;

11.2.13 An explanation and supporting details of any financing costs applicable to the Agreement;

11.2.14 A statement of the Contractor's anticipated cashflow for the Term;

11.2.15 The actual Charges profile for each Service Period; and

11.2.16 Any additional information as the Authority reasonably requires.

12. CUSTODY OF THE FINANCIAL MODEL

Immediately after execution of this Agreement and following agreement by both parties of the changes to the Financial Model under paragraph 13 of this schedule, the Contractor shall deliver two (2) soft copies and two (2) hard copies of the Financial Model to the Authority.

13. UPDATES TO THE FINANCIAL MODEL

13.1 Unless otherwise agreed in writing between the parties, any updates to the Financial Model shall reflect, be consistent with and be made only in accordance with the provisions of this Agreement, and shall in all cases be subject to the prior written approval of the Authority (such approval not to be unreasonably withheld or delayed).

13.2 All changes to the Financial Model should be auditable and implemented and documented under formal version control.

13.3 The Contractor shall, inter-alia, revise the Financial Model in order to reflect any inputs, modifications or other amendments to the Financial Model which are effected pursuant to the Agreement, including but not limited to any amendments made to the Financial Model which arise from:

13.3.1 the implementation of a Change which affects the Charges; and

13.3.2 any changes to the Contractor's accounting practices.

13.4 Each Financial Model shall be constructed using the same methodology as that used for the then current Financial Model, and shall be consistent with and made in accordance with the provisions of this Agreement.

13.5 The Contractor shall adhere to and apply the following principles when preparing an updated Financial Model:

13.5.1 any amendment which is made in order to evaluate the impact of any inputs, modification or other adjustment shall relate only to such inputs, modification or other adjustment; and

13.5.2 no amendment shall affect, in any way whatsoever, the performance of the Services, save as agreed in accordance with the Change Control Procedure.

13.6 On the occurrence of any event which requires the Financial Model to be updated, the Contractor shall effect the change on the latest version of the Financial Model and deliver the updated Financial Model, to the Authority for approval. The Contractor shall ensure that each version of the Financial Model delivered to the Authority shall be certified by a director of the Contractor as being accurate and not misleading and in conformity with all generally accepted accounting principles within the United Kingdom.

13.7 Unless the Authority wishes to dispute the Financial Model in accordance with paragraph 14, the Authority shall approve the updated Financial Model within30 days of receipt of the same (or such other period as the Authority advises the Contractor in writing).

13.8 If the Authority approves the updated Financial Model submitted by the Contractor, it shall advise the Contractor of its decision in writing and the updated and approved Financial Model shall become, with effect from the date of such approval, the updated Financial Model in place for the purposes of the Agreement.

14. DISPUTE

14.1 If the Authority disputes any Financial Model, it may request such further information from the Contractor as it requires prior to delivering a decision on whether it accepts or rejects the relevant Financial Model.

14.2 In the event that the Authority and the Contractor are unable to reach agreement on any Financial Model, the matter shall be referred for determination in accordance with the Expedited Dispute Timetable.

15. CERTIFICATION OF COSTS

15.1 The Contractor shall, on each anniversary of the Effective Date, and also at the request of the Authority, - such additional requests not to exceed [five] occasions over the Term - provide to the Authority, a certificate of any of the costs incurred under paragraph [4] within 15 Working Days of such request. The Certificate should be signed by a Company Director. ***[Guidance: In situations where the Authority requires higher levels of certification, (where for example, the cost base is complex and/or Gainshare is expected to be a significant issue) it may be appropriate to require that the certificate is approved by the company's auditors, though this is likely to incur an additional cost.]***

15.2 Following receipt of the certificate of costs, the Contractor shall provide to the Authority any reasonable additional information to enable the Authority to verify the accuracy of the certificate of costs.

15.3 The Contractor shall meet with the Authority at monthly intervals during the Term to monitor the key elements of the Financial Model and the Contractor shall highlight directly to the Authority any variances from the Financial Model.

APPENDIX

Output from the Financial Model

[Guidance: A printed version of the Financial Model to be inserted here. See sample Financial Model Template which is included as part of the documents which make up this Model ICT Services Agreement.]