House of Commons

Committee of Public Accounts

Delivering better value for money from the Private Finance Initiative

Twenty-eighth Report of Session 2002–03

HC 764

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Summary

Since its launch in 1992, the Private Finance Initiative (PFI) has become one of the main methods by which the public sector procures services from the private sector. More than 500 deals have now been signed with a total capital value of over £50 billion.

In 1999, after we had examined and reported on four of the early PFI deals, we issued a progress report on experience to date to help the public sector get the best possible deals for the taxpayer.[1] Since then we have issued a further 18 reports on individual deals or cross-cuttings issues involving the PFI (**Appendix 1**). This report draws together the lessons learned from this work. Individual deals need to deliver value for money for taxpayers and users of services, and best practice needs to be applied more generally to safeguard the public interest.

We draw the following main conclusions from our examination:

- The PFI is an important method of procuring public services that has now become well established. It offers a number of potential advantages but there are also a number of potential drawbacks. The balance to be struck will depend on the circumstances of each case, and each proposed deal needs to be considered carefully on its merits. Whilst there are examples of good practice, our examination of a wide range of PFI deals shows that many departments need to get better at procuring and managing contracts. Best practice needs to be more widely adopted if the taxpayer is to reap the full benefits of the PFI approach.

- Successive administrations have adopted the policy of using the PFI for those cases where the approach is expected to deliver value for money. The Prime Minister said in September 2002 that the PFI has a central role to play in modernising the infrastructure of the NHS—but as an addition, not an alternative, to the public sector capital programme.[2] Yet the PFI is too often seen as the only option. To justify the PFI option, departments have relied too heavily on public sector comparators. These have often been used incorrectly as a pass or fail test; have been given a spurious precision which is not justified by the uncertainties involved in their calculation; or have been manipulated to get the desired result. Before the PFI route is chosen departments need to examine all realistic alternatives and make a proper value for money assessment of the available choices.

- The taxpayer is not always getting the best deal from PFI contracts because good procurement practice is not being followed. We have seen examples where competitive tension is not maintained; where there is only one bidder for the contract; or where the contractor raises the price after becoming the preferred bidder. Sound procurement procedures need to be applied to all purchases of goods and services, however they are

1 23rd Report from the Committee of Public Accounts, *Getting Better Value for Money from the Private Finance Initiative* (HC 583, Session 1998-99)

2 The Courage of our Convictions: Why Reform of the Public Services is the Route to Social Justice, UK Fabian Ideas Series No. 603, September 2002

financed. Departments need to get better at protecting the taxpayer's interests when negotiating PFI deals.

- Most PFI contracts are long-term deals of 25 years or more. Once deals have been signed, projects must be managed effectively so that the required services are delivered to an acceptable standard over the life of the contract. Effective management requires a partnership approach between departments and contractors, a proper system of rewards and penalties for good and bad performance, and satisfactory procedures for dealing with change.

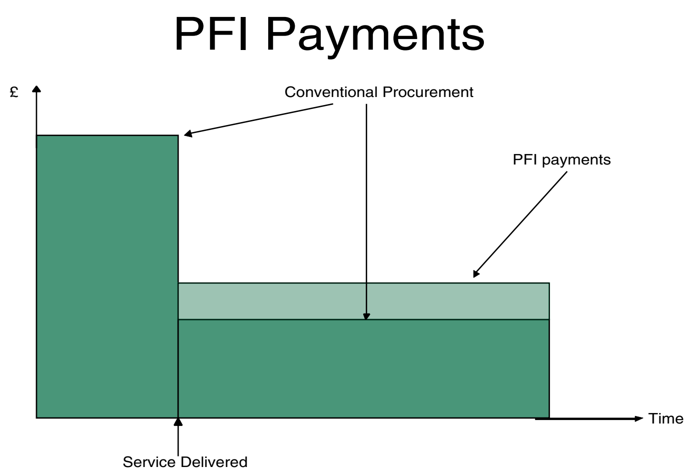
- Departments are too willing to bail out PFI contractors who get into trouble. Contractors should expect to lose out when things go wrong just as they expect to be rewarded when projects are successful. Departments must ensure that PFI contracts safeguard the taxpayer's position in circumstances where the contractor is no longer able to deliver what is required under the contract. Departments should consider in advance how they will eventually exit from deals should this prove necessary and draw up contingency plans accordingly. When projects run into difficulties prompt action is necessary to prevent costs rising further. They taxpayer must not be expected to pick up the tab whenever a deal goes wrong.

1 Choosing whether to go ahead with the PFI option

Assessment of options

1. PFI contracts are generally long term arrangements involving public expenditure over extended periods, often for 30 years or more. The public sector does not have to find the money up-front to meet the initial capital costs. But the cash payments thereafter will generally be higher than in an equivalent conventionally-financed project (**Figure 1**). The PFI approach can enable departments to undertake projects which they would be unable to finance conventionally since they do not need to find all the money for the capital asset during its construction. PFI deals can therefore be attractive in the short term. But there is a risk that this attractiveness may distort priorities in favour of those projects which are capable of being run as PFI projects.

Figure 1: Timing of payments under the PFI and conventional procurement



Note: In conventional contracts the private sector is paid for the construction of the asset and the public sector makes separate arrangements for the ongoing maintenance and operation of the asset. In PFI contracts the private sector is paid on the basis of the service provided over the lifetime of the contract. The regular unitary charge paid to the contractor is intended to cover the cost of construction, maintenance and operation of the asset.

Source: National Audit Office

2. Since the Government can borrow money at lower interest rates than private companies, PFI deals will generally cost more to finance than publicly funded projects. For the PFI route to be worthwhile, the higher financing costs and any other potential disadvantages need to be more than outweighed by the benefits achieved. Such benefits might include a better allocation of risk between the public and private sectors; improved delivery as a result of the incentives offered to private contractors through the payment mechanism; and closer integration between design, construction and operation. Some of the potential benefits and disbenefits of PFI deals are shown in **Figure 2**.

Figure 2: Potential benefits and disbenefits of PFI deals

Benefits	**Disbenefits**
There can be greater price certainty. The department and contractor agree the annual unitary payment for the services to be provided. This should usually only change as a result of agreed circumstances.	The department is tied into a long-term contract (often around 30 years). Business needs change over time so there is the risk that the contract may become unsuitable for these changing needs during the contract life.
Responsibility for assets is transferred to the contractor. The department is not involved in providing services which may not be part of its core business.	Variations may be needed as the department's business needs change. Management of these may require re-negotiation of contract terms and prices.
PFI brings the scope for innovation in service delivery. The contractor has incentives to introduce innovative ways to meet the department's needs.	There could be disbenefits, for example, if innovative methods of service delivery lead to a decrease in the level or quality of service.
Often, the unitary payment will not start until, for example, the building is operational, so the contractor has incentives to encourage timely delivery of quality service.	The unitary payment will include charges for the contractor's acceptance of risks, such as construction and service delivery risks, which may not materialise.
The contract provides greater incentives to manage risks over the life of the contract than under traditional procurement. A reduced level or quality of service would lead to compensation paid to the department.	There is the possibility that the contractor may not manage transferred risks well. Or departments may believe they have transferred core business risks, which ultimately remain with them.
A long-term PFI contract encourages the contractor and the department to consider costs over the whole life of the contract, rather than considering the construction and operational periods separately. This can lead to efficiencies through synergies between design and construction and its later operation and maintenance. The contractor takes the risk of getting the design and construction wrong.	The whole life costs will be paid through the unitary payment, which will be based on the contractor arranging financing at commercial rates which tend to be higher than government borrowing rates.

Source: National Audit Office

3. Before embarking on the PFI route, departments need to consider the available options for financing their projects. As well as the PFI, the options may include other types of partnership arrangements with the private sector and various forms of conventional finance. The assessment should include a realistic and comprehensive analysis of costs, benefits and risks. Such appraisals are not always being done adequately, however, with the PFI option too often being seen as the favoured route before a proper assessment has been carried out.

4. The question also arises as to whether the benefits of the PFI approach—particularly the use of private sector skills and the more appropriate allocation of risk—are sufficient to justify the extra cost of using private finance. One of the valuable features of private sector financing of PFI projects is the extensive due diligence that private sector risk-takers carry out. But the returns to financiers need to be commensurate with the risks that they are actually taking and this in turn depends on the market being well informed and truly competitive. External financing of PFI projects could be good value if the extra costs are

justified by the risks transferred and if due diligence serves to manage those risks more effectively. But it is also possible that these benefits could be obtained more cheaply through alternative forms of financing. A thorough evaluation of the advantages and disadvantages of possible alternative financing structures for PFI deals is needed.

The public sector comparator

5. A public sector comparator is a costing of a conventionally financed project delivering the same outputs as those of the PFI deal under examination. It is just one of a number of ways of evaluating a proposed PFI deal. It is directly relevant only when the publicly financed option on which it is based is a genuine alternative to the PFI deal. This is most likely to arise at the outset of a project.[3]

6. The use of public sector comparators has been the subject of considerable debate about their reliability, accuracy and relevance in the contexts in which they have come to be used. We have seen many cases where the public sector comparator has been incorrectly used as a pass or fail test. In these cases the desire to show that the PFI deal is "cheaper" than the public sector comparator has led to manipulation of the underlying calculations and erroneous interpretation of the results. There are likely to be qualitative and non-financial differences between the options that cannot simply be subsumed in a difference in forecast cost.

7. The accuracy of public sector comparators is limited. They are prone to error because of the complexity of the financial modelling that is often used. They are also dependent on uncertain forecasts. This places a limit on the accuracy which can be achieved, however much work or analysis may be done. Further work takes time and money without necessarily adding to the value of the public sector comparator as a decision tool. There is also a risk that the users of the public sector comparator will believe that it is more accurate than it could ever be. Decisions can be made on the basis of small and spurious differences between the public sector comparator and the PFI option.

8. Examples of some significant weaknesses in the use of public sector comparators are set out in **Figure 3**.

3 Ev 1

Figure 3: Weaknesses in the use of public sector comparators

PFI deal	Committee's findings
Dartford and Gravesham Hospital (12th Report, Session 1999–2000)	The NHS Trust did not detect significant errors in the public sector comparator. The Trust also did not quantify the full effects of changes in contract terms and of the sensitivity of the deal to changes in key assumptions, as the deal went forward. Had the Trust known that the savings were marginal when negotiating the deal, it might have made different decisions and achieved better value for money.
Airwave (64th Report, Session 2001–02)	A public sector comparator was not prepared until late in the procurement, and after a decision to use the PFI had already been made. It is therefore doubtful that the use of a comparator added to the decision-making process.
MOD Main Building (4th Report, Session 2002–03)	The public sector comparator gave a central estimate for the cost of a conventionally financed alternative to the PFI deal as £746.2 million, compared to an expected deal cost of £746.1 million. Such accuracy in long term project costings is spurious, and the small margin in favour of the PFI deal provided no assurance that the deal would deliver value for money.
West Middlesex Hospital (19th Report, Session 2002–03)	The NHS Trust's advisers strove to make slight adjustments to the calculations, well within the range of error inherent in costing a 35 year project, so that the PFI cost appeared marginally cheaper than the public sector comparator.

Comparison with the best alternative option available

9. Once the stage of choosing between PFI and non-PFI options has passed, the public sector comparator becomes less relevant. At all times, however, during the procurement negotiations departments need to keep in view the best alternative to proceeding with the PFI deal. In some cases the best alternative may be the public sector comparator project but it is likely that as time passes the real alternative to proceeding with the PFI deal will be some other project: a different technical solution, or a project delivering different benefits. Retaining a choice of action is particularly important during negotiations with bidders to maintain pressure on the price and avoid increases in the cost of the deal.

Financing costs

10. Financing costs are a major component of the contract price and the prices of alternative sources of finance can fluctuate over time. The value for money case for PFI depends on it bringing benefits that outweigh the extra costs of private finance. But the way in which financing costs are made up is often not transparent. For example, in the MOD Main Building deal (4th Report, Session 2002–03) the Department could not quantify the extra costs of private finance. It was therefore not clear whether the returns being made were reasonable in relation to the risks being borne. Closer attention to financing costs would have been particularly helpful during the 16 months it took to close the deal. Reducing the length of that period, postponing the choice of finance to the end to get the cheapest form available, and a better informed approach to the financing markets prior to closing the deal all might have helped to secure savings on this project.

2 Striking a good deal

11. Good procurement practice needs to be followed for all purchases of goods and services, however they are financed. In this respect the PFI is no different from other forms of procurement. Some of the details may differ but the basic procurement philosophy as regards ensuring competition, properly evaluating bids and controlling the costs of the procurement remains the same.

Ensuring competition

12. Competition is a fundamental requirement for getting good value from PFI deals. A procuring department needs to survey the market to establish how many companies would be interested in the project and to assess whether its proposals are likely to be attractive to potential bidders. If too few bidders are interested there may be problems with the design of the project and the department should think again. Competitive tension amongst a number of bidders needs to be maintained for as long as possible. A single preferred bidder should not be chosen prematurely or before outstanding issues have been resolved. When it is no longer possible to maintain competitive tension and exclusive negotiations with a single bidder begin, departments should aim to manage these negotiations as effectively as possible. Changes to the project at this late stage are likely to increase its cost.

13. **Figure 4** shows some examples of cases where the procurement process has not been fully competitive and value for money is unlikely to have been achieved. In some cases departments have ended up with a single bidder but have still pressed on despite evidence that there were problems with the design of their projects. In other cases there have been protracted negotiations at the preferred bidder stage and the cost of the deal has crept up.

Figure 4: Examples of inadequate competition

PFI deal	Committee's findings
Immigration and Nationality Directorate (7th Report, Session 1999–2000)	Key figures, on which future increases in productivity would be measured and payments to the contractor calculated, had not been finally agreed until more than a year after the contract was signed. Such important issues need to be finalised before a contractor is selected and the benefits of competition fall away.
Dartford and Gravesham Hospital (12th Report, Session 1999–2000)	The NHS Trust selected two firms to submit final bids but one of the firms did not submit a bid. The Trust therefore ended up with only one final bidder on this major pathfinder project for the use of the PFI in the NHS. The bidder's final bid was 33% higher in real terms than its indicative bid. The Trust did not undertake a detailed analysis of the reasons for the increase in the final bid, especially given the absence of other bids. Such action might have helped the Trust to secure a greater price reduction in the subsequent negotiations.
Newcastle Estate (19th Report, Session 1999–2000)	In this deal the Department of Social Security appointed a preferred bidder whilst important issues remained unresolved. Exclusive negotiations with the preferred bidder continued for 18 months.
Royal Armouries Museum (4th Report, Session 2001–02)	There had been a lack of market interest in the deal when it was put out to the market and only one bid had actually been received. When withdrawing from the competition for this project, one company had expressed concern over the practicality of the proposals for joint working between the public and private sectors in certain areas. The Royal Armouries were not given access to the contractor's financial records and there were disagreements between the two parties over issues which were of fundamental importance to the museum's future.
West Middlesex Hospital (19th Report, Session 2002–03)	The preferred bidder agreed to hold its price for seven months but it took the Trust eleven months to close the deal. The price increased after the commitment period had expired so the price commitment had only limited effect. The principle of securing a price commitment to deter "deal creep" is good, but a department using this approach needs to be sure that it can close the deal whilst the commitment still holds.

Evaluating bids

14. The full evaluation of bids should seek to identify the bid that offers the best combination of financial and non-financial factors. It should include an assessment of bidders' financial and technical competence, including their performance on other government projects. Information to help evaluate bids can be obtained by attempting to cost the bidder's proposed solution, which requires access to the bidder's financial model. The model would show the financial outcome of a particular set of estimated costs, revenues and charges for delivering the service over time.

15. Benchmarking the prices offered by contractors is highly desirable in a competitive situation but is absolutely essential in a single bidder scenario. In the Airwave deal (64th Report, Session 2001–02), when the procurement went down to a single bidder, the contractor recognised that there was a need to change its approach and proposed using a should-cost model. The model would describe the components that make up the system,

the contractor would make its own estimate of what it would cost and the Department could check whether it felt the estimates were appropriate.

The cost of negotiating deals

16. The procurement of PFI deals is inherently more complex than the procurement of conventional deals and can involve departments and bidders in heavy administrative costs. For example, on the Newcastle Estate deal (19th Report, Session 1999–2000), the cost of the procurement to the Department of Social Security rose from an initial estimate of £0.4 million to £4.4 million, an eleven-fold increase, reflecting the complexity of this type of procurement and the Department's inability to undertake many of the tasks required to negotiate the deal. On the Prime deal to transfer the Department of Social Security estate to the private sector (41st Report, Session 1998–99), the Department's costs totalled £10.9 million, compared with an initial budget of £1.7 million, and the final three bidders spent around £27 million in preparing their bids.

The cost of advisers

17. Advisers' costs in PFI deals can exceed budgets by significant margins. For example, on the Newcastle Estate deal (19th Report, Session 1999–2000), the cost of legal advice increased from an initial estimate of £70,000 to an outturn of £2.3 million. On the Dartford and Gravesham Hospital deal (12th Report, Session 1999–2000) the Trust incurred advisers' costs of £2.4 million, which exceeded the initial estimates by almost 700%. After a series of hospital PFI deals, the Trust spent £2.3 million on advisers on the West Middlesex Hospital deal (19th Report, Session 2002–03), virtually the same amount as at Dartford and Gravesham four years earlier.

3 Managing the contract

Adopting a partnership approach

18. The success of these long-term contracts depends critically on the effectiveness of the partnership between the department and the contractor. On the National Savings deal (40th Report, Session 1999–2000), National Savings and Siemens put in place a joint governance structure to help to ensure that the partnership worked as intended. This structure was used to manage both the wide range of issues involved in the day-to-day running of the contract and to maintain strategic commitment to the partnership at senior levels within both organisations.

Measuring performance

19. Contracts should provide for compensation to be paid in the event that the contractor fails to meet the required performance standards, together with adequate arrangements for monitoring the contractor's performance in delivering the required services. In our report on Managing the Relationship in PFI Projects (42nd Report, Session 2001–02) 58% of authorities with a performance review process had made performance deductions from payments due to PFI contractors. This suggested that many authorities were not getting the service they required. If bids are priced on the assumption that actual performance will fall short of the required level, then contractors may not have a strong incentive to perform well.

Maintaining pressure for value for money

20. PFI contracts require appropriate mechanisms, such as benchmarking, market testing and open book accounting, to ensure that value for money is maintained over the lifetime of the project. Our report on Managing the Relationship in PFI Projects (42nd Report, Session 2001–02) found, however, that only around half of the contracts surveyed had such mechanisms in place. Over one in five authorities considered that there had been a decline in value for money in PFI projects after contract letting, with high prices for additional services a key area of concern.

Dealing with change

21. PFI contracts are generally of a long term nature and it is seldom possible to foresee all the changes that may later be required. Contracts therefore need to contain appropriate provisions for dealing with changing requirements. Our report on Managing the Relationship in PFI Projects (42nd Report, Session 2001–02) noted that 55% of the authorities surveyed had already used change procedures to update their contracts. Most of the changes had related to alterations in services, the introduction of new services, and additional works and changes to the design of buildings.

Sharing in windfall and refinancing gains

22. Departments should consider putting in place mechanisms to clawback part of any future windfall gains that contractors may earn so that there is at least a sharing of such benefits. When faced with a proposed clawback arrangement it is possible that bidders may adjust their proposed contract price upwards to compensate for the possible loss of future income. A department may therefore need to ask for prices from bidders with and without clawback to help it to determine the value for money of such an arrangement. The Prime deal (41st Report, Session 1998–99), the Newcastle Estate deal (19th Report, Session 1999–2000) and the revised Royal Armouries Museum deal (4th Report, Session 2001–02) have all included mechanisms to share the benefits of future windfall gains. In negotiating a deal with the contractor on the Airwave deal (64th Report, Session 2001–02), the Department failed to secure any clawback for the taxpayer of additional profits if other emergency services decide to join Airwave or if the system is sold to overseas governments. Failure to negotiate a clawback agreement was partly a product of the contractor being the only bidder.

23. Investors in PFI deals have on occasions made substantial gains following the refinancing of contracts. But only one in four of the early PFI contracts had clear arrangements to share refinancing gains with the public sector. In our report on the Refinancing of the Fazakerley Prison PFI contract (13th Report, Session 2000–01) the contractor had refinanced the project less than two years after the prison opened. The refinancing generated £10.7 million of benefits for the contractor's shareholders. A consequence of the refinancing, however, was that the Prison Service would be exposed to increased liabilities in the event of the contract being terminated. The Prison Service secured compensation of £1 million, which was consistent with the cost of the additional risks it faced, but did not receive any further share of the refinancing benefits. Our 13th Report, Session 2000–01, recommended that departments should expect to share in such refinancing gains in future.

24. As noted in our PFI Refinancing Update report (22nd Report, Session 2002–03) the Office of Government Commerce has now issued new guidance on how departments should provide in future PFI contracts for the sharing of refinancing gains. The guidance envisages that refinancing gains should be shared 50:50 between the private and public sectors on all new deals. The Office of Government Commerce has also negotiated with the private sector a code of practice applying to past PFI deals under which a 70:30 (private sector: public sector) split of refinancing gains would take place, even if no provision for sharing refinancing gains had been made in the original deal.

Improving project management skills

25. Staff responsible for managing PFI projects need to have the appropriate skills. Even where the right contractual framework has been put in place, departments may fail to realise the full potential benefits of projects if contracts are not managed effectively. Effective management requires a thorough understanding of the project and the contractual arrangements and an ability to build effective relationships with contractors. In our report on Managing the Relationship in PFI Projects (42nd Report, Session 2001–02) we

found significant shortcomings in approaches to managing PFI contracts. Some departments, for example, provided little or no training on contract management.

4 Safeguarding the taxpayer if the contractor fails to deliver

26. Departments have tended to bail out contractors who have not delivered or got into trouble, often after a period of delay or indecision in which the situation has got worse and losses have continued to mount. Departments have been reluctant to take a robust line with contractors who have failed to deliver what is required under the terms of the contract. Rarely, for example, have contracts been terminated, often because of the fear of costly litigation and counter claims by contractors.

27. If contractors successfully manage the risks that have been allocated to them and deliver the services required they can expect to earn rewards commensurate with the level of risk that they have borne. But commercial discipline is undermined if contractors get the impression that risks will be taken back by the public sector if they materialise in any serious way.

28. One function of risk capital in a project is to secure the commitment of those who subscribe it by giving them something to lose if the project fails. It is a false economy to proceed with a deal in which too little risk capital has been subscribed by the private sector. In the case of the Royal Armouries and the Channel Tunnel Rail Link, the public sector rewarded private sector failure by agreeing to reduce the risk of the contractors losing their equity investment when the private sector had not delivered.

29. An essential public service will need to continue operating even if a particular contractor is unable to deliver the service for which it is contractually responsible. This ultimate business risk cannot be transferred from the public sector to the private sector. Departments need to identify the possible consequences arising should this risk materialise and take steps to manage it throughout the contract.

30. A common feature of deals that have hit trouble is that contingency plans have been inadequate. In many cases matters have become more serious or departments have become locked into unfavourable courses of action because they have not had a fall-back position when things went wrong. The need for a fall-back position is no different from the need for contingency plans for all programmes, whether carried out through a PFI scheme or by directly employed staff.

31. **Figure 5** shows examples of PFI projects that have encountered problems after contract signature.

Figure 5: Examples of problematic PFI deals

PFI deal	Committee's findings
Immigration and Nationality Directorate (7th Report, Session 1999–2000)	The aim of the project was to overcome backlogs of work and concerns that cases were not being handled consistently or efficiently. When delivery of the system was delayed and things started to go wrong the Directorate's contingency planning was inadequate. It consisted only of continuing with the old, paper-based system of working.
Passport Delays of Summer 1999 (24th Report, Session 1999–2000)	During the summer of 1999, many members of the public encountered great difficulty in obtaining passports from the United Kingdom Passport Agency. The Agency's contingency planning proved inadequate, despite the lessons of the flawed implementation of the Agency's previous computer system in 1989. When serious risks crystallised in the crisis of 1999, the Agency was unable to hold the contractor liable for meeting anywhere near the full costs which arose.
Benefits Payment Card Project (3rd Report, Session 2001–02)	The Benefits Payment Card project was intended to replace the existing paper-based methods of paying social security benefits with a magnetic stripe payment card. The contract was awarded in May 1996 and cancelled in May 1999. It took 18 months from the point where the Department took steps to preserve its right to cancel the project, to take the decision to do so. Meanwhile abortive costs were rising and development of alternative arrangements was stalled.
Royal Armouries Museum (4th Report, Session 2001–02)	Under this PFI deal the contractor was required to build and operate a new museum in Leeds for the Royal Armouries. However, the Department effectively bailed the company out to the tune of over £10 million when it ran into financial difficulties and faced imminent insolvency. There were no contingency plans in place, as it was considered that the risk of the project's failure lay with the contractor. However, the business risks ultimately lay with the public sector as the Department and the Royal Armouries were unwilling to countenance the closure of the museum and had therefore stepped in to rescue the project.
Channel Tunnel Rail Link (22nd Report, Session 2001–02)	The deal to build the Channel Tunnel Rail Link left the Department exposed to very substantial risk in the event of failure by the contractor to raise long-term finance. In deciding to restructure the deal, the Department put in place complex arrangements that will expose the taxpayer to substantial risk for many years to come. The level of equity capital was insufficient to reflect the high level of commercial risk in this project, which depended on inherently risky forecasts of passenger numbers.

Conclusions and recommendations

Choosing whether to go ahead with the PFI option

1. Under the PFI a department gets its project now and pays for it later. The attractiveness of not having to find the money up front to meet the initial capital costs, together with a perception that the PFI is the favoured option, creates a strong incentive for departments to present their PFI deals as the preferred choice simply to get them to proceed. Departments may also be under pressure to choose the PFI option so as to keep debt off the public sector balance sheet. These potential risks underline how important it is that the PFI route should be chosen only after a robust value for money assessment of all the options.

2. To help in assessing whether or not to go ahead with a PFI option, departments are required to prepare a public sector comparator—an estimate of what a project would cost if conventional procurement methods were used. Public sector comparators focus solely on relative costs, yet they have often been used incorrectly as a comprehensive pass or fail test. Decisions on PFI deals need to be based on a realistic, systematic and comprehensive analysis of benefits and risks as well as costs. A robust public sector comparator should be just one of the factors in this assessment.

3. Some public sector comparators have contained material errors and omissions. Others have been given a spurious precision as a result of over-complexity, a pre-occupation with financial modelling, and a failure to take account of uncertainties. Some public sector comparators have been manipulated to get the desired result. There is a need for a more intelligent use of public sector comparators by departments, with due recognition of the inherent uncertainties involved in the calculations and an awareness of the limitations of the resulting forecasts.

4. The appraisal of alternative options should not stop once the decision has been taken to procure a PFI deal. At each key stage of the procurement, and particularly before contract signature, it is essential that an assessment should be carried out of the value for money of the proposed PFI deal against the best alternative available at the time. Departments should not plough on with a poor deal just because they have spent time and effort on it. They should be prepared to start the procurement again if the best alternative solution looks likely to provide better value for money.

5. Financing costs form a significant part of the cost of a long term project. But it is often unclear how these costs are made up. Departments should always establish how the costs of private finance compare to other forms of procurement. Transparency of financing costs is essential both in comparing bids and in considering the merits of alternative forms of procurement.

6. The benefits of using the PFI approach are not always sufficient to outweigh the extra costs that private financing incurs. In some circumstances there may well be better ways of financing PFI deals. Consideration of more innovative ways of financing projects that might give a better deal for the taxpayer need to be investigated. We

therefore look to the Treasury to examine how public authorities might obtain better financing for their PFI projects through alternative financing structures.

Striking a good deal

7. Before shortlisting potential bidders departments must be satisfied as to their financial and technical competence and their performance on other government projects. Firms should not be shortlisted unless it is clear that they are capable of doing the job required. Departments should pay specific attention to the prospect of bidders' proposals being delivered and to bidders' understanding of requirements.

8. Competition is essential if value for money is to be achieved. But on a number of deals we have examined, the department concerned received only one bid. The receipt of just one bid may indicate, for example, that the proposed project has been poorly designed. Where only one bid has been received, departments should consider redesigning the project and starting the procurement again.

9. Where competitive procurement is impossible or fails, departments should seek to use appropriate mechanisms, such as should-cost models, to evaluate bids. A should cost model is an independent calculation of the expected costs of delivering the same technical solution as is being proposed by the PFI bidder. In all cases, whether competitive or not, departments must understand how bidders' prices are made up. In the absence of competition they need to benchmark the prices offered by contractors, and examine contractors' financial models to assess the reasonableness of bids.

10. In many deals the contractor's price has increased substantially over the period between being named preferred bidder and signing the contract. Departments should not appoint a preferred bidder whilst important issues remain unresolved. Negotiations with preferred bidders should be kept short and to a tight timetable.

11. PFI deals remain very costly to negotiate and these costs need to be factored into the assessment. At the outset of a deal departments need to set realistic budgets for their own administrative costs, to monitor these costs and seek to keep them under control. They must also be mindful of the costs to bidders. Imposing excessive costs on bidders is likely to result in higher charges in the long run and might deter firms from bidding.

12. The cost of employing advisers also remains very high and in many cases continues to exceed budgets by a substantial margin. A fall in advisers' costs should have resulted from growing experience of doing deals. Departments need to drive down advisers' costs and ensure that sensible budgets are set and adhered to.

Managing the contract

13. PFI projects involve long term relationships between departments and contractors and need to be approached in a spirit of partnership, where both sides are open, share information fully and work together to solve problems. The partnership needs

clear governance arrangements setting out how performance will be monitored, problems will be resolved and new services or other changes will be introduced.

14. Where contractors do not meet the required standards of service, most contracts allow departments to make performance deductions from the payments due. Whilst some fluctuations in performance are to be expected in a long term contract, the number of contracts with performance deductions suggests that some departments are not getting the service that they require. As with all public services, whether privately financed or not, departments must ensure that their PFI contracts do not allow persistent or serious under-performance to go unchallenged.

15. It is important in long-term contracts that performance and costs are measured regularly against the market to maintain pressure for value for money. Yet many contracts do not have the appropriate mechanisms, such as benchmarking, market testing and open-book accounting, to ensure that value for money is maintained over the lifetime of a project. Such mechanisms need to be an integral part of the contractual and governance arrangements for all contracts.

16. Long-term contracts should provide room for flexibility in the face of changing circumstances. Such changes might relate to alterations in services covered by the original specification, the introduction of new services, or amendments to performance measurement arrangements. Appropriate contractual procedures for dealing with change need to be built into contracts. There is a tension between leaving room for necessary changes whilst not letting contractors make undesirable changes that are to the detriment of the public sector. For example, departments need to watch that change procedures are not abused as a covert means for contractors to increase profit margins.

17. The public sector should be able to share in the benefits of a successful partnership with private sector contractors. Successful projects will create opportunities for better financing terms as financiers will see that project risks have reduced once the service is being delivered satisfactorily. A refinancing can then greatly increase the returns to the private sector. But successful delivery of a PFI project is never a one-sided matter: success will come from the public sector and private sector working effectively together. It is welcome therefore that, following the work of this Committee and the National Audit Office, the Office of Government Commerce has agreed with the private sector that refinancing gains on PFI deals should be shared. On past deals gains are to be shared 70:30 between the private sector and the public sector and on new deals the split is expected to be 50:50.

18. Having staff with the right skills is critical to good project management. But there are significant shortcomings in the approach of some departments to managing PFI contracts. Departments need to give much greater emphasis to developing the project management skills needed to get the best out of their PFI contracts.

Safeguarding the taxpayer if the contractor fails to deliver

19. The essence of PFI deals is that the private sector contractor should take appropriate risks in return for appropriate rewards. If contractors fail to manage the risks they

have taken on, they should expect that part or all of their equity investment in the project may be lost, just as they expect to be rewarded when things go well. In a number of individual cases, however, contractors have in effect been bailed out by the taxpayer. Even a small number of such cases can have a disproportionate affect on an essential commercial discipline, giving the impression that departments are likely to bail out PFI contractors whenever they get into trouble.

20. Departments should ensure that equity risk in PFI deals is real. If a project involves a high degree of commercial risk, it needs to be financed with a commensurately high level of risk capital relative to bank debt. It is a false economy for a department to acquiesce in an over-geared financial structure for a PFI deal.

21. The transfer of risk inherent in a PFI deal cannot protect the authority from the risk that the private sector simply fails to deliver what may be a key public service. The remedies available cannot fully compensate for the disruption and operational risks that would inevitably follow. It is essential that departments should fully understand these and other risks that have not been transferred and ensure that they are actively managed.

22. When projects go wrong, management should face up to the prospect of failure and take prompt action to avoid abortive costs. A reluctance to take decisive action is likely to make a difficult situation much worse and lead to costs mounting ever higher.

23. In several deals we have examined that have gone wrong, contingency plans have proved to be inadequate. As with all their major programmes, departments should have up to date contingency plans ready on all major contracts so that there is a fall-back position if and when a project gets into difficulties.

24. Termination of PFI contracts has been a very rare event despite the number of deals that have got into trouble. In several cases, departments have hesitated to use termination provisions in PFI contracts for fear of counter-claims by the contractors. Departments need to make contractors aware that termination is a very real threat. They should not always regard it as the most difficult and risky option.

Formal minutes

Wednesday 9 June 2003

Members present:

Mr Edward Leigh, in the Chair

Geraint Davies
Mr Brian Jenkins
Mr David Rendel
Mr Gerry Steinberg

The Committee deliberated.

Draft Report (Delivering better value for money from the Private Finance Initiative), 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 31 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

An Annex to the Report agreed to.

Resolved, That the Report be the Twenty-eighth 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 till Wednesday 16 June at 3.30 pm

List of written evidence

Annex: Previous PAC Reports and Treasury Minutes on the PFI

Subject	PAC Report	Treasury Minute
The Skye Bridge	42nd Report, 1997–98	Cm 4041
The Contract to Develop and Update the Replacement National Insurance Recording System	46th Report, 1997–98	Cm 4041
The Private Finance Initiative: The First Four Design, Build, Finance and Operate Roads Contracts	47th Report, 1997–98	Cm 4041
The PFI Contracts for Bridgend and Fazakerley Prisons	57th Report, 1997–98	Cm 4041
Getting Better Value for Money from the Private Finance Initiative	23rd Report, 1998–99	Cm 4469
The PRIME Project: The Transfer of the Department of Social Security Estate to the Private Sector	41st Report, 1998–99	Cm 4593
Home Office: The Immigration and Nationality Directorate's Casework Programme	7th Report, 1999–2000	Cm 4688
The PFI Contract for the New Dartford and Gravesham Hospital	12th Report, 1999–2000	Cm 4758
Ministry of Defence: The Procurement of Non-Combat Vehicles for the Royal Air Force	15th Report, 1999–2000	Cm 4758
The Contributions Agency: The Newcastle Estate Development Project	19th Report, 1999–2000	Cm 4798
The Passport Delays of Summer 1999	24th Report, 1999–2000	Cm 4863
The Private Finance Initiative: The Contract for the Defence Fixed Telecommunications System	26th Report, 1999–2000	Cm 4886
National Savings: Public-Private Partnership with Siemens Business Services	40th Report, 1999–2000	Cm 5021
The Refinancing of the Fazakerley PFI Prison Contract	13th Report, 2000–01	Cm 5261
The Cancellation of the Benefits Payment Card Project	3rd Report, 2001–02	Cm 5393
The Renegotiation of the PFI-type Deal for the Royal Armouries Museum in Leeds	4th Report, 2001–02	Cm 5450
The Channel Tunnel Rail Link	22nd Report, 2001–02	Cm 5512
Managing the Relationship to Secure a Successful Partnership in PFI Projects	42nd Report, 2001–02	Cm 5600
The Use of Funding Competitions in PFI Projects: The Treasury Building	43rd Report, 2001–02	Cm 5676
Public Private Partnerships: Airwave	64th Report, 2001–02	Cm 5728
Private Finance Initiative: The Redevelopment of MOD Main Building	4th Report, 2002–03	Cm 5789
The PFI Contract for the Redevelopment of West Middlesex University Hospital	19th Report, 2002–03	–
PFI Refinancing Update	22nd Report, 2002–03	–

List of Reports from the Committee of Public Accounts Session 2002–03

First Report	Collecting the television licence fee	HC 118 *(Cm 5770)*
Second Report	Dealing with pollution from ships	HC 119 *(Cm 5770)*
Third Report	Tobacco Smuggling	HC 143 *(Cm 5770)*
Fourth Report	Private Finance Initiative: redevelopment of MOD Main Building	HC 298 *(Cm 5789)*
Fifth Report	The 2001 outbreak of Foot and Mouth Disease	HC 487 *(Cm 5801)*
Sixth Report	Ministry of Defence: Exercise Saif Sareea II	HC 502 *(Cm 5801)*
Seventh Report	Excess Votes 2001–02	HC 503 *(N/A)*
Eighth Report	Excess Votes (Northern Ireland) 2001–02	HC 504 *(N/A)*
Ninth Report	The Office for National Statistics: outsourcing the 2001 Census	HC 543 *(Cm 5801)*
Tenth Report	Individual Learning Accounts	HC 544 *(Cm 5802)*
Eleventh Report	Facing the challenge: NHS emergency planning in England	HC 545 *(Cm 5802)*
Twelfth Report	Tackling pensioner poverty: encouraging take-up of entitlements	HC 565 *(Cm 5802)*
Thirteenth Report	Ministry of Defence: progress in reducing stocks	HC 566
Fourteenth Report	Royal Mint Trading Fund 2001–02 Accounts	HC 588 *(Cm 5802)*
Fifteenth Report	Opra: tackling the risks to pension scheme members	HC 589 *(Cm 5802)*
Sixteenth Report	Improving public services through innovation: the Invest to Save Budget	HC 170
Seventeenth Report	Helping victims and witnesses: the work of Victim Support	HC 635
Eighteenth Report	Reaping the rewards of agricultural research	HC 414
Nineteenth Report	The PFI contract for the redevelopment of West Middlesex University Hospital	HC 155
Twentieth Report	Better public services through call centres	HC 373
Twenty-first Report	The operations of HM Customs and Excise in 2001–02	HC 398
Twenty-second Report	PFI refinancing update	HC 203
Twenty-third Report	Innovation in the NHS—the acquisition of the Heart Hospital	HC 299
Twenty-fourth Report	Community Legal Service: the introduction of contracting	HC 185
Twenty-fifth Report	Protecting the public from waste	HC 352
Twenty-sixth Report	Safety, quality, efficacy: regulating medicines in the UK	HC 505

The reference number of the Treasury Minute to each Report is printed in brackets after the HC printing number

Twenty-seventh Report	The management of substitution cover for teachers	HC 473
Twenty-eighth Report	Delivering better value for money from the Private Finance Initiative	HC 764

The reference number of the Treasury Minute to each Report is printed in brackets after the HC printing number