House of Commons

Committee of Public Accounts

The refinancing of the Norfolk and Norwich PFI Hospital

Thirty–fifth Report of Session 2005–06

Report, together with formal minutes, oral and written evidence

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The Committee of Public Accounts

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Committee staff

The current staff of the Committee is Nick Wright (Clerk), Christine Randall (Committee Assistant), Emma Sawyer (Committee Assistant), Ronnie Jefferson (Secretary), and Luke Robinson (Media Officer).

Contacts

All correspondence should be addressed to the Clerk, Committee of Public Accounts, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5708; the Committee's email address is pubaccom@parliament.uk.

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Summary

In 1998, the Norfolk & Norwich University Hospital NHS Trust (the Trust) let one of the first PFI hospital contracts to a private sector consortium Octagon. In 2003, just two years after the new hospital opened, Octagon refinanced the project, dramatically increasing its investors' rate of return to over three times the level Octagon had predicted when bidding for the contract. The Trust only received 29% of the refinancing gains despite taking on substantial new risks following the refinancing.

Octagon achieved this outcome by increasing its borrowings by 53% from £200 million to £306 million. Octagon then used the increased funds to accelerate the financial benefits which the investors would receive from the project. After other financing adjustments, the total refinancing gain was £116 million. £82 million of the gain was retained by Octagon increasing its investors' internal rate of return, which it had said would be 19% when it bid for the contract, to 60%.

In securing the right to receive £34 million of the gains the Trust accepted that the money it would have to pay to end the contract early could increase by up to £257 million following the refinancing as its termination liabilities are related to the amount of Octagon's outstanding borrowings. The Trust also agreed to extend the PFI contract from 34 to 39 years and to receive its share of the refinancing gains over the life of the contract, rather than as an immediate payment.

On the basis of a report by the Comptroller and Auditor General,[1] the Committee took evidence from the Trust and the Department of Health (the Department) on how this PFI deal should be viewed in the light of the refinancing and the implications of these refinancing arrangements for other PFI deals.

In summary, our conclusions and recommendations are:

- The opportunity for large refinancing gains on this early PFI deal does not seem to have been seriously considered as part of the original deal negotiations. Yet, through simply borrowing more, the benefits to Octagon's investors have soared on refinancing to levels which are unacceptable even for an early PFI deal.
- The Trust further contributed to the inappropriate outcome by accepting that, should it wish to end this contract early, its liabilities could now include all the additional borrowings Octagon used to boost its investors' returns.
- We would not expect to see another Accounting Officer appearing before this Committee defending what we believe to be the unacceptable face of capitalism in the consortium's dealings with the public sector.

1 C&AG's Report, *The refinancing of the Norfolk and Norwich PFI Hospital: how the deal can be viewed in the light of the refinancing* (HC 78, Session 2005–06)

Conclusions and recommendations

1. **Octagon's investors' internal rate of return more than trebled following the refinancing.** The total cash which investors expect to receive from the project reduced from £464 million to £335 million following the refinancing, but they have now got a large part of it much earlier. As a result, their internal rate of return, reflecting the value of getting benefits sooner rather than later, soared from 19% when the contract was let to 60%.

2. **This refinancing produced a balance of risks and rewards between the public and private sectors which, even for an early PFI deal, is unacceptable.** Octagon was able to optimise its refinancing gain by reducing its interest costs and extending the period of its borrowings. It was then able to increase its debt from £200 million to £306 million, thus accelerating the benefits to its investors.

3. **The Trust secured the right to receive only £34 million (29%) of the resulting £116 million gain.** This was despite the gain arising just two years after the hospital opened and the Trust being exposed to significantly increased risks. Contracts are now expected to include provisions to share refinancing gains with the public sector on a 50:50 basis.

4. **The possible impact of refinancing gains to the private sector was not considered before the Trust awarded this PFI contract.** Although the Department was aware of the potential for refinancing when entering this contract, there was no contractual arrangement to share in refinancing gains and no assessment of the effect of refinancing on the investors' returns. As a result, the Trust's liabilities could now also include all the additional borrowings Octagon took on to accelerate the benefits to its investors.

5. **Following the refinancing, the Trust could have to pay up to £257 million more if it needs to end this PFI contract early.** It is wholly inappropriate that, in the event of termination, the Trust's liabilities could now include not just the cost of the hospital, but all the additional borrowings Octagon took on to boost its investors' returns. It is unacceptable that, in the event of termination, the Trust could be left with liabilities incurred simply to make it easier for the investors to achieve high returns.

6. **To maximise the refinancing gains, the Trust agreed to extend the minimum period of its PFI contract by five years to 2037.** There can be no certainty that a hospital will be needed in its current form in over thirty years time, and the Trust need not have incurred the risks of extending the contract.

7. **The investors took their benefits from the refinancing immediately whereas the Trust is receiving its share over 35 years.** On advice from the Department, the Trust is receiving its share of the refinancing gains as a reduction to the annual PFI contract charge it pays to Octagon. If the contract is terminated early, the Trust may find it difficult to recover the outstanding balance of its share of the refinancing gain.

8. **This project again shows an authority too readily agreeing with refinancing proposals when more robust negotiations could have produced a better outcome.** Staff managing PFI projects should be trained to understand refinancing issues and should appoint experienced advisers to assist in robustly negotiating refinancings.

9. **The Trust incurred additional financing costs by entering into an early contract in the emerging PFI hospital market.** Financing costs were higher on early PFI hospital deals than current deals reflecting the risks of a new market, and the Trust should not be expected to bear the additional cost unaided. The Department argues that the Trust avoided subsequent construction cost inflation, but this is a different issue which does not relieve the Trust of the higher financial costs.

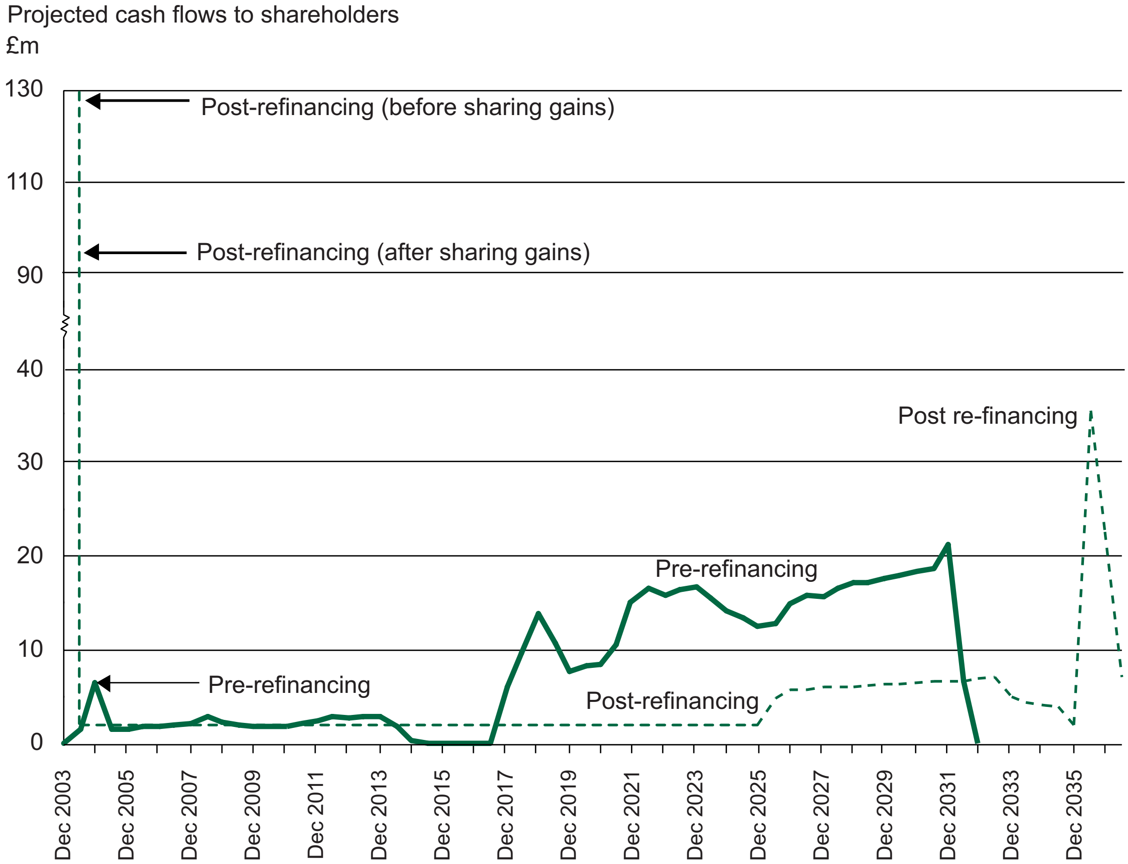
10. **There is no central data on PFI construction cost inflation or the impact of government building programmes on public sector building costs.** In order to manage better the future PFI programme, the Treasury should provide an annual assessment of the effect of construction cost inflation on public building projects, including the effect on PFI projects and a comparison with private sector experience.

1 The risks and rewards from refinancing

1. The Trust let a PFI hospital contract to Octagon in January 1998 to build a new hospital, to then maintain it and provide facilities management services for a minimum period of 30 years. Octagon subsequently refinanced the contract in December 2003, two years after the new hospital opened. Octagon was able to secure improved financing terms because the construction phase of the project had been completed; the PFI market had become established; and commercial interest rates generally had fallen.[2]

2. On refinancing, Octagon was able to extend the period of its borrowings, replacing bank finance repayable by 2018 with bond finance repayable by 2035. The longer borrowing period and lower interest rates available enabled it to increase its borrowings by 53% from £200 million to £306 million. It then used the additional funds to accelerate the benefits which its investors would receive from the project **(Figure 1)**.[3]

Figure 1: Octagon's assessment of projected benefits to its shareholders following the refinancing



Note: Based on information provided by Octagon at the time of the refinancing the maximum potential immediate cash benefit to Octagon's investors following the refinancing was £129 million. After agreeing to share the refinancing gains with the Trust, the available immediate cash benefit to Octagon's investors was £95 million.

2 C&AG's Report, paras 1–2, 1.2–1.3

3 *ibid*, Figures 6 and 7a, p8 and Figure 8, p9

3. The net present value of the total refinancing gain was £116 million of which the Trust secured the right to receive £34 million (29%) under the voluntary code for early PFI deals which the Treasury had agreed with the private sector. The refinancing gain was calculated, in accordance with Treasury guidance, by discounting the expected cash flows to Octagon's investors at a rate of just under 19%, the expected cost of Octagon's equity capital when bidding for the contract. The use of a higher, rather than a lower, discount rate in these calculations increases the value of the refinancing gains because the value of accelerating benefits is enhanced by a higher discount rate.[4]

4. The acceleration of benefits to the investors, permitted by Octagon increasing its debt on refinancing, more than trebled the internal rate of return (IRR) which investors expected to receive from the project. The IRR is the discount rate at which the present value of the investors' receipts from a project equals that of their payments, including their initial investment. IRRs are often used to compare the investor cash flows in different bids for a project. This measure is very sensitive to increases to investor benefits in the early years of a project. In this project, the expected IRR, which had been disclosed as 19% when Octagon bid for the contract, rose to 60% following the refinancing and the sharing of the gains with the Trust.[5]

5. The Trust and the Department did not seek to defend the very high investor returns. They noted, however, that these high returns had arisen on what had been an early PFI deal; that the Trust had secured a share of around 30% of the refinancing gains it had not been entitled to contractually; and that Octagon's service had been very good. Whilst this was an early PFI hospital deal and investors will seek higher returns for the risks of investing in a new market, the involvement of the bank ABN Amro, which had financed the Fazakerley Prison PFI deal three years earlier, would have contributed relevant general PFI experience. That experience should have limited the investors' exposure to risks and their need for very high returns.[6]

6. At current prices, the Trust expects to pay £1.3 billion to Octagon over the life of the contract. The total cash Octagon's investors expect to receive over the life of the contract was projected to fall following the refinancing from £464 million to £335 million. The investors have, however, significantly increased their benefits from the project in the early years, in exchange for reduced benefits in the later years of the contract. The increase in the return to the investors reflected the value of receiving accelerated benefits from the project. The advantage of these accelerated benefits is similarly reflected in an increase in the net present value of the aggregate projected cash flows to the investors over the life of the contract **(Figure 2)**.[7]

4 C&AG's Report, Figure 2, p2, para 1.3; Qq 2–3, 123–126; Ev 20

5 C&AG's Report, Figure 2, p2 and para 1.3

6 Qq 1, 9–10, 14, 23, 123

7 C&AG's Report, Figure 8, p9 and Figure 24, p22; Ev 20, 24; Qq 60–71

Figure 2: Changes in Octagon's investors' projected financial benefits

	At contract award	Just before the refinancing	Just after the refinancing	Post-refinancing benefits as multiple of pre-refinancing benefits
Total projected cash flows to the investors over the life of the contract	£501m	£464m	£335m	0.72 (or -28%)
Net present value of the projected cash flows to the investors over the life of the contract (note 1)	£47m	£35m	£117m	3.34 (or +234%)
Internal rate of return to the investors (note 2)	19%	16%	60%	3.75 (or +275%)

Notes:

1 The net present values of the benefits to Octagon's investors are calculated, in accordance with Treasury guidance, by discounting the projected cash flows at 18.94%, the anticipated IRR to Octagon's investors reported by Octagon when the contract was let.

2 The internal rate of return is the discount rate at which the present value of the investors' receipts from a project equals that of their payments, including their initial investment. The increase following the refinancing reflects the high value of receiving large returns early in the project.

Source: Derived from Octagon's financial records relating to the refinancing held by the Trust's financial advisers, Royal Bank of Canada

7. The high rate of return to Octagon's investors following the refinancing is in line with the Darent Valley Hospital refinancing where the private sector also substantially increased its borrowings at the time of the refinancing in order to provide additional funds to pay accelerated benefits to the investors (**Figure 3**).[8]

8 Qq 11, 48–49, 77

Figure 3: Comparison of the returns to Octagon's investors following the refinancing with other PFI refinancings of comparable building projects

Project	Projected internal rate of return (IRR) to investors at contract letting	Projected IRR to investors just before the refinancing	Projected IRR to investors just after the refinancing (note)	Substantial increase in borrowings at time of refinancing	Projected IRR to investors following the refinancing as a multiple of the pre-refinancing IRR
Norfolk & Norwich hospital	19%	16%	60%	Yes	3.75 (or +275%)
Darent Valley Hospital	21%	23%	56%	Yes	2.44 (or +144%)
Fazakerley Prison	13%	16%	39%	No	2.44 (or +144%)
Ministry of Defence: Joint Services Command and Staff College	18%	Not available	31%	Yes	1.72 (or +72%)

Note: These rates of return are after the sharing of refinancing gains with the public sector. The comparator projects are other early PFI building projects on which the NAO has previously reported which have been refinanced.

Source: National Audit Office, from private sector financial models held by departments

8. The outcome of this refinancing has been that Octagon's investors have both increased their returns and reduced their risks as financial benefits from the project that were previously uncertain have now been realised. But the Trust, whilst sharing in the refinancing gains, has significantly increased its risks. In particular, the Trust could face significantly higher costs to break the contract as a result of Octagon increasing its borrowings.[9]

9. The additional risks to the Trust from the refinancing were as follows.

Increased termination liabilities

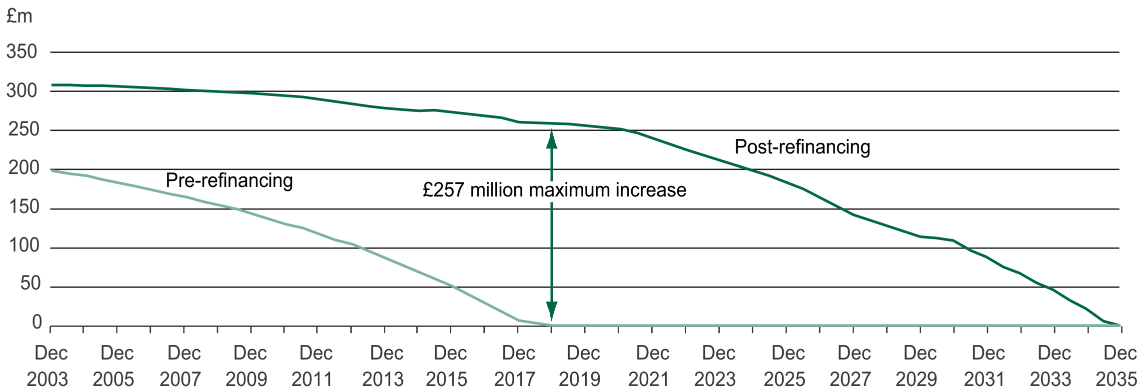
The amount the Trust would have to pay to end the contract early could increase by up to £257 million. If Octagon defaults on its contractual obligations, and the contract is ended by the Trust, the Trust will continue to pay monthly payments. These monthly payments will be related to the Trust's previous contractual payments for using the hospital and the costs of repaying Octagon's debt but reduced by any increased costs the Trust may incur in re-procuring the required services. The Trust's liabilities, following contract termination in these circumstances, are likely to cover most, but not necessarily all, of Octagon's outstanding debt. In other circumstances, if the Trust defaults, or chooses to end the contract, its liabilities will be the full amount of Octagon's outstanding debt, payable as a lump sum. The purpose of these contractual arrangements was to ensure that the Trust

9 Qq 171–172

pays a fair amount for its use of the hospital if it wants to end the contract early. As the Trust's termination liabilities under these arrangements were linked to Octagon's debt, the liabilities rose in line with the increase in Octagon's borrowings on refinancing. The Trust did not, however, challenge this outcome in a situation where the increased borrowings were not being used to expand the hospital buildings which it was using. The £257 million maximum increase in these liabilities would arise if the Trust terminates the contract, without Octagon default, in 2018, fifteen years after the refinancing **(Figure 4)**.

The Department considered these additional termination risks were justified on the grounds that it had not experienced any terminations on 46 large PFI projects which were operational. The Trust judged that, taking this experience into account, on the balance of probabilities, it would be value for money to obtain a 30% share of the refinancing gains on the terms Octagon had proposed. There is a risk, however, that changing circumstances over the next fifteen years could increase the likelihood of the Trust needing to end this contract early.[10]

Figure 4: Change in Octagon's outstanding debt and the Trust's maximum termination liabilities



Note: The Trust's termination liabilities would be payable as a lump sum equal to Octagon's outstanding debt if the Trust defaults on its contractual obligations or chooses to end the contract early (for reasons other than Octagon defaulting on its contractual obligations).

An extended contract period

By agreeing to extend the minimum period of the contract by five years to 2037 the Trust accepted the risk that it would be committed to paying for services under the contract over a longer period. This was despite the fact that changing patterns of clinical provision make it impossible to predict, that far in advance, the nature and extent of the services that may be needed. In some situations, such as the current initiative to provide clinical care in the community rather than in hospitals, the demand for certain hospital services can reduce. The Trust acknowledged, however, that, if it were in deficit, it would not be able to reduce what it would pay for the hospital building and its maintenance but could only make savings in ways which would affect its capacity to provide clinical services. There might be scope for savings by reducing the other services provided by Octagon such as porters,

10 C&AG's Report, Figure 12, p12; Qq 4–8, 14–17, 34–48

catering and cleaning but the Trust would have to reduce its clinical capacity to achieve these savings.[11]

Service risks

The withdrawal by Octagon's investors of large early benefits from the project was, in effect, an advance payment of the profits that Octagon expected to earn over the life of the contract. It creates a risk that Octagon's investors may not be so concerned about the quality of Octagon's future service delivery because the investors have already received a substantial part of their project benefits which previously depended on service performance. The Trust, so far, has found Octagon's service to be very good but these are early days in a contract which now extends to 2037.[12]

Credit risk on the balance of the Trust's share of the refinancing gains

In choosing, under guidance from the Department, to receive its share of the refinancing gains over 35 years the Trust was accepting the risk that, if the contract were to be terminated early, it could find it difficult to recover the outstanding balance of its share of the refinancing gains. The Trust's decision to receive its gains over 35 years is in contrast to Octagon's investors' decision to take their refinancing gains immediately at the time of the refinancing which reduced their risks from investing in the project. The Department acknowledged that, if Octagon were to fail financially, the Trust would not be certain of receiving its share of the refinancing gains whereas there would have been certainty if it had taken the gains as cash at the time of the refinancing.[13]

11 C&AG's Report, para 2 and Figure 24, p22; Qq 84–89, 115–116

12 C&AG's Report, Figure 8, p 9; Qq 9, 18–21

13 C&AG's Report, Figure 13, p13; Qq 162–170

2 Negotiating financing issues

10. The financing of a PFI deal can be complex and raise issues with which public authorities may not be familiar. Our predecessors underlined the importance of authorities equipping themselves with suitable skills and drawing on appropriate advice if they are to deal effectively with financing negotiations to secure the best outcome for the taxpayer. Our predecessors also stressed that authorities should ensure that they are aware of, and use, the full strength of their negotiating position when dealing with requests to vary the terms of PFI deals. The finalisation of the financing arrangements before the Trust let its PFI contract and the subsequent refinancing were situations where negotiations on complex financing issues were likely to be critical to achieving value for money.[14]

11. Before letting this PFI contract, the Trust did not take steps to make Octagon compete its funding arrangements for the project, despite the fact that there had been a two year delay in closing the deal. The availability and pricing of alternative financing options can change over time, so competing the financing could have produced savings in the financing costs. When the Treasury subsequently ran a funding competition on its PFI deal the competition reduced the contract price by 7%. Octagon undertook a funding competition when refinancing its contract with the Trust. The Trust argued that, when it was finalising this contract during 1997, the PFI funding market was insufficiently developed to facilitate a competition. The Trust considered there would have been a greater risk to value for money from delaying the closure of the deal at a time when construction costs were increasing. The finance terms in the PFI deal which the Trust closed in 1998 were in line with other early bank financed PFI deals. However, as the Trust had not pressed Octagon to test the financing options, including the newly emerging PFI bond market, during the two years it took to finalise this deal, the Trust had not demonstrated that the best possible financing terms were achieved.[15]

12. In letting its PFI contract, the Trust had not negotiated to share refinancing gains even though the Department was aware of the potential for refinancing benefits. During the subsequent refinancing negotiations the Trust accepted increased risks which it could have resisted through more robust negotiations when Octagon was seeking to treble the returns to its investors. The Trust acknowledged that it could have blocked the increase to the liabilities it will now have to pay to end this contract early. Yet it took no steps during the refinancing negotiations to avoid the possible increase to these termination liabilities of up to £257 million. The Trust thought that objecting to the higher termination liabilities would have limited the amount of the refinancing gain but this belief was untested.[16]

13. Alternatively, the Trust could have sought to strike a better deal by negotiating a bigger share of the refinancing gains as compensation for taking on the increase in termination liabilities, a strategy which the Prison Service had adopted successfully when it was faced

14 13th Report from the Committee of Public Accounts, *The refinancing of the Fazakerley PFI Prison Contract* (HC 372, Session 2000–01) and 22nd Report from the Committee of Public Accounts, *PFI refinancing update* (HC 203, Session 2002–03); Q 161

15 C&AG's Report, Figure 23, p21; C&AG's Report, *Innovation in PFI financing: The Treasury Building project* (HC 328, Session 2001–02); Qq 26–34, 72, 75–76

16 C&AG's Report, Figure 12, p12; Qq 11, 77, 118, 128

with increased termination liabilities on the refinancing of the Fazakerley Prison PFI contract. The Department argued that, rather than be ambitious for an increase to the share of the refinancing gains, it had been important to show the market an initial example of a refinancing which complied with the terms of the new voluntary code for early PFI deals by giving the public sector a 30% share of the refinancing gains. The Department also considered that it would have been inappropriate for the Trust to seek a larger share of the refinancing gains as there were three PFI building contractors which had each made losses of between £40 and £100 million on certain PFI projects and the public sector was not obliged to share in these losses. The Department acknowledged, however, that the public sector now expected to share in 50% of the refinancing gains in current deals. The Treasury considers that it is too early to judge whether the 50% share needs to be adjusted but it will review this as experience emerges of using this gain sharing arrangement.[17]

17 C&AG's Report, *The refinancing of the Fazakerley PFI prison contract* (HC 584, Session 1999–2000) paras 1.24–1.30; Qq 78–83, 117–119, 121–122, 127, 129–147, 158–160, 173–176

3 The PFI hospital market

14. The Department pointed out that recent PFI deals had been affected by high rates of construction cost inflation. Heavy global demand for building materials combined with a relatively large supply of government building projects in the United Kingdom market have contributed to recent construction cost inflation in both the public and private sectors. Since 1998, when the Trust entered into its PFI deal, building cost inflation has been 60%, with inflation on private sector building projects higher than that experienced in the public sector. The Department estimates that, if the Norfolk and Norwich PFI hospital deal were entered into today, construction cost inflation would have increased the construction costs by 64% **(Figure 5)**.[18]

18 C&AG's Report, Figure 17, p17; Ev 25

Figure 5: Construction cost inflation

Indicator	Inflation 1998–2005	Source
PFI Hospital building cost inflation		
The Department's estimate of the effect that construction cost inflation would have had on the Norfolk & Norwich hospital building costs	64%	The Department (note)
Building cost inflation (public and private sector combined)		
Public and private sector building inflation on tenders including PFI	60%	The Royal Institute of Chartered Surveyors (RICS)
Private sector building inflation		
Private sector building cost inflation on tenders	65%	RICS
Public Sector Building Inflation		
Public sector building cost inflation on tenders including PFI	56%	RICS
Public sector building inflation on tenders excluding PFI	50% 49%	The Department of Trade and Industry NHS Estates
Other Inflation		
General building cost inflation relating to contract variations (public and private sectors)	41%	RICS
Maintenance cost inflation	23%	RICS
Retail price inflation	19%	The Retail Prices Index

Note: The Norfolk & Norwich hospital PFI contract in 1998 was based upon building costs per square meter of £1,589. In summer 2005 the Department's information was that the building work for a PFI hospital outside London, comparable to the Norfolk & Norwich hospital, had been priced recently at £2,600 per square metre. That is equivalent to construction cost inflation of 64%.

15. The Department had not fully analysed the pricing of deals in the PFI hospitals market or identified all the lessons from the Trust's handling of this deal. Based on current pricing information from market sources, the Department estimates that construction cost inflation on its PFI deals has been in the range of 57% to 89% between 1998 and 2005. This wide range reflects the different types of PFI hospital buildings procured by the Department. The Department's PFI construction inflation has been higher than the average public sector building inflation during this period of 56%. The Department believes that its costs have been influenced by improvements to patient environment and relatively expensive refurbishments of existing hospitals. It is unclear whether the Department's experience of PFI construction cost inflation has been different from other

areas of government as neither the Treasury nor individual departments maintain detailed data on PFI construction cost inflation.[19]

16. The Department collects a range of data to assist its monitoring of its PFI projects. The data includes construction and service price trends from the NHS, financial models relating to its PFI projects and other pricing data from the Treasury. Despite this information, the Department has not fully analysed all the factors which will have affected the pricing of current PFI hospital deals. So it is not possible to judge, for example, whether increased familiarity by the private sector in estimating and managing the costs of PFI projects is leading to lower prices.[20]

17. Additional capacity has been added to a number of PFI hospital projects because of the commitment to reduce waiting list times. Buying more capacity after a contract has been let may enable NHS Trusts to treat more patients but, as the Trust acknowledged, also carries the risk that the contract variations will be expensive. The Trust's PFI contract payments had increased by a fifth (£7.1 million a year) to secure 252 additional beds and other variations. The Trust's bed numbers have increased from 701 to around 950 and it is also providing an expanded range of services. The Trust had taken steps to check that the cost of the variations was in line with the pricing of the original contract.[21]

18. After sharing in refinancing benefits, NHS Trusts with early PFI deals continue to pay a premium on the financing costs compared to current deals. This is because the financing costs on early PFI deals reflected the risks of an immature market and the public sector will only get, at best, 30% of subsequent refinancing gains. By closing this early PFI deal in 1998, the Trust is, therefore, paying a financing premium which helped to establish the PFI hospital market. The benefits of establishing the PFI hospital market have been widely shared among many PFI hospital projects. Around 40 large PFI hospital contracts have now been let and PFI contracts for a further 40 smaller new facilities have also been awarded. The additional financing costs of early PFI deals which helped to establish this PFI market were, however, borne by a relatively small number of NHS Trusts, Norfolk and Norwich being one of nine initial deals which were closed in 1997 and 1998. The Trust has, however, been able to deliver clinical benefits by having early use of the new hospital. The Department also believes that the additional construction costs the Trust would have paid if it had built its new hospital today would balance the lower financing costs that would now be available; but this is a different issue which could not have been anticipated when the Trust entered its PFI contract in 1998.[22]

19 C&AG's Report, Figures 16–17, p17; Ev 26; Qq 24, 101–113, 177–183

20 C&AG's Report, para 2.1, Figure 15, p16; Q 21

21 C&AG's Report, para 3.3 and Figure 24, p22; Ev 19; Qq 87–100, 153–154

22 C&AG's Report, para 1.5; Qq 22, 24–25, 73–74, 90–91, 157, 184

Formal minutes

Monday 27 March 2006

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon
Mr Greg Clark
Mr Ian Davidson
Helen Goodman
Mr Sadiq Khan
Mr Austin Mitchell
Mr Alan Williams

A draft Report (The refinancing of the Norfolk and Norwich PFI Hospital), proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 18 read and agreed to.

Summary read and agreed to.

Conclusions and recommendations read and agreed to.

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

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

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned until Wednesday 29 March at 3.30 pm.

Witnesses

List of written evidence

List of Reports from the Committee of Public Accounts Session 2005–06

First Report	Managing National Lottery Distribution Fund balances	HC 408 *(Cm 6712)*
Second Report	The regeneration of the Millennium Dome and associated land	HC 409 *(Cm 6689)*
Third Report	Ministry of Defence: Major Projects Report 2004	HC 410 *(Cm 6712)*
Fourth Report	Fraud and error in benefit expenditure	HC 411 *(Cm 6728)*
Fifth Report	Inland Revenue: Tax Credits and deleted tax cases	HC 412 *(Cm 6689)*
Sixth Report	Department of Trade and Industry: Renewable energy	HC 413 *(Cm 6689)*
Seventh Report	The use of operating theatres in the Northern Ireland Health and Personal Social Services	HC 414 *(Cm 6699)*
Eighth Report	Navan Centre	HC 415 *(Cm 6699)*
Ninth Report	Foot and Mouth Disease: applying the lessons	HC 563 *(Cm 6728)*
Tenth Report	Jobskills	HC 564 *(Cm 6724)*
Eleventh Report	Local Management of Schools	HC 565 *(Cm 6724)*
Twelfth Report	Helping those in financial hardship: the running of the Social Fund	HC 601 *(Cm 6728)*
Thirteenth Report	The Office of the Deputy Prime Minister: Tackling homelessness	HC 653 *(Cm 6743)*
Fourteenth Report	Energywatch and Postwatch	HC 654 *(Cm 6743)*
Fifteenth Report	HM Customs and Excise Standard Report 2003–04	HC 695 *(Cm 6743)*
Sixteenth Report	Home Office: Reducing vehicle crime	HC 696 *(Cm 6743)*
Seventeenth Report	Achieving value for money in the delivery of public services	HC 742 *(Cm 6743)*
First Special Report	The BBC's investment in Freeview: The response of the BBC Governors to the Committee's Third Report of Session 2004–05	HC 750 *(N/A)*
Eighteenth Report	Department for Education and Skills: Improving school attendance in England	HC 789 *(Cm 6766)*
Nineteenth Report	Department of Health: Tackling cancer: improving the patient journey	HC 790 *(Cm 6766)*
Twentieth Report	The NHS Cancer Plan: a progress report	HC 791 *(Cm 6766)*
Twenty-first Report	Skills for Life: Improving adult literacy and numeracy	HC 792 *(Cm 6766)*
Twenty-second Report	Maintaining and improving Britain's railway stations	HC 535
Twenty-third Report	Filing of income tax self assessment returns	HC 681
Twenty-fourth Report	The BBC's White City 2 development	HC 652
Twenty-fifth Report	Securing strategic leadership in the learning and skills sector	HC 602
Twenty-sixth Report	Assessing and reporting military readiness	HC 667
Twenty-seventh Report	Lost in translation? Responding to the challenges of European law	HC 590
Twenty-eighth Report	Extending access to learning through technology: Ufi and the learndirect service	HC 706
Twenty-ninth Report	Excess Votes 2004–05	HC 916 *(N/A)*

Thirtieth Report	Excess Votes (Northern Ireland) 2004–05	HC 917 *(N/A)*
Thirty-first Report	Northern Ireland's Waste Management Strategy	HC 741
Thirty-second Report	Working with the voluntary sector	HC 717
Thirty-third Report	The Royal Parks and the Diana, Princess of Wales Memorial Fountain	HC 644
Thirty-fourth Report	Returning failed asylum applicants	HC 620
Thirty-fifth Report	The refinancing of the Norfolk and Norwich PFI Hospital	HC 694

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

Oral evidence

Taken before the Committee of Public Accounts

on Wednesday 16 November 2005

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon	Sarah McCarthy-Fry
Greg Clark	Jon Trickett
Mr Ian Davidson	Kitty Ussher
Helen Goodman	Mr Alan Williams

Mr Tim Burr, Deputy Comptroller and Auditor General, National Audit Office, **Mr David Finlay,** Director of PFI Development, National Audit Office and **Ms Anna Simons,** Assistant Auditor General, National Audit Office, were in attendance and gave oral evidence.

Mr Brian Glicksman CB, Treasury Officer of Accounts, was in attendance and gave oral evidence.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

THE REFINANCING OF THE NORFOLK AND NORWICH PFI HOSPITAL: HOW THE DEAL CAN BE VIEWED IN THE LIGHT OF THE REFINANCING (HC78)

Witnesses: **Mr Peter Coates, CBE,** Deputy Director of Finance, Department of Health, **Mr Paul Forden,** Chief Executive and **Mrs Anna Dugdale,** Director of Resources, Norfolk and Norwich University Hospital, examined.

Q1 Chairman: Good afternoon, welcome to the Committee of Public Accounts, where today we are looking at *The Refinancing of the Norfolk and Norwich PFI Hospital*, and we are joined from the Department of Health by Mr Peter Coates, who is the Deputy Director of Finance, and from the Norfolk and Norwich University Hospital, Mr Paul Forden, who is the Chief Executive, and Mrs Anna Dugdale, who is Director of Resources. Perhaps I could ask some questions of the Trust, first of all, and start with you, Mr Forden, if I may? Thank you for coming, by the way, we are very grateful. Could you please look at the Comptroller and Audit General's Report, particularly page 2, figure 2? If we look at that figure we will see that two years after the new hospital opened the shareholders of Octagon were enjoying a rate of return of over 60%. Surely you cannot say that this is value for money, can you, Mr Forden?
Mr Forden: I would not possibly try to defend any rate of return at 60% as necessarily being the very best value for money for us. What I can say, though, is that clearly there is an output from several factors.

Q2 Chairman: You will have to try to speak up, and speak clearly, and speak to us.
Mr Forden: We do know that the shareholders took the refinancing very early and that clearly makes a big difference on the internal rate of return—the fact they actually took it upfront. From the Trust perspective though we also see that as something of a return as well because actually we got back £30 million, which is our contribution from the success of the project.

Q3 Chairman: We will also look in a moment at the fact that this rate of return was largely because they borrowed an extra £100 million, was it not?
Mr Forden: That is correct.

Q4 Chairman: For which ultimately you are liable in the event of termination; that is correct as well, is it not?
Mr Forden: In the event of termination it is much more likely that actually the liability will be sold on to another investor. It would not be in Octagon's interests to actually fail and not to try to sell that liability.

Q5 Chairman: Why not?
Mr Forden: Because the future gains from the hospital would still make it an attractive investment to anybody else.

Q6 Chairman: But there is still that possibility?
Mr Forden: There is.

Q7 Chairman: Which you did not foresee at the time?
Mr Forden: We foresaw that at the time; we actually did an analysis on that risk.

Q8 Chairman: You foresaw refinancing, did you?
Mr Forden: No, we foresaw the potential termination, sorry.

Q9 Chairman: Let us look now at figure 2 on page 2 again and you will see the 60% return, which I have just mentioned, which is very high, compared to the initial shareholder expectation of 18%, which is of

course an enormous jump. Has the service from Octagon similarly exceeded your provisional expectations? The answer must be no.
Mr Forden: Our service from Octagon is actually very good. I have worked in another hospital where there is a PFI company, and I have to say that I am more impressed with Octagon than I was in the previous hospital. It is not necessarily a 300% improvement, but it is certainly a very satisfactory service.

Q10 Chairman: So you think that is good enough, that they cannot possibly give you 300% improvement, but they have given you some sort of improvement so you are happy with that, are you? And their shareholders are now enjoying a rate of return at 60%, having thought at the beginning of this contract that they were only going to get 18.9%, and you think that is a satisfactory position that this Committee should not be unduly concerned about, do you?
Mr Forden: There is very little the Trust could actually do around that. We have followed the guidance throughout on the programme; we have followed the guidance around the refinancing.

Q11 Chairman: Could the National Audit Office just comment to me whether these rates of return might have been foreseeable, particularly in the private sector, by the time this contract was undertaken?
Ms Simons: I think the refinancing, the fact that a loan of 20 years could be refinanced, would have been foreseen by the lenders or the investors; it is a usual project finance technique. However, the scale and the speed at which the markets have moved was probably more difficult to predict.

Q12 Chairman: Thank you. If we look at figure 6, page 8, we are now looking at Octagon's debt. You have underwritten it, as I have already mentioned. The debt rose by 53% to £306 million. The question I would like to ask you when you come back is why is the taxpayer underwriting debt used to improve private investors' benefit? Or perhaps you would like to answer that quickly now?
Mr Forden: We are actually not underwriting their debt, what we are doing is we have agreed to make a payment to them in respect of the services we receive and also obviously the excess to the building. That allows them to borrow against that; but we are not actually underwriting the debt.

Q13 Chairman: What is the difference?
Mr Forden: I think one is where we actually have a liability. It is Octagon who actually entered into the agreement with the banks, not the Trust itself.
Chairman: We will stop there and go to vote and we will come back in a moment.

The Committee suspended from 15.37 pm to 15.43 pm for a division in the House

Q14 Chairman: Mr Coates, what lessons do you think the Department has learned from these unusually high returns?
Mr Coates: We have learnt that we need to be aware that these are potential benefits for the private sectors to make; that equally we share the view of the Trust that they are very large sums of money. But equally the contract gave the Trust no right to access to that money and that the large sum of money was shared with the Trust at 30%, and therefore the Trust received a benefit that it would normally not expect to receive.

Q15 Chairman: It received a benefit but it is ultimately responsible, potentially, for these increased borrowings, is it not?
Mr Coates: It is responsible in the sense that it keeps paying a fee to Octagon if it keeps delivering the hospital to standard and to quality. The Trust does not pay any additional costs, any additional fees to Octagon as a result of the refinancing.

Q16 Chairman: They exposed themselves on the additional liabilities, did they not? How much thought do you think was given to this at the time, either in the Department or in the Trust?
Mr Coates: The potential additional liabilities?

Q17 Chairman: Yes.
Mr Coates: We, alongside the Trust, did do a VFM appraisal of the risks against the rewards in terms of the refinancing, which is table 12, and what we tried to look at there was what the likelihood of termination was. My recollection is that we looked at the probability of default based on a typical project financing rated by the likes of Standard and Poor's and rated as of Triple B, and they say that in any year any one project has a 5% to 10% probability of defaulting. We currently have 46 operational major PFI schemes, 23 being open for three years continuously. We have had no defaults yet and so all we can say is that 5% to 10% probability looks conservative based on these probabilities.

Q18 Chairman: Mr Coates, would you look at figure 8, page 9? You can see that the shareholders of Octagon have withdrawn £130 million from the project.
Mr Coates: I do.

Q19 Chairman: Do you think that any of that is going to be used for the benefit of this hospital or indeed other PFI hospitals?
Mr Coates: When we have talked to the industry generally about what they propose to do with the fund for refinancing, and I think when other consortia have appeared before various Committees, they have said they would intend to recycle a proportion of that for bidding against further projects and investing in further projects.

Q20 Chairman: That still does not really say a great deal. You may want to send us a note on that[1]; we would like to have some evidence behind that.

[1] Ev 17

Basically you are saying that this £130 million that the shareholders have withdrawn from this project is going to be recycled into other hospitals, are you?
Mr Coates: I said a proportion.

Q21 Chairman: That was the implication of your question but I would like to have more evidence behind that because I would be surprised if that were entirely true. I do not know, but I would be surprised if it was. If you look at page 16, paragraph 2.1, it says there, "There are a range of factors, some of which have yet to be fully analysed by the Department, which will have affected the pricing of current PFI hospital deals." So how can you, Mr Coates, judge whether these deals are good value if you cannot explain all the reasons why the contract prices have changed over time?
Mr Coates: The Department of Health finance team do keep a close watch on the PFI market through a variety of sources. We collect construction and service price trends from the NHS; we have copies of every financial model of every PFI transaction in the NHS; and we also collect data from the Treasury across departmental issues in terms of prices and such like. We believe we do keep a fairly close watch on what the PFI markets do in terms of price and activity.

Q22 Chairman: Let us look at page 14, paragraph 1.5, "After sharing in refinancing benefits NHS Trusts will continue to pay a premium on the financing costs on early PFI hospital deals." So is this kind of refinancing and this deal entirely fair on the NHS Trust who entered into early PFI deals, because they have to bear the higher financing costs?
Mr Coates: Indeed, and I think the Report does go on to say elsewhere that we have to look at other costs that the Trust may have incurred if it had come later in the process. It seems to me that there are two issues for the Department. One is: is the Trust paying more than it should for this hospital? And: is the Trust paying more than others are paying for this hospital? We have undertaken further work in the Department looking at the various factors and it is not easy to bring forward today's cost, but we believe that the additional construction costs and the costs that the Trust would have incurred if it built the hospital today do balance off against it.

Q23 Chairman: My last question to you, Mr Coates, just speaking on behalf of the taxpayer—you are the guardian of the taxpayer on this—are you entirely happy with a situation where private investors have got away with a rate of return of 60%? Does that seem to you a good deal for us?
Mr Coates: It is hard to defend such large returns, but all I can say is that the contract itself gave us no right of access and the private sector has done a deal with the taxpayer generally to share those benefits with us on a *post hoc* basis.
Chairman: I am sure my colleagues can come back on that. Mr Bacon.

Q24 Mr Bacon: Chairman, thank you very much. I would like to start with the question about the building costs because the NAO Report says on page 4 that additional building costs arising from construction inflation, if you had done it later, probably offset the benefits of lower financing costs that you would get if you were doing it now, and therefore that is all right then, so to speak. Is it not the case, Mr Forden, that at the end of the day nobody trying to let this contract on behalf of your Trust was in a position to know what would happen to construction costs going forward; is that correct?
Mr Forden: That is correct.

Q25 Chairman: Is it not also true that you are basically faced with a premium compared with other PFI deals, even after your refinancing?
Mr Forden: The audit Report says there is a premium that we pay after the refinancing. If you took the same financing terms as we could expect today, if we were able to achieve those when we let the contract and financial close in 1998.

Q26 Mr Bacon: Mrs Dugdale, could you say something about the way the financing was approached because there was no competition for the financing, was there?
Mrs Dugdale: Initially, no. When the initial deal was made there was not a competition.

Q27 Mr Bacon: Why not?
Mrs Dugdale: Because there was a two-year gap between commercial close and financial close, but even during that period the PFI market for health was very new. There were discussions with the PFI partners about the possibility of a competition, but it was determined that there was not enough of the market to actually have a competition at that stage.

Q28 Mr Bacon: How does one determine that other than by asking?
Mrs Dugdale: It was agreed between us that there was not enough of a market at that stage, and if you look at PFI deals closing at around the same time there was no competition because funding competitions were not known.

Q29 Mr Bacon: Mr Finlay, is it not correct that Octagon had a competition when it closed the deal for its refinancing—it had a funding competition?
Mr Finlay: At the time that Octagon carried out its refinancing, yes, it held a funding competition, and that is referred to in figure 23 in our Report.

Q30 Mr Bacon: Mr Glicksman, when the Treasury building, which was a PFI project, wanted to finance it had a competition, did it not?
Mr Glicksman: It did, but I think that was the very first one that we had done in the public sector, and it followed a gap when the project contract had been put on hold for a couple of years, and we picked it up again.
Chairman: We will have to break for about five minutes.

The Committee suspended from 15.52 pm to 15.58 pm for a division in the House

Q31 Mr Bacon: I was asking about competitions and Mr Glicksman had agreed that the Treasury building had a competition for its financing, although it was the first one, he said, and Mr Finlay agreed that Octagon had had a competition for its financing. When most people go out into the market place looking for a mortgage to buy a house they do not necessarily go to the first building society that gives them the price, do they?
Mrs Dugdale: No, but I think that you have to appreciate that we were the groundbreaker for the market for PFI financing, and at the time when the original deal was struck there was not such a thing as a funding competition.

Q32 Mr Bacon: There was not such a thing as a PFI bond market. You say that there was not such a thing as a funding competition and I find that is not possible to believe. For PFI *per se* maybe, because PFI was new, but 20 years ago when I left university and started working in an investment bank we did what were commonly known as "beauty parades"; they are a standard feature of the City, a standard feature of how things work. You go along with three or four other banks, you tout your stuff, you strut your stuff, you tout you wares and then the client chooses. Is that not obvious, and why was that not done?
Mr Coates: Can I come in there?

Q33 Mr Bacon: Actually I was asking Mrs Dugdale. Was that not an obvious thing to do?
Mrs Dugdale: In the PFI market at the time, funding competitions did not take place in the market, they were not something that were done ordinarily in the market. Also, PFI at the time was very much the concept of a package, so that the private sector brought a package deal to the public sector, which included the finance as part of that overall package.

Q34 Mr Bacon: I will not pursue that any further. Can I ask you to turn to page 12? The hospital, I think I am right in saying, is now paying £1.7 million per year less in the annual unitary charge than would otherwise have been the case before the refinancing; is that right? That is basically how you are taking your gains?
Mr Forden: It is paying a total of £3.6 million a year less—

Q35 Mr Bacon: Is it?
Mr Forden: Of which £1.8 million was due to the refinancing gain and £1.8 million was as a result of extending the contract period.

Q36 Mr Bacon: I am talking specifically in relation to the refinancing gain, it was £1.7 million?
Mr Forden: Yes.

Q37 Mr Bacon: And it is true that, as the Chairman said at the beginning, you have taken on additional potential termination liabilities because of the refinancing?
Mr Forden: We have not taken on additional termination liability unless we terminate the contract ourselves, sorry.

Q38 Mr Bacon: Termination liability will only kick in if there was termination, I would have thought that was self-evident. The point I am referring to is maximum increase in termination liabilities in figure 12, £257 million. Obviously it is a contingent liability, if you like, a contingent situation, but it seems to me that in return for getting this extra refinancing gain that you shared, which means you pay £1.7 million per year less, you have taken on the risk—the *risk*, mark you—of £257 million extra should, for any reason, Octagon fail. That is correct, is it not?
Mr Forden: Should we wish to withdraw from the contract—

Q39 Mr Bacon: If Octagon fail—
Mr Forden: No, if Octagon fail actually we have not taken on that liability, no, because what happens then is we become responsible for servicing the debt, which is true.

Q40 Mr Bacon: And you will have the money with which to do it. Basically you have increased the risk to the hospital; you have taken on this extra. Am I right in thinking that the contract that you have with Octagon says that your termination liabilities are equal to total borrowings?
Mr Forden: To the maximum of the total borrowings, no.

Q41 Mr Bacon: That is not correct?
Mrs Dugdale: May I just help with this?

Q42 Mr Bacon: Yes.
Mrs Dugdale: On the event of Trust default we would have to repay the senior debt outstanding.

Q43 Mr Bacon: I am not talking about Trust default, but if the provider fails?
Mrs Dugdale: No, then we would not have to repay the borrowing. What we would have to pay is 95% of the usage fee or the core usage fee less the increased costs to the Trust, or the scheduled senior debt service, and we pay the lower of those three. So we would not have to pay the debt outstanding.

Q44 Mr Bacon: What I understand is this—and I have talked to the National Audit Office about this—that because Octagon borrowed money—and as it happened it was borrowing extra money when they refinanced, they borrowed an extra £100 million or so, which is shown on page 8 in figure 6, which is why it goes from £200 million to £306 million—when

they did that I understand that your termination liability also increased. Are you saying that that is not true?
Mr Forden: Our termination liability increases if we terminate; if Octagon fail then we have to, as Mrs Dugdale has set out, service that debt, but that debt is no more than we would be servicing through our payments to Octagon.

Q45 Mr Bacon: NAO, would you like to comment on that? Mr Finlay?
Mr Finlay: I think the situation is that there is this amount of debt outstanding, which is the £300 million. As the Chief Executive of the Trust has said, the Trust would have to service that debt. If the Trust chose to terminate the contract in any event our understanding is that it would be liable for the termination liabilities.

Q46 Mr Bacon: You accept that?
Mr Forden: I accept that.

Q47 Mr Bacon: The point I was making, that debt is now £100 million higher than it was, for no other reason than that Octagon wanted to take its money out early, is it not? It is like what Phillip Green did with BHS. He borrowed money to pay himself a big dividend, and is that not basically what has happened here?
Mr Forden: Partly, but we did take an analysis of the risk of that and our assessment of that risk is shown in table 12, that shows that actually it was a sensible investment risk to take.

Q48 Mr Bacon: It seems to me that Octagon have managed to decrease their risk while taking out money early, and you have admittedly a bit of a refinancing gain, but you have had to increase your risk to do that. I remember when Fazakerly Prison refinanced they increased their return from 16% to 39% while reducing their risk. Is it possible that we could have a league table, if you like, of PFI refinancings showing the percentage internal rates of return at contract letting and the percentage of internal rates of return following the refinancing, so that we can see where the gain is biggest? Is that possible?
Mr Finlay: On Fazakerley?

Q49 Mr Bacon: No, on PFI refinancings in general, so that we can look at them and compare the before refinancing and the after refinancing situation.
Mr Finlay: We will see whether we can get this information.[2]
Mr Bacon: That would be extremely helpful, and I think my time is up.
Chairman: Jon Trickett.

Q50 Jon Trickett: Can I ask the Comptroller and Auditor General whether he agrees with the statement that this Report which has been put before us has limited effectiveness in evaluating value for money or managerial context in relation to this particular deal?
Mr Burr: The Report certainly does not attempt to reach a judgment as to whether the deal was or was not value for money. I think it provides a lot of contextual information which contributes to such a judgment, but it does not reach a view either way on that.

Q51 Jon Trickett: That sentence I quote from a document that you have, by Oxford University Consulting, and in fact the whole document—which I understand you have commissioned, and in fact I understand you commission one for every Report that comes in front of the Committee of Public Accounts, which was not made available to Members and I had to request it and at first was refused permission to see it—makes it quite clear that this document here avoids the issue of value for money, does it not? Your consultants have told you that this Report does not address value for money issues properly, does it not?
Mr Burr: It does not attempt to say whether this transaction was or was not value for money.
Jon Trickett: Have you seen this document before, Chairman?
Chairman: I have not.
Jon Trickett: Were you aware that the NAO were commissioning regular reports?
Chairman: No.

Q52 Jon Trickett: Apparently you have a contract with two contractors which evaluate each Report which comes before the PAC.
Mr Burr: We have a very longstanding arrangement under which we get an external academic review of each Report we make.

Q53 Jon Trickett: I have seen some of these reports and some of them are very, very damning, yet you must have had those reports in hand at the time that the Chair was presented with your Report. Would that be true?
Mr Burr: There is obviously a range of assessments which are made of these Reports. Some are very good, in some of them there are obviously more criticisms.

Q54 Jon Trickett: This document gives you marks, does it not?
Mr Burr: Yes, they all do.

Q55 Jon Trickett: I do not know if the Chairman was as surprised as I was that these documents are in existence and they are not made available to Members, because at the end of the day we are in a kind of fishing expedition with these Reports. I would have thought that these Reports would be the best that could be presented to us and I now discover in fact that you have independent evaluations of every Report we have ever seen, some of which are very damning, are they not?
Mr Burr: I do not think they are generally damning. Some of them are very favourable.

[2] Ev 24

Q56 Jon Trickett: Do you remember I was extremely critical on the LIFT Report, which is somewhat off the subject today, but I want to make the general point first? The report which you received on that was particularly frank.
Mr Burr: The Oxford University evaluation of that Report—I am not sure off the top of my head I can remember exactly what they had to say.
Jon Trickett: I will just leave it at that. This report is extremely illuminating. It makes an evaluation on seven separate areas of work, points out of three, as to how good or bad the Report is and in some cases the NAO gets one; in some cases it gets three. The overall conclusion is that the Report itself, "It does address some important consequences of the maturing PFI market but has limited effectiveness in evaluating value for money on managerial context." If the Report is not going to be improved before it comes to us at least we should know why we should be fishing. It is a substantial Report, as you can see, and it would point Members to some very interesting questions. I wonder if we might address this issue as Members perhaps at the end of the meeting or whenever you think is appropriate because I think this is something of a revelation.

Q57 Chairman: We can discuss it, yes.
Mr Burr: These reports would not normally be available until a little while after the Report had been prepared and often after the Committee has considered the Report.

Q58 Jon Trickett: I understand that this Report was clearly available before, since I got it.
Mr Burr: Yes, on this occasion, yes.

Q59 Jon Trickett: And the LIFT one, which was a particularly poor Report, I felt, you also had it in advance. Some of my questions are now going to be directed, but not all of them because I have taken up some time on this particular matter, to points which are made in here. First of all, I do not believe that a single figure in this whole Report is accurate in terms of the amount of cash going between the public sector and Octagon because they are all calculated, having taken into account something called a discount rate, are they not?
Mr Burr: Yes.

Q60 Jon Trickett: Is there any figure in here which actually represents the real amount of money that is going between the Trust and Octagon?
Mr Finlay: There is a figure in figure 24 on page 22 which sets out the annual price which the Trust is paying to Octagon under the contract.

Q61 Jon Trickett: Let me take you to table 2 on page 2. One of the things which your consultants told you, which might have been helpful to tell us, is that most of the detail in this is contained in small print, in notes, and note 1 on that table, the sentence is so obscure as to be impenetrable. The first sentence talks about "Figures expressed as net present values based on cashflows discounted at 18.94% in nominal terms." I have no idea actually what that sentence is referring to, other than I think every figure in table 2 is not a real figure; it has been discounted, has it not?
Mr Finlay: I can explain this point. This table is dealing with how the refinancing gain was calculated. The method of how refinancing gains are calculated is quite closely prescribed in Treasury guidance and this is the method used which we set out here.

Q62 Jon Trickett: I think it would be helpful to those of us who speak English and try to make numbers mean what they actually mean in reality, if we could know what the numbers mean. There is an increase from £47.3 million to £117 million going to Octagon, is there not? It looks as though they are going to get an additional £70 million, but in fact that is not a real figure, that £70 million, is it, because it has been discounted at 18.94%? What is the real figure?
Mr Finlay: This is the value, if you like, in today's money of the returns which flow—

Q63 Jon Trickett: What is the real money? What is the real profit, not the £70 million which is, to some extent, a mythical figure, because 18.94, you would have to get a mathematician to tell us why 18.94 was the chosen figure? So what is the real figure?
Mr Finlay: It would be possible to produce a calculation which showed that figure in cash terms. I do not have the figure here.

Q64 Jon Trickett: Tens of millions of pounds more than £117 million.
Mr Finlay: It is certainly more than £117 million because you can see that from figure 8 on page 9.

Q65 Jon Trickett: Do you not know what the figure is? Because this is a mythical figure, it does not really exist except on a piece of paper. Do we not know what it is going to cost to pay Octagon following the refinancing?
Mr Finlay: I do not have the figure here. The data exists and we could provide it.

Q66 Jon Trickett: In a previous Report on the Skye Bridge, the PAC was provided with figures which both showed the discounted figure, which at that point was £10 million, and the true figure, which was £37 million, a multiple of four. I understand that the discount rate on the Skye Bridge deal was about the same as this one. If that is the case am I right in assuming that the figure of £117 million is more likely to be £400 million?
Mr Burr: We can certainly provide—

Q67 Jon Trickett: Is it in that kind of order?
Mr Burr: I cannot say exactly.

Q68 Jon Trickett: Is the £117 million within £100 million of the true figure?
Mr Finlay: You can see the cash flows; they are set out in figure 8 on page 9. The figure that you are interested in is effectively the aggregation of the annual distributions to the shareholders as set out in figure 8.

Q69 Jon Trickett: It is an amount of dosh that goes out of our wallet as taxpayers to a private company, is it not? And it is not £70 million, is it, it is probably a multiple of that, two or three times that amount?
Mr Burr: Yes, it probably is.

Q70 Jon Trickett: It is 100s of millions of pounds more than £117 million, is it not?
Mr Burr: Yes, it is. All we have done is follow the general practice of discounting this back to current values.

Q71 Jon Trickett: We are representing taxpayers and it is important to see how accountants calculate things and the discount rate is such a fine tool that it can produce a figure of a £70 million windfall gain for Octagon but in fact that is a completely mythical figure—it is probably £250 million or £300 million.
Mr Burr: We can certainly provide the figures for the cash flows; we can provide that information.[3]

Q72 Jon Trickett: There were two other points I wanted to make. If I could go to table 23 on page 21, and also table 22. What these two tables tell us in fact is that the Department had decided that we should exclude bond finance; if I could look to Mr Forden? This has cost the Trust a huge amount of money. This was an active policy determined by the Department, but do you have an idea what the cost might have been if we had used bond finance?
Mr Forden: I actually had not calculated that, I am sorry.

Q73 Jon Trickett: Is it true to say that the decision of the Department to instruct you not to go to bond finance has resulted probably in additional cost falling on the Trust which the Department is failing to assist you with? Is that an accurate description of what has happened?
Mr Forden: The fact that the bond market is more developed now would indicate that that is the case, and I was not around at the time and I do not know whether the bond market was so developed at the time.
Jon Trickett: I do not think I have time to explore it but I think it is a serious point. It is clearly costing the Trust huge amounts of money; it was an active policy to create a market in PFI which may or may not have been right at the time, but the burden of that is falling on the Trust and that is the point I was trying to make.

Q74 Chairman: I am afraid the answer, "I was not around at the time" does not impress this Committee.
Mr Forden: I am sorry about that.
Chairman: Mrs McCarthy-Fry.

Q75 Sarah McCarthy-Fry: On page 4 of the Report, "Alternative financing solutions were not seriously explored to ensure the financing terms remained competitive during a two year close deal," and I accept that point that it was assessed for value for money at the start, but you had a two-year period in which case you could have reacted to change. You already reacted to change because you reassessed how many beds you needed. Why did you not reassess whether the financing was correct, given how the markets had changed?
Mr Forden: During the period of the two years, as Mrs Dugdale has said, what we bought was almost a special vehicle as a company that brought finance, building expertise, *et cetera*, and that is what we purchased. Even going through the competition two years prior to getting down to Octagon, there was very little interest. Our advice from advisers and our advice from the Department at the time when we looked toward financial close was that it would have been a higher risk to the Trust to actually go back out to the market as it would incur further delay, and at the time building costs were rising quite steeply, and it potentially would have cost the Trust more than it could gain.

Q76 Sarah McCarthy-Fry: May I ask Mr Coates if there was any pressure from the Department to close the deal early because it was a pathfinder to prove that PFI worked?
Mr Coates: There was a mutual interest from the Trust and the Department to reach a financial close for this transaction, which we recognised as being one of the most important transactions in the PFI market at the time. I need to emphasise that the Department in its processes did encourage the Trust to come to the contract with a whole consortium. The reason it did this, it did not want to have endless different contract negotiations with different parts of the consortium. Basically a builder will promise to do the work and a banker may have a totally different view whether it is feasible or not. So we insisted that they had one set of negotiations with us so that we had one deal we could take through and knew that we could reach financial close and sign a deal on.

Q77 Sarah McCarthy-Fry: Forgive me for my ignorance, but was there any thought at the time that there could be possible refinancing in the future?
Mr Coates: We were aware of the potential for refinancing benefits to accrue from contracts such as this one.

Q78 Sarah McCarthy-Fry: If I can take you to page 2, which is the analysis of the Trust's share of the refinancing gain, how was that balanced between sharing the benefit between the Trust and sharing the benefit between Octagon arrived at?
Mr Coates: The balance was struck in accordance with the Treasury Code of Conduct at the time, which was that of deals you might say are history, 30% goes to the Trust and 70% to the consortium. New deals are 50-50. We treated the extension to the contract as in effect a new deal and therefore was 50-50.

Q79 Sarah McCarthy-Fry: You say it was a voluntary code at the time. Was there any room to negotiate a different arrangement?

[3] Ev 24

Mr Coates: Based on our experience at Dartford and Gravesham, which was the first refinancing under the code, I can assure you that it was quite difficult to convince the private sector to accept the full wording of the code because it does work against them in the way that various principles are set out.

Q80 Sarah McCarthy-Fry: Was this Octagon's first venture into the PFI market?
Mr Coates: As far as I am aware, yes.

Q81 Sarah McCarthy-Fry: So you could have sold it to them on the basis that, "If this one works and you agree a better deal, that we prove this works and you go on to get further work"?
Mr Coates: There is a secondary market in PFI transactions where people want to buy the equity and certainly there is potential for Octagon to sell their equity on after this transaction, as happened at Dartford and Gravesham, where Carrillion sold their equity to another partner.

Q82 Sarah McCarthy-Fry: So you do not feel that at the point of the refinancing there might have been an argument to go to Octagon for the 50-50?
Mr Coates: We did haggle around the share on the extension to the contract but 50-50 was the best we could do. The private sector took the view that they were living with the code and that meant that both sides had to live with the code and do what the code said.

Q83 Sarah McCarthy-Fry: Even though circumstances may have changed since the code was drawn up?
Mr Coates: The code had just been published, from memory, at the time the negotiations were taking place

Q84 Sarah McCarthy-Fry: Can I come back to the extension of the contract term and come back to the Trust. Do you not think that you have brought in a much greater risk by extending the terms of the contract?
Mr Forden: No, our analysis was very much based on the National Audit Office's methodology used for Fazakerley Prison, and on that basis it clearly demonstrates that actually there is a sensible financial decision for the Trust to take, and that is evidenced in the Report[4].

Q85 Sarah McCarthy-Fry: I am not talking financial, I am talking in terms of clinical need. With respect, a prison is not the same as a hospital. What are we going to say, with extending the terms for that length of time? If we look back over the last 20, 30 years for things that are required for the infrastructure of a hospital it is radically different now. How have you assessed the risk of whether in the service you are getting you might even have the same sort of building as the requirements you have now?
Mr Forden: That is very much why we are much better in this hospital than we were in the old hospital. The old hospital was built of an original type of construction, which is very inflexible in trying to change for patient need. The design of the new hospital is such that we can actually flex it much more simply, and that is something of which we are very conscious.

Q86 Sarah McCarthy-Fry: If we are looking to the future and we look at the new paper commissioning a Patient Led NHS, which is looking to moving much more out into the community and having less inside the hospital, could you be stuck with a building that is far too big for your requirements, which you are servicing?
Mr Forden: I think if you look at acute care over the past 50 years many times we have actually asked the question, is it likely that the number of patients will reduce? I have not seen it in any year of my analysis yet. I think it is true that some services will move into the community but there are more things that we are doing now than ever before as well, which will have to start off in the acute setting. I think it is just a cycle.

Q87 Sarah McCarthy-Fry: If you look back to your original requirements your bed requirements changed dramatically from when you first drew up the deal to when you closed.
Mr Forden: What happened originally was that it was actually that the regional office commissioned a Report to see how many beds we would need. It assumed that there would be more movement towards community hospitals, *et cetera*. They made the decision to go with the lower end of the spectrum and that has proved to be not as accurate as it should have been. The Trust's view at the time was that we needed about 950 beds and we actually have 950 beds.

Q88 Sarah McCarthy-Fry: Do you believe that that is enough now on the forecasting you are doing?
Mr Forden: Based on everything we know at the moment, yes, and that allows us also to move down to the 18-week target.

Q89 Sarah McCarthy-Fry: Back to the point, based on what we know at the moment and the point I am trying to make is that things have moved so much over, how can you be sure that what you have now is going to serve you going forward? What processes do you have in place to manage that?
Mr Forden: We try to plan our demand five years in advance. We cannot be certain that it is accurate but we have to take as best educated guess as we can, as you would in any walk of life, whether it was in a hospital or any other field.

Q90 Sarah McCarthy-Fry: To come back to my original point. One of the points that comes in the book is that the Report says that you received a

[4] *Note by witness:* The methodology of the Prison Service's advisers NM Rothschild & Sons as set out in the National Audit Office's Report on the Refinancing of the Fazakerley PFI Prison contract (HC 584 1999–2000).

benefit earlier. By closing early you received a benefit earlier and you had the hospital quicker than you would have done. Do you have statistics to prove the clinical benefit of having the hospital earlier in terms of statistics of delivering patient needs?
Mr Forden: We have treated an extra 23,000 patients more each year now than we could in the old hospital in real terms, and that is about a 20% increase. We have reduced our waiting list lower than 10,000 for the first time in 15 years. So I believe that there are real clinical benefits, and we are actually delivering a wider range of services than we ever could as well. We are now moving towards things like interventional cardiology, *et cetera*.

Q91 Sarah McCarthy-Fry: I accept the second part of your point. The first part of your point, how do you know that it is the new building that has delivered those additional 23,000 patients and not additional nurses, additional doctors?
Mr Forden: Because we know how many beds we would have needed to be able to do that and we know the types of beds and the types of layouts, *et cetera*, we required, and that is on what we made that analysis.
Chairman: Thank you. Greg Clark.

Q92 Greg Clark: Mr Forden, did you follow national guidance from the Department of Health on how many beds you would need when you were planning this project?
Mr Forden: I know that the regional office gave us guidance as to how many beds they believed we would need, and that was clearly indicative of the guidance from the centre.

Q93 Greg Clark: So it was in conformity with guidance, and then you found that you needed 40% more beds. Did the guidance change?
Mr Forden: No, I believe what had was that there were a number of assumptions made in the Report for the regional office. Some of those came to fruition, some did not, but there were also changes in policy at the time which changed. Trying to reduce waiting lists, *et cetera*, was not in the original guidance and that was something that started to come along. Also the actual change in the population of Norfolk is changing constantly.

Q94 Greg Clark: These policy changes had a big impact because you had to pay one-fifth more in terms of your annual charge as a result of these changes, did you not?
Mr Forden: We certainly had to pay more. We paid one-fifth more for a 40% increase in beds, yes.

Q95 Greg Clark: A major component. Can I ask Mr Coates, has additional capacity been added at other PFI hospital projects because of a new commitment to reduce waiting lists that was not around at the time?
Mr Coates: I feel certain that there has. I do not have details with me but from memory this is the largest variation to a PFI hospital that I am aware of.

Q96 Greg Clark: Mr Coates, would you mind writing to the Committee perhaps with a full account of all the variants for PFI projects up and down the country that have been caused by an increase in the number of beds?[5] Because we have seen that there has been a big increase in the cost here and I imagine that is the case around the country and I think it would be interesting for the Committee to know how much the Department of Health is responsible for increasing unnecessarily the annual bill for these things. We know from this Committee that variations to contracts once they have been let tend to be very expensive, and this seems to be an example which, through no fault of the Trust, the Department has caused some increasing costs. If you can provide us with that note?
Mr Coates: I can provide you with a note but, as I say, I think this is the most exceptional and large one that I am aware of.

Q97 Greg Clark: That is helpful to know. Are you expecting any changes in the guidelines coming up? Do you think that the recommended number of beds for new PFI projects is now right or is that something that you are reviewing?
Mr Coates: Bed numbers within PFI hospitals are not set by the Department of Health, they are set by the local health economy. They may, for example, take independent Reports on trends and development trends, *et cetera*.

Q98 Greg Clark: But you were given guidance on the type of provision they should make, I assume?
Mr Coates: We have just started checking or looking at OBCs, which are Outline Business Cases, which are the statement of need Trusts state for a new hospital. That goes to our capacity people who check to make sure that the assumptions—

Q99 Greg Clark: You have started, but that has not been done before?
Mr Coates: No, up to that point it was left to the local health economies.

Q100 Greg Clark: So there was no guidance from the centre as to what the new capacity should be in PFI hospitals?
Mr Coates: There was no central guidance I am aware of on exact capacity, no.

Q101 Greg Clark: Can I ask about the building costs inflation? If we turn to paragraph 2.21 of the Report, which is on page 17, we see that the construction costs inflation in public sector work has been much higher than the increase in general retail prices. Indeed, the RPI has increased by 18.5% and public sector construction has increased by 49.2% during the same period. Why is that?
Mr Coates: The note in figure 16 attributes this to high recent construction inflation costs caused by large purchase of materials from certain overseas countries and a large demand from government building projects.

[5] Ev 19

Q102 Greg Clark: So there are two explanations for that. One is a general effect that one might expect to see in building costs generally, and that is reflected, I think, in the BMI index, which has increased by 22%, but we find that public sector, particularly PFI building projects, has increased by at least twice or building costs have increased in the country as a whole. You say that this is because of the increased demand for PFI; does that mean that there has been so much money chasing so little capacity that the government has been getting less and less value for money?
Mr Coates: As figure 16 points out, there is an element where the supply side or demand side has caused inflation.

Q103 Greg Clark: Can we just be clear on that point? The fact of PFI schemes has itself caused the cost for these schemes to rise?
Mr Coates: No, I think the note says general government contracts, not PFI contracts; it is saying that there has been an increase in demand from the government in terms of building contracts and that has had an impact on the indices.

Q104 Greg Clark: If we look at PFI projects in particular—and in this one in particular—there has been an increase of well above the general public sector increase; why is that the case?
Mr Coates: We have been looking at these indices and why they are changing as part of our analysis of the Report by the NAO and what we have concluded is that the BMI index is a maintenance index and therefore inappropriate when looking at major construction projects. The MIPS index is an index of public sector building projects. It is derived from DTI-based data but it is specific to the NHS; but it excludes PFI contracts. So the MIPS data is one of general traditional building contract prices.

Q105 Greg Clark: Do you expect to find that PFI contracts have been increasing more or less than MIPS?
Mr Coates: A good question. We then turned to the Royal Institute of Chartered Surveyors and looked at their indices and this showed that their BCIS index, which is the general tender price index for all contracts, including PFI, public sector, *et cetera*, have risen in line with the MIPS. Theirs have gone up by 41% and MIPS have gone up by 49%.

Q106 Greg Clark: So in general it is the case that where the government is spending the money inflation for building is high; where it is the private sector, spending the money not for government contracts, then it is much lower?
Mr Coates: No. The BCIS index includes all contracts, including PFI contracts, for the governments.

Q107 Greg Clark: I am not worried about that; I am comparing that to the BMI index, the general construction.
Mr Coates: The BMI index is one of maintenance.

Q108 Greg Clark: What is the relevant comparator for private sector construction costs that have nothing to do with taking money from the government?
Mr Coates: We believe that MIPS or BCIS is relevant in terms of PFI.

Q109 Greg Clark: So MIPS or?
Mr Coates: Or BCIS index, the RICS index that I just talked about a minute ago.

Q110 Greg Clark: But that includes government projects, you said?
Mr Coates: It includes all projects.

Q111 Greg Clark: I am looking for a comparison between what has happened to construction inflation where the government is paying for it and what has happened when it has nothing to do with the government. Do you have no comparison of that?
Mr Coates: No.

Q112 Greg Clark: Do you not think you ought to?
Mr Coates: The point I am trying to make is that if you map out indices that include and exclude government or PFI they are about the same.

Q113 Greg Clark: Can I ask the NAO about this because this is another feature that comes out in the helpful Report that Mr Trickett found. It says that the Report does not explain why the public sector MIPS has risen so much faster than BMI, nor why PFI costs have increased so dramatically more in the economy as a whole. This goes to the heart of the issue if we are looking at value for money here and we want to know whether this project has proved value for money. It seems on the face of it that the inflation in public sector building has been an extraordinary amount and Mr Coates admitted that this is because of the increase in supply of PFI contracts. This seems to me to go to the heart of it. Mr Coates is going to write to me with some of the specifics, but perhaps the NAO could give us an analysis of this comparison between what happens to the costs when the public sector bills it versus other sectors.[6]
Mr Burr: Yes, we will certainly provide that.
Greg Clark: Thank you. No more questions, Chairman.
Chairman: Thank you very much. Helen Goodman.

Q114 Helen Goodman: I would like to ask the Chief Executive of the Trust a couple of questions first. Do you have a deficit at the moment?
Mr Forden: In the last five years' accounts—and they are the only five I have looked at recently—there was no deficit within the Trust.

[6] Ev 25–26

Q115 Helen Goodman: If a deficit were to appear would you be able, under the PFI contract, to cut services in order to meet your financial obligation to break even?
Mr Forden: We would not be able to reduce the costs we pay for the building, the rent or the mortgage, that we would wish to see. We would not be able to reduce the costs of the hard facilities management. We could potentially reduce some of the cost of the soft facilities management but we would have to reduce our capacity in accordance to do that.

Q116 Helen Goodman: So in the event of a deficit the PFI contract would be protected and it would be other areas of service provision to which you would have to look to make savings; is that correct?
Mr Forden: That is correct.

Q117 Helen Goodman: I would like to go back to follow up some of the points that Mrs McCarthy-Fry was making, and I would like to address these to the Department of Health, please. I did not quite understand when you were talking about the code of conduct, was that a voluntary code or a mandatory code?
Mr Coates: It was a voluntary code; it is called a voluntary code but the reality is that would only participate or agree to refinancing as much as we can to protect ourselves if the code was adhered to.

Q118 Helen Goodman: Are you saying that when you initially allow a Trust to make a PFI agreement the provision for a split in the event of refinancing is not written into the original contract?
Mr Coates: That is right.

Q119 Helen Goodman: Even now, even after this experience?
Mr Coates: The refinancing has happened and that is facilitated by an addendum to the contract to allow the share to happen.

Q120 Helen Goodman: I understand that, but my question is you know that a refinancing has happened in this case; you know that it has produced results which are very controversial, but have you written in to subsequent contracts the share that would be agreed in the event of refinancing?
Mr Coates: Yes.

Q121 Helen Goodman: I would like to ask a question to the Treasury Officer of Accounts, if I could, which is: have you considered shifting the 50-50 split even further in favour of the taxpayer?
Mr Glicksman: The 50-50 split was negotiated with the industry just four years ago now and we have published it and applied it to all PFI contracts since then. I do not think that we have had any experience of refinancings under that 50-50 split, so I do not think we have had any experience on which to consider changing it.

Q122 Helen Goodman: And there is no current review of the 50-50 split? You are happy that if another refinancing occurs you will continue with guidance to departments on a 50-50 split?
Mr Glicksman: We would obviously review whatever experience came forward. Our minds are not closed but we have not had any further refinancings under that arrangement.

Q123 Helen Goodman: Fine, there is just one point I would like to correct earlier just so that we have got that on record, if that is possible. Although Octagon themselves have not previously done a PFI deal, looking at Table 4 on Page 6, ABN Amro, who are one of the major partners, had been involved nearly three years before so there was some prior experience. I would just like to place that on the record if that is possible. Finally, I would like to ask a question of the NAO which comes back to the points that Mr Trickett was raising. In Table 2, Note 1, why was the test discount rate 18.94%? Why was that test discount rate used here? Why was it discounting using 18.94%, which was the internal rate of return for shareholders and not the standard test discount rate of public sector investment?
Mr Finlay: In that respect it follows the Treasury guidance and the intention was to compare with the return that the shareholders originally expected. That is a very clear explanation. The method of calculation is set out in Treasury guidance. It is effectively calculating refinancing gains using as a comparison the rate of return that the shareholders expected at the outset. You have to use some discount rate and the Treasury consider that that is the most appropriate rate.

Q124 Helen Goodman: Why do they want to use the internal discount rate of the shareholders for these PFIs when they are not using that discount rate for other pieces of public sector investment or for measuring other long-term future costs?
Mr Finlay: Because it is a different type of calculation. The other calculation you are referring to, where a discount rate is used at the moment of 3.5% in real terms, is used for calculating investment flows which the Government is going to enter into. This is a different type of calculation. This is essentially about the benefits to the private sector from refinancing and so it is not unreasonable that the test is by reference to their own particular expected rate of return.
Mr Glicksman: Would it be helpful if I comment? As Mr Finlay said, what we are looking at here is quite different from comparing an investment through one route with another route. What it is doing is trying to look at how the returns from the financing should be split between the two parties, so for that purpose it is more appropriate, we have felt in our guidance, to use the rate of return that was originally expected in the contract in order to divide up the returns between the two parties.
Helen Goodman: Could I just make another comment or ask another question which is I do not fully understand why you take that view and in particular I would like to challenge it because this

internal rate of return is much higher than the private sector's internal rate of return across the economy as a whole, so using that one does seem rather strange.

Q125 Jon Trickett: It is generous.
Mr Glicksman: It is this one because this was the one that they were using for this particular contract when we signed up to it in the first place. For another contract it would be a different figure. It would be the figure that was proposed for that contract. So we are using the figure that was proposed for the contract and we are looking at it on the refinancing, and the impact of using different rates of returns is to change the way in which sums received earlier on and sums received later on in the contract are evaluated. That is the impact of using a different rate of return.

Q126 Helen Goodman: I understand that but it does make it quite difficult for the Committee of Public Accounts to compare projects if different numbers are being used.
Mr Coates: Having been involved in discussions about the code and the numbers, this is an area where there is no science to it. It is simply the higher the discount rate you choose the better the benefit is to the public sector because it values gains more highly that way. If I may suggest, we will provide you with a note of what it is at 18.94 to demonstrate that forcing the private sector to use a high rate benefits the public sector because the cash yields are deemed to be higher.[7]
Chairman: Mr Davidson?

Q127 Mr Davidson: Could I ask Mr Forden if you had known at the time you were signing the deal what you know now what would you have done differently?
Mr Forden: I would have tried to ensure that my colleagues knew the same as I know now in the Treasury and Department of Health, that we could renegotiate it to a higher share of the split.

Q128 Mr Davidson: Can I just clarify the extent to which you and the Trust had any veto over the refinancing?
Mr Forden: We could have objected to taking on the potential higher liability and that would have limited the amount of refinancing.

Q129 Mr Davidson: It does strike me that you have not played your hand as well as you might have in this regard because, as I understand it from the Report we have here, Octagon, which is John Laing and Serco and these other people, were receiving in the run-up to the refinancing less than the 18.9% surplus that they had anticipated and that you agreed to a deal which allowed them to move up to 60% of a surplus from the position. Now, if you had the opportunity to block that, it does seem to me you did rather have a stronger hand than it might appear from the deal that you ended up with. Can you just clarify that for me?
Mr Forden: Unlike Mr Trickett, I like to look at the cash and our cash payments have actually gone down. Whether the shareholders got 60% or 100% or 3% our cash payments went down, so that was good news for the Trust. The maximum we could get was very much governed by the guidance at the time. The guidance at the time was 30% and 50% on the extension. So we actually got as a trust as much as we possibly could by following the guidance.

Q130 Mr Davidson: Can I be clear then about that. I accept that you got a better deal than you had before but you could have got a better deal than you had before by getting sixpence off the amount you are paying. You are saying to me you would have taken anything. If you had the opportunity to block the deal why is it that you got such a small benefit and they got such a big benefit?
Mr Forden: The maximum we were able to go for as a trust was the 30%.

Q131 Mr Davidson: Why was that the maximum?
Mr Forden: That was the guidance at the time of the voluntary code.

Q132 Mr Davidson: That was the guidance under a voluntary code. Why was that the maximum?
Mr Forden: I think maybe Mr Coates will want to add to that but as a trust we are not allowed to set the trend for PFI deals for the whole of the NHS; we have to follow the guidance.

Q133 Mr Davidson: Have you no ambition? If you had been able to get even more of the share of the benefits you would have been even happier. Who knows, your bonus might have been even higher. I just cannot understand why you self-limited yourself in this way.
Mr Forden: As a Trust we were not able to go any higher.

Q134 Mr Davidson: Explain to you me why you were not able to—because the Department would not let you; is that what you are saying?
Mr Forden: The Department had very clear engagement with the trust in trying to deal with the refinancing. We were very much advised by the Department, quite rightly, as to what we should be able to achieve. We were able to achieve the maximum on the extension at 50-50 and 30% on the re-financing.

Q135 Mr Davidson: That was because that was what the Department was telling you was the maximum?
Mr Forden: That is because all of the guidance in the voluntary code which had been agreed between the Treasury and the—

Q136 Mr Davidson: And you regarded yourself as bound by that?

[7] Ev 20

Mr Forden: Yes.

Q137 Mr Davidson: And you had no ambition to get more of it?
Mr Forden: We had a great deal of ambition to get as much as we could. The other way of looking at it is we certainly did not get less than what we were told the maximum was.

Q138 Mr Davidson: I understand that and can I just clarify that Mr Coates. It seems to me that you were tying hand and foot the trust in terms of what the limits of their expectation ought to be. That displays, surely, a poverty of ambition on your part because here we have a PFI organisation which was making less than they expected under the existing financing arrangements and they were going to move to a situation where they were going to get triple what they were expecting. I would have thought in those circumstances you really ought to have been able to strike a better deal.
Mr Coates: It is important to look at this in the context of what was happening at the time. The first deal that went through under the voluntary code did not meet the code's requirements in the sense that we could not persuade the private sector to accept a discount rate of 18.9%. So we had to make compromises so although the code was voluntary and was signed it had not been fully adhered to in the market.

Q139 Mr Davidson: By the private sector?
Mr Coates: By the private sector, yes, so we had to approach it in a way of trying to force the code through. Rather than being ambitious we had to try and make the provisions of the code stick. In this sense this is the first deal in the NHS where the code stuck and they had to adhere to it.

Q140 Mr Davidson: I bet it was. If I were in the position of John Laing and I had the opportunity here to renegotiate something that will give me 60% profit or I stay in a position where I am earning less than the expected rate of return, and some gullible guy from the Health Service comes along and says, "Look, I will strike this deal with you, you have got to limit yourself to 60%," I would say, "Thank you very much, I will bite off your arm."
Mr Coates: What John Laing said to us was, "When we make losses you do not come to us and say here is a load of money to compensate for our losses"; so why should we give you money when we are making a profit—

Q141 Mr Davidson: Yes, I can understand why they were saying that, but this was not a question of profits and losses arising from the original deal. This is a rejigging of it and it is a rejigging which extended the period and it made a number of changes, did it not?
Mr Coates: Yes, but you cannot say to the private sector on this particular transaction you made a whopping great profit and therefore we are taking it and on all the ones you made a loss that is your look out. You have to take these things in the round. The code is in the round—

Q142 Mr Davidson: In the round, that is a good one. On how many occasions then, in the round, have John Laing, Serco, 3i, Barclays, Innisfree actually made losses on any of the constructions?
Mr Coates: John Laing Construction went bankrupt after a PFI contract. They lost £40 million and the John Laing you see here is different to John Laing Construction.

Q143 Mr Davidson: So this is a different John Laing?
Mr Coates: It is.

Q144 Mr Davidson: So the other John Laing had nothing to do with that then?
Mr Coates: John Laing Construction that built the hospital is now owned by Laing O'Rouke Construction.

Q145 Mr Davidson: And the other companies?
Mr Coates: The rest are banks.

Q146 Mr Davidson: None of them have gone bust then because they never do, do they?
Mr Coates: Banks, no.

Q147 Mr Davidson: Right, I think I understand that extent of it. Can I just clarify in terms of the potential for striking a better deal—and I can understand why you settled for this voluntary deal because otherwise they were not going to give you anything at all—again, is this the limit of your ambition? Now that PFI deals are well stabilised and the risks are much more understood, you are quite happy to settle for a maximum of 50%, are you?
Mr Coates: I do understand the point you are making but I take the view that you have to see these things in the round and there is plenty of evidence in the private sector that they are not all making very handsome profits, and we cannot say to them the moment you make a profit we want to share it with you and when you make a loss it is your look out. We have to say in the round how can we share the benefits on something that sounds sensible, sounds equal and has equity about it? I think 50-50 sounds about right in these situations.
Chairman: Thank you, Mr Davidson. Alan Williams?

Q148 Mr Williams: Can I just ask the National Audit Office was this Report financed out of the value for money budget that you have?
Mr Burr: This study—

Q149 Mr Williams: Yes?
Mr Burr: Yes.

Q150 Mr Williams: Why is this not a value for money Report?
Mr Burr: It does not attempt to say categorically whether this was value for money but it does identify a number of risks to value for money.

Q151 Mr Williams: That is what the value for money budget is for. That is what we gave it to you for and that is why we increased it from 50 Reports a year to 60 Reports a year. Why do we not have a value for money assessment in relation to this project?
Mr Burr: We do identify a number of the risks so in that sense it is a value for money Report, for example, the fact that there was no provision for sharing in refinancing gains and that clearly prejudiced value for money.

Q152 Mr Williams: But you were not able to conclude whether it was or was not value for money?
Mr Burr: I think it is always difficult to do that with a deal of this kind because you are comparing it with something that did not happen and therefore it is difficult to quantify precisely.
Mr Finlay: Can I add to that. This particular Report developed out a piece of correspondence raised with us by an MP focusing on specific aspects relating to the refinancing, so it did not start out as a complete examination of all aspects of this deal. It focused on the specific issues which were raised with us. Having completed that piece of work we felt this was a Report which should be presented to Parliament, but it started out as a piece of work answering particular questions which were posed to us.

Q153 Mr Williams: Mr Forden, you were not there at the time and I know it happened before you were in office, but do you think in hindsight it was very clever to modify a contract part way through because our experience has been that modifying contracts in the middle of the contract means that you are over a barrel and you virtually have to take whatever terms you are offered?
Mr Forden: I am a great believer in future-proofing especially buildings because it is so difficult to change them later and it is always much more expensive than if you did it in the first instance. Saying that, the trust did take advice from the advisers to demonstrate that had the trust actually built the building the way it finally ended up, it would have been in line with the original financing. The additional construction costs were not so different from the original deal that we actually lost out.

Q154 Mr Williams: I know we came across a case that looked appalling in Northern Ireland where a new hospital was built and as soon as it was built the X-ray department was demolished and a new X-ray department was constructed. We came here as a Committee (although not this particular membership) ready to chase them round the room for doing anything so absurd and they were able to demonstrate to us that it was cheaper to complete the existing contract and then negotiate in a completely free position for subsequent contracts. Is there anything to suggest, despite what you have just said, that you might have got a better deal if you had done that?
Mr Forden: No, if you actually visit the hospital, the way the extension has been done is very much an integrated part of the whole building. It is not a separate building that has been built. It is part of the whole infrastructure of the unit. My personal belief is that was the right thing to do at the time which was to build it as it was needed for the demand then and the demand as is now.

Q155 Mr Williams: This contract has been an absolute cash machine as far as Barclays, 3i Laing and Innisfree are concerned. The trouble is it is a cash machine where they have drawn out someone else's money. Have they been eager participants, can I ask the Department, in subsequent contracts?
Mr Coates: 3i are not as far I am aware bidding for any other PFI contracts at present. All the other investors are still active in the PFI market.

Q156 Mr Williams: Thank you. This was an early contract and we recognise that there is a degree of testing the water and so on in the early phase, and this was accepted by us when PFI first came before us, but looking at this particular project, as it was one of the early ones, what are the key lessons you think the Department has learned from it and how far have they applied those lessons to future contracts?
Mr Coates: I think for this particular contract what being Head of the Private Finance Unit in the Department I felt I learned is that perhaps we could be more pushy on the private sector and try and push them along more quickly in what they are trying to do and try and make them be less lawyer and bank driven than they are at present.

Q157 Mr Williams: That answer rather worries me because it sounds rather like an off-the-top-of-my-head, what-the-hell-do-I-say-now reply than an example of systematic analysis of something that was a bit of a financial debacle. Did you analyse what had happened, what had gone wrong, and what could be done differently?
Mr Coates: This particular contract in terms of outcomes is a fairly good example of a hospital building contract. It has won awards for design and in our view in terms of does it deliver a good product and a good-quality product it does do so.

Q158 Mr Williams: Why has the Department stuck on the 30-70 formula? When I first started raising questions about refinancing I put a question down to every department and the NAO then on the basis of all the answers I received produced a Report on refinancing. Why have you stuck on the 30-70? Why have you not pushed for 50-50 because it is still a good deal as far as the contractor is concerned?
Mr Coates: As I said, at the time the code was being applied to this contract, it had not stuck.

Q159 Mr Williams: I understand that was the case then but you are still applying 30-70 now.
Mr Coates: Only to contracts that have been signed already. New contracts are 50-50.

Q160 Mr Williams: They are 50-50? Since when?
Mr Coates: Since the code was produced.
Chairman: I think there are a few supplementaries from Mr Bacon.

Q161 Mr Bacon: Mr Forden, it is true, is it not, that under the contract that you originally had there was no legal obligation on Octagon to pay you anything so it had to be done, as it were, by negotiation and persuasion? That is right, is it not?
Mr Forden: That is correct.

Q162 Mr Bacon: Mr Coates, as far as the way in which the hospital took its gain of £30 million or so, the 30%, it is true that they took the gain over the life of the contract because that was the guidance from your Department, was it not? That is correct, is it not?
Mr Coates: That is the guidance from our Department, yes.

Q163 Mr Bacon: Octagon took its gain in a lump sum upfront. It is interesting to see the instinct of the private sector is to take a lump sum of cash when they get the chance, and Mr Forden said he liked cash, but the hospital's guidance from your Department was to take it over the life of the contract. What is it that the private sector know about taking cash upfront that you do not? Have you never heard the expression "cash is king"?
Mr Coates: I have heard that expression and what the private sector are doing by refinancing, as you rightly observed earlier, is reducing some of the risk for the contract. They are turning uncertain profits into certain profits, so they take it as cash.

Q164 Mr Bacon: But surely whether in the private sector or the public sector, given the choice between having a large lump of cash and not having a large lump of cash, most people would go for the first, would they not, in the public sector as well?
Mr Coates: No, I do not believe so.

Q165 Mr Bacon: You do not think so? Not the Department of Health obviously.
Mr Coates: No, the issue is whether the trust is protected from losing that benefit if they take it over time.

Q166 Mr Bacon: Yes indeed and if Octagon were to fail—and by the way you said there have been no defaults so far over PFI; try telling that to any of the school teachers in Norfolk with the Jarvis negotiations where the county council managed to lose nearly £2 million, which may not sound a lot in PFI terms but it is equivalent to the budget of a primary school in my constituency for eight years and a huge amount of time for governors and so on, and then a big argument about who owns the intellectual property for the designs of the schools, mostly dreamed up by the governors and the teachers and the parents themselves rather than by Jarvis who did not actually do a whole lot—if Octagon were to fail, and let's hope it does not, and Mr Forden had had his lump sum of cash upfront there would be no argument about it, would there; possession is nine-tenths of the law, but if Octagon were to fail and he had not had his lump sum upfront then he must necessarily have less protection than if he had already had it? Is that not the case?
Mr Coates: I do accept that. The best response I can give to you is—

Q167 Mr Bacon: You already have. You have accepted my point.
Mr Coates: If I may, if the trust had taken that lump sum gain and Octagon had borrowed the money to pay the lump sum to the trust, so the trust got £34 million and Octagon borrowed £34 million to pay the trust that money, but Octagon then went bankrupt, the trust liability would then be for—

Q168 Mr Bacon: Are you suggesting that Octagon was at risk of going bankrupt if the hospital had taken its lump sum upfront in the way that Octagon took its own lump sum upfront?
Mr Coates: No, I am not suggesting that.

Q169 Mr Bacon: That is what it sounded like.
Mr Coates: I am not saying that. If you follow your train which is to say if Octagon went bankrupt, what would happen, if the trust had insisted that Octagon borrowed the money to pay the lump then that would have been an additional liability that the trust would have had to pay to the bank on termination.

Q170 Mr Bacon: It would already have had the money to do that so it would not necessarily have made any difference.
Mr Coates: If it was three years later then they would not have had the money any more.
Chairman: I am afraid that is your 15 minutes up, Mr Bacon. Helen Goodman?

Q171 Helen Goodman: In response to Mr Bacon, Mr Coates, you just said that the impact of re-financing was to reduce the risk faced by the private sector. My understanding of the basic principles of the PFI framework is that it is about risk sharing between the public and the private sector. If the risk to the private sector has fallen should it not therefore be the case that the returns that they get should also fall?
Mr Coates: Ordinarily yes, but the risks still faced by the consortium are the same post and pre-refinancing.

Q172 Helen Goodman: Sorry, that is not what you said a minute ago so could you just elaborate on that?
Mr Coates: What I meant by saying that they are around the profits is that profits in the future are uncertain. You cannot be certain you will make those profits until they are crystallised. By taking a lump sum refinancing gain you bring forward those profits and you take them in advance. The overall basket of risks that the consortium manages post or pre-refinancing is the same.
Helen Goodman: I see, thank you very much.
Chairman: Mr Davidson?

Q173 Mr Davidson: Mr Coates, I wonder if I could just follow up the point you made earlier on about taking this thing in the round in terms of gains and losses and so on and so forth, this swings and roundabouts argument. Could you just clarify for us if not now later on some evidence that demonstrates that this 60% surplus that this contractor was getting is balanced by an equivalent amount of losses by participation in other things. I am very struck by the idea that now so much experience has been gained by PFIs that maybe the level of risk is substantially down and that not only should that affect the 18.7% or so surplus that is being built into this contract so that overall these rates should come down but so the 50% to the public sector should go up.
Mr Coates: The only examples I can give you where risks have materialised beyond the Laing one is Sir Robert McAlpine's have lost over £100 million on the Dudley PFI contract and there is a Report in the *Construction News* this week that a Japanese construction firm Kajima have lost £80 million on a PFI contracting in schools and they are pulling out of that market.

Q174 Mr Davidson: That is two then, is it?
Mr Coates: Those are the only two I have today.

Q175 Mr Davidson: How many PFIs are you aware of? There must be hundreds of them so two out of 100 or so is pretty—
Mr Coates: About 100, yes.

Q176 Mr Davidson: I want therefore to come back to this swings and roundabouts argument, separating the sheep from the goats (and I am never quite sure which one you are after) but the swings one, where they make inordinately high amounts of money, seems to be much greater than the roundabouts one, which is where they do badly. In those circumstances is it not fair for us to think that 18.7% is unduly high and 50% gains from refinancing is unduly low?
Mr Coates: Those are the only examples I have for you today of risks materialising and gain. I will have to come to you in a note about other examples of risk.
Mr Davidson: I would be very interested, Chairman, in getting something back about trying to balance this issue of swings and roundabouts or "in the round", or whatever other cliché we have, in order to demonstrate whether or not 18.7% and 60% are reasonable.[8]

Q177 Jon Trickett: On the building costs inflation, which actually was commented on by the consultants, I want to go back to Mr Coates. I think you gave us two figures, one was a 49% increase in costs for PFI schemes and then you quoted another index, either the RBI or the RICS index and that was 41%, but the 41% included the PFI schemes, so my understanding of maths is that if the PFI schemes are running at 49% and they are included in the lower figure, the RICS figure, that would have dragged the average up to a higher point and therefore one assumes that if you take the PFI schemes out of the industry-wide index that you just used, it would be much less than 41%, would it not, because the mathematics are such that it can be nothing else but that, therefore it is a false comparison, is it not?
Mr Coates: I am afraid I cannot that question.

Q178 Jon Trickett: You must understand the basic principles of maths just as I do and anybody else around this table. If you put a figure and it is 49% as part of an aggregate figure which is lower, we are talking about averages, it follows as night follows day that the 41% would be lower for the rest of the building sector outside of the PFI, does it not?
Mr Coates: What I said was that the mixed increase does not include PFI contracts. It does not include PFI contracts, it is just ordinary government building contracts and that is 49% of the relevant—

Q179 Jon Trickett: So it is even worse. Nevertheless, the government contracts are increasing by 49%. That is a rate of inflation of building costs?
Mr Coates: Yes.

Q180 Jon Trickett: The other index which you used which you said was broadly comparable was 41%?
Mr Coates: That is right.

Q181 Jon Trickett: That includes the 49% does it not and therefore the 41% would not be so high if it did not include government contracts, would it not?
Mr Coates: Yes.

Q182 Jon Trickett:—which suggests a wider division or disparity between the two rates of inflation. Now I know that the NAO said they were going to give us a note on this, but I would expect really that given the fact that the consultants had drawn the attention of the NAO to this that some answer might be provided to us today. The fact is that for some reason or another the private sector builders are charging much more to public sector contracts than they are to private sector contracts in terms of the rate of inflation. That is what is happening, is it not?
Mr Coates: I cannot positively answer that question because I do not know what makes up the 41% and what makes up the 49%.

Q183 Jon Trickett: Except you introduced the figures to the Committee. You brought the evidence to us. I am no mathematician but even I understand that the logic of what you said was that private sector inflation in terms of the building costs is running at less than the public sector but probably we will look at that when the figures come back to us.
Mr Glicksman: Chairman, would it help if I commented on this. There are quite a lot of different statistics on tender prices for different sectors of the economy, public sector, private sector, and different bits within the public sector such as road construction and other sorts of construction. There are quite wide divergences. It is not the case that all public sector comes in at a high level and private sector comes in at a low level. There is a quite wide divergence of indices.

[8] Ev 20–21

Jon Trickett: It is precisely for this reason, Chairman, that we wanted a value-for-money Report because all we have got in front of us is information that appears to indicate two rates of inflation in the construction sector, never mind refinancing, and what was required was an objective analysis on value for money terms on what was in front of us, and that is precisely what we have not got.

Chairman: You want to ask for a note, Mr Bacon?

Q184 Mr Bacon: Very quickly, yes, if I could Chairman, if the hospital could provide a note on the average occupancy of the hospital, in your experience, compared with what the occupancy was designed to be, because I am interested in understanding more about the stresses and strains on the hospital and on the Norfolk health economy more widely.

Mr Forden: I can answer that question now if it would help. Both were 90%. We are averaging around 90.5% and the business case set out for 90%, so it is very close.

Chairman: Thank you very much. That concludes our questioning. To sum up, Octagon have achieved a refinancing gain of £116 million in present value terms. It did that mainly by just increasing its borrowings by 53% which provided cash to the shareholders to give a rate of return of 60%. I know this was an early PFI project but I never want to see an Accounting Officer appearing before this Committee defending what I believe to be the unacceptable face of capitalism in relation to the public sector.

Supplementary memorandum submitted by the Department of Health

Question 20 (Chairman): Withdrawal of funding by Octagon

The Department, in general discussions with industry, has been told that a proportion of the funds released by refinancing deals would be used for bidding and investing in further projects. We understand that this has been repeated, by consortia, before various committees.

The shareholders of Octagon are (as noted in the Report)

3i Group plc	25%
Barclays Infrastructure Limited	25%
Innisfree Partners Limited	25%
John Laing plc	20%
Serco Investments Limited	5%

The refinancing was completed in December 2003. Since that time, the shareholders have been involved in the following hospital bidding situations

	Health PFI schemes bid unsuccessfully or still in competition	*Health PFI schemes bid successfully*
3i Group plc	None	None
Barclays Infrastructure Limited	Newton Abbot—still in competition 2 Local LIFT projects—still in competition Frome—Unsuccessful Billericay—Unsuccessful	Avon & Western Wilts—contract signed Lewisham—contract signed Lymington—contract signed Oxford Radcliffe Churchill—not reached contract signature yet 10 Local LIFT companies
Innisfree Partners Limited	Walsall—still in competition Wakefield—Unsuccessful	Sherwood Forest—contract signed Hinchinbrooke—contract signed Taunton—not reached contract signature stage yet Essex Rivers—not reached contract signature stage yet St Helens—not reached contract signature stage yet Barts & London—not reached contract signature stage yet
John Laing plc	Maidstone & Tunbridge Wells—still in competition	Newham Healthcare—contract signed Kingston—contract signed

	Health PFI schemes bid unsuccessfully or still in competition	*Health PFI schemes bid successfully*
	Northern Batch—Unsuccessful	Newcastle—contract signed North Staffs—not reached contract signature stage yet Leicester—not reached contract signature stage yet Barts and the London—not reached contract signature stage yet
Serco Investments Limited	None	None

Question 96 (Mr Greg Clark): Impact of the variations to PFI contracts caused by an increase in bed numbers (and/or associated clinical services provision)[1, 2]

Trust	*Unitary fee at Financial Close £000s*	*Revised Unitary Fee £000s*	*% change*	*Reason*
Worcestershire Acute Hospitals	19,399	22,280	14.9	Additional services extended to Newtown Site, Additional Equipment and other design and building changes required by the Trust.
Luton & Dunstable	1,021	1,139	11.6	Provision of an additional ward.
Barking, Havering & Redbridge Hospitals	31,003	32,653	5.3	The increases were caused by: a new coronary care unit creating additional capacity for ITU & HDU beds; a 60-bed emergency ward as a reserve to accommodate future pressures on bed demand. Other minor variations such as increased cot space and an additional bunker for a linear accelerator.
Norfolk & Norwich	28,401	29,788	4.9	Variations for provision of additional 144 beds; other variations including additional renal and cardiology facilities. In 2003–04 a refinancing of original deal led to a £1 million reduction to the Unitary payments for a 30 year period. Variations on soft FM services. The revised fee is 2005–06 forecast fee and includes indexation increases.
St George's Healthcare	7,327	7,629	4.1	The increase was due to an additional cardiac theatre, 12 cardiac beds, hot laboratory and additional ITU pendants.
Berkshire Healthcare	4,020	4,151	3.3	Contract variation to include relocation of Reading PCT intermediate care beds.
Wandsworth PCT—Queen Mary's Roehampton	9,700	9,840	1.4	Variations for inclusion of a Burns Dressing Clinic, amendments to Trust Equipment Specification due to changes in technology (under Managed Equipment Service) and minor design changes. Figures are Trust estimates as the revised financial model has not yet been agreed.
Northumbria Healthcare—Hexham[3]	4,193	6,773	61.5	The third and final phase of the Hexham general hospital reconfiguration was always planned within the original business case and, whilst likely to proceed as a variation rather than a new PFI, is therefore not a conventional post-contract variation per se. The variation comprises a Primary Care Centre; an Education Centre; a 10 place assessment/ treatment unit to the Emergency Care Centre; a 30 bed in-patient ward; a Chronic Disease Treatment & Management Centre and a Laparoscopic Surgical Training facility.
South Tees Acute Hospitals	30,000 (first year's UP includes the variation.		5.6	£1.6 million variation for cardiothoracic facilities (wards and high dependency Unit). This was reflected in the first Unitary payment made by the trust.
Calderdale & Huddersfield[4]	Non recurrent increase from 14,326 to 14,786 (see 4 below)		3.2	Cancer Unit.

1. This information is collected from NHS Trusts.
2. The information above sets out the increased unitary payments (UP) arising from the provision of additional physical capacity (ie arising from a capital investment and associated facilities management costs—eg maintenance & cleaning). There are more instances where increased patient throughput, staff residences etc have led to an increase in the UP but these do not appear on this table but are presented to the HSC.
3. This proposed £25 million variation has yet to be approved by the Strategic Health Authority and the Department of Health's Capital Investment Branch. Quoted unitary increase is from existing forecasted payment in 2008–09 to fee once new phase is operational in the same year.
4. The new cancer unit, costing around 500k, was paid for by the Trust. However, Macmillan Cancer charity reimbursed the Trust for the capital cost of the cancer unit and there were no further services or service costs involved for the Trust.

Question 126 (Helen Goodman): Example of different discount rates and the benefits for the public sector

The Code of Conduct recommends that that discount rate should be equivalent to the base case shareholder internal rate of return (IRR). In the case of the Norfolk & Norwich this was 18.94%.

Applying a discount rate of 18.94% per annum to both the pre and post refinancing equity cash flows, produces a refinancing gain (ie the difference) of £115.501 million. The Trust was then entitled to a share of this gain.

Applying a discount rate of 3.5% per annum real to the two cash flow series, produces a refinancing gain of £47.163 million. Again, the Trust would only have been entitled to take a share of this gain.

The variation in the refinancing gain can be explained by looking closely at the profile of the two cash flow series.

In the pre-refinancing scenario much of the shareholder return was at the end of the concession. Discounting these equity cash flows at a high discount rate means that their present value is relatively low. Using the same high discount rate to the post refinancing cash flows has a dramatically different effect. The shareholders have exchanged returns in the future for up-front returns. The acceleration of shareholder returns means that these amounts are relatively unaffected by the high discount rate.

	Pre-refinancing	*Post refinancing*	*Refinancing gain*
Present value at 18.94% of the distributions occurring after December 2003	£35.372 million	£150.873 million	£115.501 million

Applying a low discount rate (3.5% real) to the pre-refinancing equity cash flows, and the present value of the back ended returns is maintained at a high level. In the post refinancing scenario the accelerated returns paid up front when combined with the ongoing but lower future returns still exceed the previous level.

	Pre-refinancing	*Post refinancing*	*Refinancing gain*
Present value at 3.5% real of distributions occurring after December 2003	£162.473 million	£209.636 million	£47.163 million

Question 176 (Mr Ian Davidson): Details of risks for private companies involved in PFI projects

There are a number of PFI projects where significant risks have occurred for the private sector counterparties. Whilst there is no collated information, the following was collected from publicly recorded sources for the purposes of informing the Committee.

The National Physical Laboratory—A PFI contract awarded by the DTI in January 1998 was terminated in December 2004 following difficulties experienced by the private sector consortium in completing the construction to specification. The National Audit Office is currently studying how the DTI approached the project, negotiated the termination and evaluated the contractor's interest.

Press reports, including the Building magazine article of 17 June 2005 "No regrets" recorded that problems with the temperature in the facility "was the major factor in the £70 million hit that Laing took on the scheme in 2001".

The Dudley Hospital—A PFI contract was awarded to a consortium including the construction company Sir Robert McAlpine in 2000.

The National Audit Office noted in its Report Darent Valley Hospital: The PFI Contract in Action—HC 209 Session 2004–05 10 February 2005, that "Sir Robert McAlpine reported losses of £27 million in the two years to 31 October 2003". Higher figures (up to £71 million) have appeared subsequently in newspapers.

A contract to build and run an Energy Centre at the Mayday Healthcare NHS Trust in Croydon, was terminated in 2000, as the private sector consortium, which included Miller Construction failed to complete successfully the facility.

The financial problems at Jarvis plc have been widely reported. The group won up to 25 PFI contracts in the schools, local authority and smaller health facility sectors. Jarvis encountered problems with the construction on a number of those projects. In its consolidated balance sheet as at 30 September 2005, the group recorded accumulated losses of £710.8 million.

In September 2005 Mowlem announced a £70 million cut in profit and the contracts were all related to building, infrastructure and engineering, and that some of were PFI jobs.

Earlier this year it was Reported that Kajima, a Japanese construction firm was set to make a loss of £80 million because of problems on its PFI schools contracts.

In late 2003 the contractor Ballast was put into administration, after the company has lost £14.3 million in eight months to 31 August. Ballast was involved a number of PFI projects, including Tower Hamlets Schools.

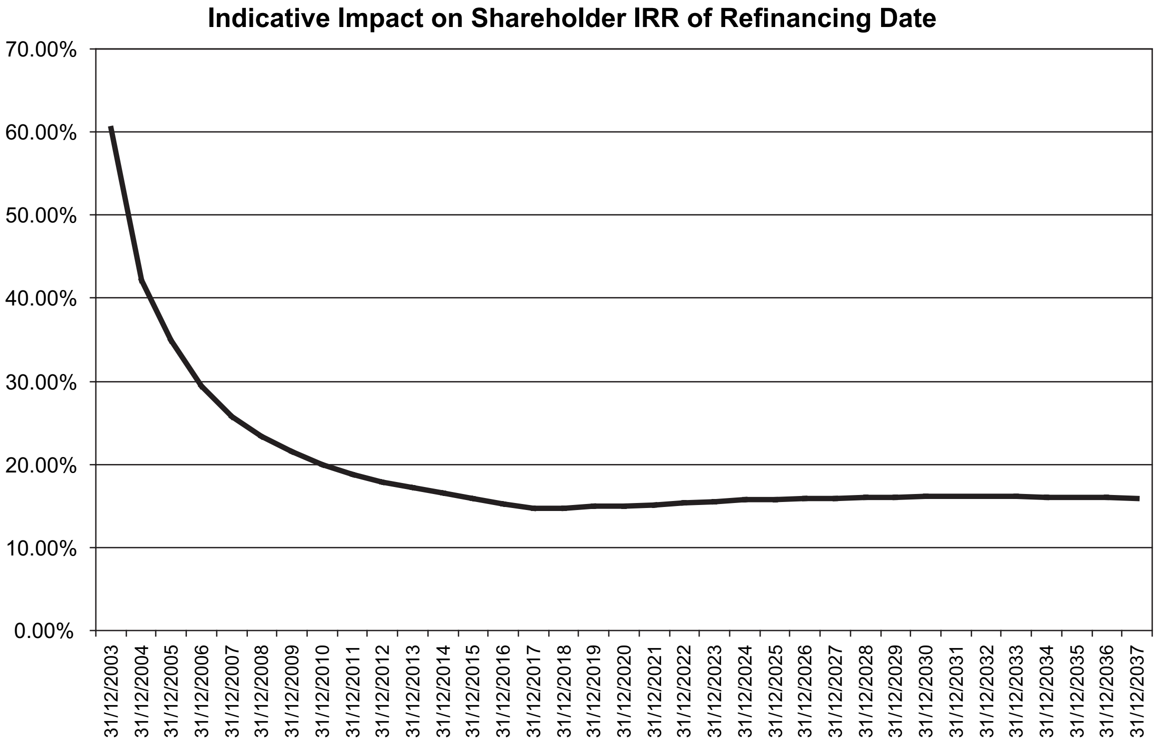
Financial and accounting problems at Amey, a PFI and outsourcing company, led to a £55 million pre-tax profit in 2001 being restated as an £18 million loss.

The Internal Rate of Return (IRR) is the rate that when used to calculate the net present value of future cash flows gives an answer of zero.

The shareholder's IRR of 18.7% was the return that the shareholders expected to generate as a result of the competitive process for the entire PFI contract. The Octagon consortium was selected because their bid overall was the best for the Trust.

The calculation of the shareholder's IRR is sensitive to the timing of the receipts. The graph shown on the attached sheet shows what the shareholder IRR would be if the refinancing was delayed.

The IRR is a product of the timing of the refinancing and as a result of the refinancing being completed in December 2003 the IRR for the shareholders is 60%. The graph attached shows that the IRR changes dramatically dependent on the timing of the refinancing.



Supplementary question from Mr Richard Bacon

Have annual "smoothing payments" in the region of £3.4 million per year have been made to the Norfolk and Norwich University Hospital NHS Trust in recognition of the accelerated rate of depreciation-equivalent incurred by the Trust in purchasing the buildings from Octagon Healthcare over a shorter period than 60 years? Please supply details, including the value and frequency of such payments and stating for how much longer these payments will be made.

Payments to the Norfolk and Norwich University Hospitals NHS Trust under the "smoothing monies" initiative started in financial year 2003–04. The amount was £3,778 million, a fixed annual amount, never inflated, which was paid in full up to 2005–06 (see the attached spreadsheet). The initiative was introduced for a number of the early PFI projects due to the effect on affordability which arises from the difference between the length of the primary contract period, which was typically 25 to 30 years, and the expected life of the asset generated under the project, which is usually 60 years.

In PFI deals the private sector partner will plan to recover the full capital cost during the primary concession period whereas an equivalent public sector scheme would depreciate the asset over 60 years (ie pay the money back through capital charges to the Department). The support, paid when the unitary charge starts as the new hospital opens, therefore created a level playing field between privately financed and public capital projects by spreading capital cost across 60 years rather than the primary concession period.

The spreadsheet also shows that from 2002–03 the trust has received support for the capital charges on the land it contributed to the deal as "bullet payments" to offset the annual charges; these are prepayments (that will reduce over the contract period) and attract capital charges at the appropriate rate. The background to this is that prior to the publication of the guidance "Land and Buildings in PFI schemes" in February 1999, there was uncertainty amongst accountants about whether there would be a requirement to fund the 6% capital charges on land and buildings transferred to the private sector as part of PFI projects. Work for the land and buildings guidance confirmed this was required so it was decided that schemes which had not previously funded this charge should be reimbursed via direct funding from the centre. The capital charge rate changed to 3.5% for financial year 2003–04, which reduced the capital charges payable.

These were two of the reported revenue and resource pressures which emerged from the use of PFI in the NHS. However, at the end of 2003 the Department's Finance and Investment Sub-Committee (FISC) advised that central revenue support mechanisms for PFI schemes could not be justified in the long term and, in principle, should stop immediately. They were not compatible with the changes in the way funds are now allocated to the NHS (ie directly to local health bodies), nor consistent with the way Trusts' income would be determined in future, ie through the amount of activity they deliver under a national tariff rather than simply pricing services to cover costs (Payment by Results). The decision was taken of course in the context of the largest ever sustained increase in NHS Funding—an average of 7.3% over and above inflation each year from 2003–04 to 2007–08.

However, to prevent sudden falls in income for Trusts, we agreed with Strategic Health Authority Directors of Finance that this funding should be phased out over a number of years to give local NHS bodies time to adjust. Funding was due to cease in 2006–07 but the tapering arrangement was actually extended to 5 years from 2003–04 (ie to 2007–08) in line with the tapering proposed under the Payment by Results tariff supplement.

SHA/Trust	*Capital Value*			*Smoothing Monies*						*Deferred Asset Support*						*On Balance Sheet*			*Further 2 years Phasing*	
	£m	*00–01 £000's*	*01–02 £000's*	*02–03 £000's*	*03–04 £000's*	*04–05 £000's*	*05–06 £000's*	*00–01 £000's*	*01–02 £000's*	*02–03 £000's*	*03–04 £000's*	*04–05 £000's*	*05–06 £000's*	*00–01 £000's*	*01–02 £000's*	*02–03 £000's*	*03–04 £000's*	*04–05 £000's*	*05–06 £000's*	*06–07 £000's*	*07–08 £000's*
Norfolk & Norwich	158.00	0	0	0	3,778	3,778	3,788	0	0	571	571	381	190	0	0	0	0	0	0	2,646.00	1,323.00

Supplementary memorandum submitted by the National Audit Office

Question 49 (Mr Richard Bacon): Information on the returns to investors from other PFI refinancings

1. We have obtained data on the returns to investors in other comparable PFI building projects which have been refinanced (Figure 1). The data shows that the high rate of return to Octagon's investors following the refinancing of the Norfolk & Norwich University Hospital NHS Trust's PFI contract is in line with the Darent Valley Hospital refinancing where the private sector also substantially increased its borrowings at the time of the refinancing in order to provide additional funds to pay accelerated benefits to the investors.

Figure 1 : Comparison of the returns to Octagon's investors following the refinancing with other PFI refinancings of comparable building projects

Project	*Projected internal rate of return (IRR) to investors at contract letting*	*Projected IRR to investors just before the refinancing*	*Projected IRR to investors just after the refinancing (note)*	*Substantial increase in borrowings at time of refinancing*	*Projected IRR to investors following the refinancing as a multiple of the pre-refinancing IRR*
Norfolk & Norwich hospital	19%	16%	60%	Yes	3.75 (or +275%)
Darent Valley Hospital	21%	23%	56%	Yes	2.44 (or +144%)
Fazakerley Prison	13%	16%	39%	No	2.44 (or +144%)
Ministry of Defence: Joint Services Command and Staff College	18%	Not available	31%	Yes	1.72 (or +72%)

Note: These rates of return are after the sharing of refinancing gains with the public sector. The comparator projects are other early PFI building projects on which the NAO has previously reported which have been refinanced.

Source: National Audit Office, from private sector financial models held by departments

Question 71 (Jon Trickett): Information on the projected cash which will investors will receive from the project

1. As a result of the Octagon's refinancing there were changes to the aggregate amount of financial benefits which Octagon's investors expected to receive from the project and the timing of when those benefits were expected to be received.

2. The effect of these changes to the expected financial benefits to Octagon's investors is set out in Figure 1.

Figure 1: Changes in Octagon's investors' projected financial benefits

	At contract award	*Just before the refinancing*	*Just after the refinancing*	*Post- refinancing benefits as multiple of pre-refinancing benefits*
Total projected cash flows to the investors over the life of the contract	£501m	£464m	£335m	0.72 (or -28%)
Net present value of the projected cash flows to the investors over the life of the contract (Note 1)	£47m	£35m	£117m	3.34 (or +234%)
Internal rate of return to the investors (Note 2)	19%	16%	60%	3.75 (or +275%)

Notes: 1. The net present values of the benefits to Octagon's investors are calculated, in accordance with Treasury guidance, by discounting the projected cash flows at 18.94%, the anticipated IRR to Octagon's investors reported by Octagon when the contract was let.

2. The internal rate of return is the discount rate at which the present value of the investors' receipts from a project equals that of their payments, including their initial investment. The increase following the refinancing reflects the high value of receiving large returns early in the project.

Source: Derived from Octagon's financial records relating to the refinancing held by the Trust's financial advisers' Royal Bank of Canada.

3. At current prices, the Trust expects to pay £1.3 billion to Octagon over the life of the contract. The total cash Octagon's investors expect to receive over the life of the contract was projected to fall following the refinancing from £464 million to £335 million. The investors have, however, significantly increased their benefits from the project in the early years, in exchange for reduced benefits in the later years of the contract. The increase in the internal rate of return to the investors to 60% reflected the value of receiving accelerated benefits from the project. The value of these accelerated benefits is similarly reflected in an increase from £35 million to £117 million in the net present value of the aggregate projected cash flows to the investors over the life of the contract.

Question 113 (Greg Clark): Information on construction cost increases

1. We consulted the following organisations to identify information on construction cost increases in both the public and private sectors:

— HM Treasury;
— The Office of Government Commerce;
— The Office of National Statistics;
— Department of Trade and Industry;
— Department for Education and Skills;
— Department of Health;
— The Highways Agency;
— Royal Institute of Chartered Surveyors;
— The Construction Confederation;
— The Construction Industry Council;
— Davis Langdon, surveyors;
— The Major Contractors Group.

2. There are a number of different sources for measures of construction cost inflation in both the public and private sectors. A further complication is that measures of the rate of construction cost increase between different dates will be influenced not just by changes to the costs of labour and particular materials but also by changes in the type of building work undertaken.

3. The extent of construction cost inflation between 1998, when the Norfolk & Norwich University Hospital NHS Trust (the Trust) let its PFI contract, and 2005 identified by these different measures is set out in Figure 1.

Figure 1: Construction cost inflation

Indicator	*Inflation 1998–2005*	*Source*
PFI Hospital building cost inflation		
The Department's estimate of the effect that construction cost inflation would have had on the Norfolk & Norwich hospital building costs	64%	Note 1
Building cost inflation (public and private sector combined)		
Public and private sector building inflation on tenders including PFI	60%	Note 2
Private sector building inflation		
Private sector building cost inflation on tenders	65%	Note 3
Public sector Building Inflation		
Public sector building cost inflation on tenders including PFI	56%	Note 4
Public sector building inflation on tenders excluding PFI (DTI)	50%	Note 5
Public sector building inflation on tenders excluding PFI (NHS Estates)	49%	Note 6
Other Inflation		
General building cost inflation relating to contract variations (public and private sectors)	41%	Note 7
Maintenance cost inflation	23%	Note 8
Retail price inflation	19%	Note 9

Notes: 1. The Norfolk & Norwich hospital PFI contract in 1998 was based upon building costs per square meter of £1,589. In summer 2005, the Department's information was that the building work for a PFI hospital outside London, comparable to the Norfolk & Norwich hospital, had been priced recently at £2,600 per square metre. That is equivalent to construction cost inflation of 64%.

2. The Royal Institute of Chartered Surveyors through its Building Cost Information Service (BCIS) maintains indices on building costs. The BCIS All-in-Tender Price Index is based on a quarterly sample of 80 projects from both the public and private sectors. The RICS have included PFI projects in the compilation of the index, but they are too small in number to be representative of PFI projects in general.

3. Royal Institute of Chartered Surveyors, BCIS Private Sector Tender Price Index of private sector building cost inflation.

4. Royal Institute of Chartered Surveyors, BCIS Public Sector Tender Price Index of public sector building cost inflation.

5. The Department of Trade and Industry compiles the public sector building (non-housing) tender price index based on the submission of priced bills of quantities. The principal contributors are NHS Trusts, Ministry of Defence, other

Government departments and the Local Authorities of England, Scotland and Wales.
6. The Median Index of Public Sector Tender Prices (MIPS) published by NHS Estates, based on information compiled by the Department of Trade and Industry of construction cost inflation in government building projects excluding PFI projects.
7. Royal Institute of Chartered Surveyors Index of general building cost inflation.
8. Royal Institute of Chartered Surveyors Building Maintenance Index.
9. The Retail Prices Index.

3. Heavy global demand for building materials combined with a relatively large supply of government building projects in the United Kingdom market have contributed to recent construction cost inflation. Since 1998 construction cost inflation has been 60%, more than three times the rate of retail price inflation. Construction cost inflation on private sector building projects has been higher than that experienced in the public sector.

4. Based on current pricing information from market sources, the Department estimates that construction cost inflation on its PFI deals has been in the range of 57 to 89% between 1998 and 2005. This wide range reflects the different types of PFI hospital projects being procured by the Department. The Department's range of PFI construction cost inflation is higher than the average public sector building inflation during this period of 56%. The Department has identified, however, that its costs have been influenced by improvements to patient environment and refurbishments of existing hospitals whose complexities resulted in higher costs per square metre than the early PFI projects which were mainly new builds.

5. Despite the various sources of data on construction cost inflation there are areas of uncertainty about the factors which have given rise to differences between the different measures. From our discussions with the organisations we have consulted it remains uncertain:

— to what extent the supply of government building projects, including those under the PFI, has contributed to construction cost inflation;

— why private sector construction cost inflation has been greater than public sector construction cost inflation during 1998 to 2005;

— the extent to which the information on PFI construction cost inflation provided by the Department of Health, based on market sources, is consistent with PFI experience in other areas of government. Neither the Treasury nor the individual departments we have consulted maintain detailed data on PFI construction cost inflation.

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