House of Commons

Committee of Public Accounts

PFI Construction Performance

Thirty-fifth Report of Session 2002–03

HC 567

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Report, together with formal minutes and written evidence

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The Committee of Public Accounts

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Summary

The Private Finance Initiative (PFI) is being used to procure many projects involving the construction of assets which are needed to deliver public services. Central government projects include hospitals, roads, prisons and government buildings. The Office of Government Commerce (OGC) has central responsibility for promoting good practice in public sector construction projects. Until 1 April 2003 it also had responsibility for the development of PFI policy. That responsibility now rests with the Treasury.

On the basis of a Report by the Comptroller and Auditor General[1] the Committee took evidence from the OGC and the Construction Industry Council (CIC) on the extent to which the PFI was delivering greater certainty to departments, the relationship between the returns the private sector earn from PFI construction projects and the risks they actually bear, the extent to which there are alternatives to using the PFI, and whether departments are maintaining value for money where they require additional work during the contract period.

Our key conclusions are:

- The PFI is delivering greater certainty on the timing and on the cost to departments of their construction projects. Greater certainty in the delivery of a built asset is an important benefit likely to arise from use of the PFI approach that needs to be assessed in each case alongside all the other benefits, costs and risks of PFI to determine overall value for money.

- There is a lack of transparency as to whether the total returns which construction companies derive from PFI projects are reasonable in relation to the risks the companies are actually bearing. Construction companies seek greater returns from PFI projects compared to conventional procurement because they say they are bearing greater risks. There is, however, very little information available to show all the returns which construction companies will earn from PFI projects (including both fees for construction services and dividends on funds invested in the project company). And it is unclear whether the pricing of PFI deals reflect the steps that construction companies can take to reduce their risks through the checking process known as due diligence and by insuring risks.

- The PFI as a form of procurement should not be used without proper consideration of other options. The PFI is but one of three recommended procurement methods which aim to improve value for money through transferring risk to those best able to manage it and by improving the integration between parties involved in the construction process. The other recommended methods are Design and Build, and Prime Contracting. The PFI should only be used where it is the best of these options and not solely because capital budget constraints make it a convenient form of procurement.

1 C&AG's Report, *PFI: Construction Performance* (HC 371, Session 2002–03)

- Departments need to pay very close attention to maintaining value for money throughout the PFI contract period. The NAO census identified that one in five public authorities had already asked for additions or changes to facilities within a few years of letting a PFI contract. Yet in less than half of these cases had the authority attempted to benchmark the resulting price change. A PFI consortium is in a strong position once a contract has been let because it is the contractual supplier for 30 years or more. It is essential that departments take steps to rigorously test any prices for additional work and to impose credible conditions that will allow them to have additional work carried out by alternative suppliers of their choice if there are doubts about value for money.

1 Greater certainty from the PFI

1. The National Audit Office (NAO) carried out a census of all 38 central government PFI projects where the construction phase was due to have been completed by Summer 2002. The results showed that departments were experiencing greater certainty in project delivery under the PFI. The proportions of projects which were not delivered on time, or which cost the public sector more than had been expected at contract letting, were much smaller under the PFI than under previous government building procurement (**Figure 1**).[2]

2. The OGC considered that the more timely delivery of PFI projects reflected a genuine improvement in building times from the PFI's more disciplined approach and was not due to soft timetables being negotiated. The OGC placed emphasis on the benefits which departments would derive from the greater certainty over when an asset will be available and that the asset will be kept in good order for the whole of its life. Where departments had experienced price increases this had mainly related to additional work which had not been part of the original specification.[3]

Figure 1: Improved project delivery under the PFI

	PFI experience (2002 NAO census)	Previous experience (1999 Government survey)
Price exceeds that agreed at contract	22%	73%
Built asset delivered late to public sector	24%	70%
Over 2 months late	8%	

Sources: PFI experience: NAO census of central government & building projects due to be completed summer 2002. Previous experience based on a government building survey 1999

3. It is encouraging that greater certainty for the public sector is being achieved under the PFI. This certainty may carry a price, however, particularly as the private sector will be charging for the risk of maintaining the built asset throughout the PFI contract period. The CIC told us that the PFI gives the private sector greater incentive to focus from the outset on the whole life costs of the contract. The construction industry had found that PFI produced cost improvements of 5 to 10%, both on construction and subsequent operations or facilities management. The PFI contract is also supposed to give the private sector less scope to escalate the price after contract award. More evidence is needed, however, to show whether these cost reductions have fed through into lower prices compared with conventional procurement. And the CIC's calculations of cost reductions were before any changes to staff costs that may arise if steps are taken to address the two tier workforce

2 C&AG's Report, Figure 1, p3 and paras 5, 2.3–2.5, 2.17–2.25

3 Qq 1, 11–12, 20, 39–42, 57–63, 92–93, 165–168

issue, where the pay and conditions of former public sector staff transferring to a private sector contractor are different than those of other employees of he contractor.[4]

4. As well as the consideration of project delivery and price, it is important that there is a full evaluation of the wider benefits from PFI projects compared with other forms of procurement. It was disappointing that formal user surveys had only been undertaken in four of the 37 PFI projects surveyed by the NAO. For example, in hospitals the views of doctors, nurses and patients are essential to building up a picture of how well the built asset is serving its intended purpose. The OGC said it would be giving greater prominence to the need for user surveys. It also expected that the design quality indicators developed by the Commission for Architecture and the Built Environment (CABE) would help in assessing public buildings.[5]

5. Because a PFI consortium is not paid until the built asset is operational, contractors might tend to use working methods which deliver the asset quickly without necessarily encouraging new ideas in design and construction. The CIC said that the PFI process should encourage innovation because contractors should be considering methods which minimise the costs of maintaining the built asset over the life of a PFI contract. There was a need to improve on the extent of innovation in PFI projects, however, though there were sometimes constraints in practice. In particular, funders tended to prefer tried and tested solutions as the risks could be more easily predicted.[6]

4 Qq 11–12, 22–24, 43–48, 92–94, 106–107, 115–117, 135–136, 146–151, 186; Ev 18–19; Qq 146–151

5 C&AG's Report, para 2.29; Qq 4–6, 170–178

6 C&AG's Report, para 1.20; Qq 13, 18–19, 22–24, 112–114, 133–134

2 Relationship between the returns which contractors earn and the risks they actually bear

6. We have sought on a number of occasions to gain an understanding of the relationship between the returns which contractors earn from PFI projects and the risks they actually bear. At present the available information is limited and rather mixed. A study of contractors' returns initiated by the OGC, which it told us about over a year ago,[7] had yet to reach any conclusions. There has been some publicity about individual cases in which heavy losses have fallen on construction companies in PFI deals, and to that extent risk transfer has worked. Yet there have also been indications that construction companies can hope to earn substantially more from PFI projects than from conventional building work (**Figure 2**).[8]

7. More thought needs to be given to the most appropriate measures for monitoring the returns of private sector participants in PFI projects. In many PFI projects construction companies are both investors in the project company set up to manage the PFI contract and suppliers of construction services to the project company. The limited information we have been given previously has either been the contractors' returns on turnover for providing construction service to PFI projects or the separate rate of return equity shareholders are expected, at contract letting, to receive on their investment (a rate which is often understated as it does not include the benefits of subsequent refinancings). We have not seen information to show the total expected return which construction companies will make from PFI projects taking account of both their remuneration for construction services and their investment in the project company (including the benefit of any refinancing).[9]

Figure 2: Information on PFI returns previously given to the PAC

In 2000 Carillion plc said that it expected higher construction profits on PFI work and had been achieving a profit margin of 2.7% against turnover.

In 2001 the Kier Group said it had made returns of 2.5% of turnover compared with 1% on other contracts.

In 2001 the OGC said the normal rate of return (post tax in real terms) on investments in PFI projects was in the range of 8 to 15%.

After refinancing, the expected rate of return to shareholders in the Fazakerley PFI prison project was 39% compared with 13% at contract letting.

Sources: The Committee's reports on the Refinancing of the Fazakerley PFI Prison (HC 372, Session 2000–01) and Managing the relationship to secure a successful partnership in PFI projects (HC 460, Session 2001–02)

7 42nd Report from the Committee of Public Accounts, *Managing the relationship to secure a successful partnership in PFI Projects* (HC 460, Session 2001–02), Ev 16 (Q 178)

8 C&AG's Report, paras 5, 2.16; Qq 88–91, 135–136, 184–185; Ev 22

9 C&AG's Report, paras 2.14–2.16; Qq 7–12, 64–70, 152–158, 184–185, 198; Ev 23–29

8. With more transparency on the returns which construction companies earn from PFI projects it would be possible to consider further the reasonableness of those returns compared with the risks which the companies are actually bearing. Construction companies may be earning over twice the rate of profit for construction services compared with what they earn from conventional projects, before taking account of the additional dividends or capital appreciation they will receive on any investment they have in a PFI project. The construction industry attributes the need for better profits as a reward for bearing the greater construction risks which are transferred to it in PFI contracts. It also considers the previous problems on building work were related to poor profitability, which had led to a lack of investment in people, research and development. Projects had been delayed and had not been value for money. The low level of profitability had also encouraged adversarial relationships between departments and contractors, litigation and arguments over money due for contract variations. The CIC said the better rewards from PFI projects would enable the construction companies' investment programme to be improved and the public sector would get better value for money. The CIC would not speculate on the extent to which the scope for additional work during a thirty year contract would provide construction companies with additional profits. But it expected the prices offered to the public sector to come down as more PFI projects were repeated.[10]

9. Construction companies are able to manage their risk exposure through due diligence and insurance. Due diligence is the process which the construction companies and their funders carry out to clarify the nature and extent of risks in the project. After due diligence some of the risks can then be insured against, which helps the private sector to price the project with greater precision. The OGC told us that the timing of due diligence is up to the private sector project company but is supposed to be completed before best and final offers are submitted by competing bidders, as an offer from this point is potentially binding. In practice, however, a significant amount of due diligence is completed after the preferred bidder is selected, because funders will not want to commit large resources to due diligence unless they have the certainty that their client will be awarded the contract for the project. Insurance of risks, where this is possible, will also often take place in the closing stages of the negotiations. It is not clear what effect due diligence and insurance has on the expected costs of the project and whether any benefits that it may create are passed back to the public sector in the final pricing of a PFI contract. The CIC considers that due diligence and insurance provide PFI project companies and their funders with greater certainty over costs but do not necessarily reduce costs. In theory insurance could be sought for risks in conventional procurement, but the OGC doubted whether in practice external parties could be found to offer insurance at economic rates.[11]

10 C&AG's Report, para 2.15; Qq 7–12, 49–56, 64–70, 95–104, 108–111, 141–142, 193

11 Qq 98–105, 159–162, 187–198; Ev 23–29

3 Alternatives to PFI

10. PFI is giving the public sector greater certainty in the timing of the delivery of its building projects and the price to be paid. But some of these benefits could possibly have been achieved with other forms of well managed procurement. There will be advantages and disadvantages from using alternative forms of procurement, so departments should always consider which form of procurement will be best for a particular project. For example, PFI may give greater certainty in project delivery and defined service standards but it also involves departments in being locked into long term contracts. There is a risk that procurement choices will become distorted towards using the PFI simply because departments do not incur a capital outlay when using the PFI.[12]

11. The OGC has three recommended forms of procurement which are expected to produce better benefits than traditional building procurement: PFI, Design and Build and Prime Contracting (**Figure 3**). The OGC considered that comparable benefits to those which have arisen in PFI building projects might have been possible from Design and Build and Prime Contracting, procurement routes where the public sector retains ownership of the asset. NHS Estates, Defence Estates and the Highways Agency have made use of these forms of procurement. It is for departments to decide which procurement route will offer the best value for money on a particular project.[13]

12. The CIC told us that Design and Build was widely used in the private sector and that projects such as supermarkets were often developed to a standard model to facilitate fast construction. The OGC told us that where innovation was desirable PFI was more likely to produce better long term solutions. This was because the structure of the PFI contract created incentives for the private sector companies to look at effective ways of minimising costs over an extended period. It is important, however, that minimising costs does not compromise health and safety. The OGC and CIC were not aware of any data on health and safety under the PFI compared with other forms of procurement. The CIC thought PFI should produce a better result on health and safety because of the extensive risk analysis that is done on PFI projects. Employee issues, such as the use of sub-contractors and the two tier workforce, also need to be considered when considering the merits of alternative methods of procurement.[14]

12 C&AG's Report, para 2.38; Q 20

13 C&AG's Report, para 2.35; Qq 14–17, 20–21, 71–80, 169; Ev 19

14 Qq 22–38, 81–82, 163–164

Figure 3: The OGC's recommended forms of building procurement

PFI: usually a consortium will be responsible for providing an integrated approach to the design and construction and also the ongoing maintenance and facilities services over a contract period of 25 or 30 years.
Design and build: a single supplier is responsible for both the design and construction of the asset.
Prime Contracting: a single supplier coordinates and manages all activities through the design and construction period to ensure the asset is fit for purpose and meets predicted whole life costs.

Source: C&AG's Report, para 2.35

13. The OGC agreed that competition between its three recommended procurement options would be a good thing. We suggested that if a similar batch of projects were taken forwards under each procurement method then the outcomes could be compared. The OGC considered, however, that each procurement method was more likely to fit particular types of projects. PFI was likely to be applicable where there was a strong service element in the requirements. Prime Contracting often suited smaller projects.[15]

15 Qq 179–183

4 Maintaining value for money throughout the contract period

14. PFI contracts for built assets are typically for a minimum of 25 or 30 years. The benefit of having a prison or hospital delivered on time and to the cost expected by the public sector will count for little if PFI contractors exploit their contractual position by overcharging for additional services that departments may require during the contract period. In 22% of the central government building projects examined by the NAO the price to the department had increased. These price increases mainly related to further work which had not been part of the original specification, on additional or improved facilities or changes to the function of a building. Since around one in five of the projects examined had already been expanded within a few years of contract letting, additional works are likely to be a significant feature of PFI contracts in the long term. But as the department is tied to its PFI contractor for a long period this further work gives PFI contractors the potential to earn a lot of additional money.[16]

15. If additional work is given to an incumbent supplier there is a risk that value for money will not be as good as that achieved through competition. The OGC acknowledged that in private sector construction there is a lower rate of post-contract changes because standard building models are often used and specifications are less likely to be changed after contract letting. Departments were contractually obliged to ask the PFI project company to undertake additional works after contract letting, they were expected to obtain the right to ask the PFI project company to conduct a competitive tender to determine which construction sub-contractor should undertake the work. The PFI project company therefore had control over the running of the competition, although a department could debate with the company which companies should be invited to bid for the work. Under conventional procurement, on the other hand, departments would be free to run their own competition for any additional works. A department might be able to negotiate a better price where it had direct control over the competition than in a competition run by a PFI project company.[17]

16. Where additional work is given to a PFI project company it is essential that a department satisfies itself that the pricing of the additional work is value for money. Yet in only three of the eight projects examined by the NAO where there had been a construction related price increase had the departments benchmarked the price increase. The OGC's July 2002 guidance had strengthened the requirement for departments to benchmark the price of any additional works. If a department was not satisfied with the proposed price for additional work it could require the PFI project company to re-tender the work or have the price determined by an independent third party. Departments would be able to obtain benchmarking data from third parties or from the departments' records of previous transactions.[18]

16 C&AG's Report, paras 5–6 and Figure 1, p3; Qq 53, 126–128, 137

17 Qq 83–87, 118–120, 163–164; Ev 19–20

18 C&AG's Report, para 2.8; Qq 2–3, 125, 138–140; Ev 20–21

17. Another risk with a long term PFI contract is that, rather than needing additional work, a department may find it no longer needs the built asset at all. The OGC accepted that in this situation it would be more costly for a department to extricate itself from a PFI contract than if the asset had been procured conventionally. A further risk from the long term nature of a PFI contract is that the PFI project company may develop an overriding advantage which may deter other companies from bidding when the contract comes to an end. The National Lottery has illustrated the strong position which an incumbent supplier can establish. Alternatively, a company might seek to purchase an interest in all the PFI contracts in a particular sector in order to become a monopoly supplier to the sector. The OGC acknowledged these points but said that at the end of a PFI contract the built asset would come back into public ownership, giving a department the choice of managing the asset itself or recompeting the service. A department would have similar rights if the PFI project company became bankrupt. Departments also generally had the right to restrict the transfer of shares in a PFI project company to any party the department deemed unsuitable. The OGC said that aspects of the PFI service such as catering and cleaning would be re-competed every five or seven years. Such break clauses might help to avoid incumbent PFI contractors building up an overriding advantage.[19]

19 Qq 118–132, 143–145; Ev 21–22

Conclusions and recommendations

1. It is good practice in all major projects, certainly including PFI projects, to institute explicit management of the expected benefits of the project. Departments should therefore be clear how benefits will be measured and monitored on each of their PFI projects. User surveys can play an important role in benefits management. It is a weakness in the evaluation process that, to date, user surveys have been rarely carried out.

2. Departments need to understand the economics of PFI bids. They need to satisfy themselves the returns to the private sector are proportionate to the risks borne by the private sector in the project. As a high priority, the Treasury should complete the review of PFI contractors' returns initiated by the Office of Government Commerce (OGC). The Treasury should use this review to aid greater understanding of the relationship between the various returns which contractors will derive from PFI projects and the risks they actually bear. The Treasury review should clarify the extent to which there is available information to assess these matters.

3. When, as is usual, a PFI deal involves exclusive negotiations with a preferred bidder, departments need to reassess the reasonableness of the proposed contract price for any changes to the deal. Such changes can include the impact that due diligence and the insurance of risks may have on the risks to the private sector in the deal. Departments should not agree to high returns unless high risks are actually being borne.

4. The Comptroller and Auditor General has received new statutory powers to examine the records of both those contracting with government bodies (such as PFI project companies) and their sub-contractors (such as construction companies). These powers should be used to examine any situations where there is a lack of competition influencing the pricing of PFI contracts and to improve the information available to departments for assessing the reasonableness of prices offered to them on PFI deals.

5. Departments should explore thoroughly the OGC's three recommended forms of procurement (Design and Build, Prime Contracting and PFI) before committing themselves to a particular form of procurement for a building project. Any decision to use the PFI should be taken after a careful analysis of the advantages and disadvantages of each form of procurement for the particular project. Decisions to use the PFI should not be taken solely on the grounds that capital constraints may make it difficult to use the other methods in the short term.

6. The OGC should set out clearly for departments the potential advantages and disadvantages of using its three recommended procurement methods. Such a summary will help departments in their analysis of the three options in each building project they undertake.

7. The Treasury should ascertain why, despite its previous guidance, benchmarking had not been used by departments to check most of the price increases for additional building work after contract letting identified in the NAO census. The Treasury

should take steps to strengthen departments' awareness of how benchmarking should be used to assess the reasonableness of proposed price changes. We would expect this to include both training and the reinforcement of relevant guidance.

8. Departments should insist on competitions for the provision of any additional work they may require after the building work to fulfil the original PFI contract has been completed. They should expect to take a close interest in these competitions and to make recommendations on firms who should be invited to compete for the additional work. There is a risk that value for money may be compromised if additional work is not subject to effective competition, particularly where the building contractor which undertook the original work continues to be a shareholder of the project company.

Formal minutes

Monday 30 June 2003

Members present:

Mr Edward Leigh, in the Chair

Mr Ian Davidson
Geraint Davies
Mr Nick Gibb
Mr Brian Jenkins
Mr George Osborne
Mr David Rendel
Jon Trickett
Mr Alan Williams

The Committee deliberated.

Draft Report (PFI Construction Performance), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 17 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Thirty-fifth Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order No. 134 (Select Committees (Reports)) be applied to the Report.

Adjourned until Wednesday 2 July at 3.30 pm

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