House of Commons
Committee of Public Accounts

Equity Investment in privately financed projects

Eighty – first report of Session 2010–12

Report, together with formal minutes, oral and written evidence

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Committee of Public Accounts

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Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the internet at www.parliament.uk/pac. A list of Reports of the Committee in the present Parliament is at the back of this volume.
Additional written evidence may be published on the internet only.

Committee staff

The current staff of the Committee is Philip Aylett (Clerk), Ian Blair and Michelle Garratty (Committee Assistants) and Alex Paterson (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

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Summary

The Private Finance Initiative (PFI) model has been used by governments in some 700 projects over the last 20 years. Under the present Government, contracts for 41 projects have been concluded and over 30 projects are currently being negotiated.[1] This Committee has often reported on defects in the PFI model, including failures to demonstrate the value for money case satisfactorily, the use of long inflexible contracts and the costly contracting process. The increased costs of using private debt finance since the global financial crisis and now further evidence of inefficient pricing of equity have made continuing with the current model unsustainable.

The Treasury has recognised that the time has come for a radical rethink and is currently reviewing the PFI model. It needs to address the intrinsic flaws in the current model by improving flexibility in the way that private finance is used, establishing quicker and more efficient procurement procedures and achieving a better balance between investors' risks and their rewards.

It is essential that the case for using private finance, in whatever form, is properly tested at the outset. Private finance should only be used where it secures real value for money for the taxpayer, not because of definitional statistical incentives to use it to get projects done. Such incentives persist because, despite recent changes to accounting rules which require most PFI projects to be accounted for on departments' balance sheets, under separate European statistical rules PFI is still rarely scored against scarce departmental budgets. So at a time of public expenditure constraints incentives still exist to use PFI models to provide public assets and services. Only some 20% of long term PFI liabilities are recorded as debt in the national accounts.

Business cases must be an unbiased assessment of the best form of procurement for the particular project being undertaken, taking account of expected tax receipts from alternative options and not adjusting assumptions to bias the outcome of the assessment. Where private finance is to be used business cases should be clear on the reasons for doing so and why the particular form of private finance proposed is better than alternatives. This requires much broader thinking about the ways of using private finance than the previous focus on a standard PFI model. For example, it is not clear that committing to 30 year service contracts at the outset is sensible if this locks authorities into inflexible prices which can only be reduced by service cuts or services that are required today but will cease to be a priority in future years.

The Treasury needs to collect data on investors' experiences and use this information to assess and challenge investors' returns which in many cases appear difficult to justify. There needs to be greater transparency over the pricing of contracts to clearly demonstrate that the rewards to those providing finance are in line with the risks they bear. Inefficiencies which add to the cost of private deals, such as long procurement times, need

1 Daily Hansard – Written Answers 15 Mar 2012 : Column 358W and http://www.hm-treasury.gov.uk/ppp_pfi_stats.htm

to be addressed.

On the basis of a report by the Comptroller and Auditor General,[2] we took evidence from the Treasury and parties involved in investing in and analysing the PFI market on the risks and rewards for private equity investors in government private finance projects.

2 C&AG's Report, *HM Treasury: Equity investment in privately financed projects*, HC1792, Session 2010-2012

Conclusions and recommendations

1. Our past reports on the use of the PFI model have often criticised the value for money case, the inflexibility of the contracts and the costly procurement process. In December 2010, we reported on the increased costs of using private debt finance since the global financial crisis which have made it difficult to sustain a value for money case for using PFI. In that report we also expressed concern on whether investors were systematically realising gains on share sales.[3]

2. **The excessively high returns being made by private investors in PFI projects are further evidence that the previous emphasis on using PFI is inappropriate for the future.** For many years most public sector infrastructure projects have been undertaken using the standard PFI model as the funding involved does not count as part of national debt or a public authority's capital budget. This has incentivised authorities to treat a typical 30 year PFI deal (including bundled services) as the only feasible procurement route for a new project and very few conventionally procured projects are now undertaken which could provide comparators. To correct the previous emphasis in using PFI, the Treasury should ensure that all new business cases:

- demonstrate whether private finance is being used because it is better than a conventional procurement and not because it is the only financing alternative;
- in cases using private finance, demonstrate that the particular method proposed is optimal; and
- take account of tax issues in the comparison between PFI and other procurement options, based on actual tax experience in past projects.

3. The Treasury should also undertake regular reviews to ensure that the standard of business cases is satisfactory and that assumptions, for example on the benefits of risk transfer, are robust and empirically based.

4. **There is restricted access to data and insufficient transparency over the amounts the public sector pays for equity and the returns that investors make.** The lack of full transparency on financial performance and returns to investors has hampered proper evaluation. Public confidence in privately financed projects has been eroded by a perception that PFI deals are expensive with high returns to investors. Building public trust is essential to any future procurement model that relies on private finance. Contracts should set out the levels of on-going disclosure required from investors to enable full evaluation of all costs and benefits of privately financed schemes. The Treasury and Cabinet Office must also reconsider how private companies providing public services, whether or not in the form of PFI, can be bound by the provisions of the Freedom of Information Act.

3 Committee of Public Accounts: 9th Report 2010-2011

5. Not all services included in PFI contracts need to be priced at the outset, and some could be the subject of a separate contract. PFI contracts for constructing assets have typically included a range of services, at a contracted price, for periods of around 30 years. Fixing the service provision in this way has limited public authorities' recent attempts to make operational savings. The Treasury should consider separately the procurement process for building the asset from that for providing a service to ensure that operation and maintenance services are based on actual requirements.

6. **The PFI procurement process takes too long, costs too much and restricts the market.** The time and cost involved do not serve investors or taxpayers well. The scale of procurement costs constitutes a barrier to market entry for financial investors such as pension funds and smaller contractors. Successful bidders recover their procurement costs in the contract price which means the taxpayer foots the bill. Those negotiating contracts for the public sector too often lack the appropriate commercial and financial skills. The growing emphasis on localism makes this skills problem worse as all too often inexperienced local bodies undertake complex negotiations with experienced private sector counterparts. The Treasury, in consultation with investors, should identify and address the sources of cost and delay in the procurement process. The Treasury should consider whether best value would be secured by greater centralization of the procurement of PFI projects.

7. **Competition in the procurement of privately financed projects is limited and has not been a guarantee of value for money.** The financial resources needed to bid for PFI contracts have restricted the number of companies bidding for contracts thereby limiting any competition. As the pricing of equity in PFI contracts appears higher than the risks would justify, there is no assurance that competitive bidding on its own will lead to effective market pricing. The Treasury needs to analyse the working of the private finance market, including the returns for investors, to demonstrate how any new approach will address these current inefficiencies and hence poor value.

8. **There is evidence from the amounts being realised by investors selling shares in PFI projects of excess profits being built into the initial pricing of contracts.** The low risks associated with government contracts are not fully reflected in the pricing of PFI contracts. Project cash flow to meet bank requirements also appears to over-compensate investors. The Treasury should instruct departments to require investors to demonstrate that their pricing of equity is appropriate. The Treasury should introduce standard contractual arrangements to recover excess cash left after contractors have met bank requirements; and share in other investor returns above defined levels.

1 The current PFI model

2. In using private investment to finance government projects the government has been unduly reliant on one model, the Private Finance Initiative (PFI) which was introduced twenty years ago. Since then 700 projects have been delivered using PFI but during this period there have been very few conventionally procured projects on which to base value for money comparisons and only limited use of other forms of private finance. [4] The Treasury is currently reviewing the PFI model.

3. The Treasury's view is that broadly speaking PFI has been a good deal for the taxpayer.[5] But our previous reports have repeatedly raised concerns about the value for money of PFI projects which commit the taxpayer to expensive deals with long inflexible contracts.[6] It also appears that the returns to investors in PFI projects are too high for the risks they bear in developing government backed projects.[7] Inefficiency in pricing equity investment was less apparent previously because of a lack of information on how deals were priced.

4. The Treasury maintains that it has no bias in favour of PFI. It has removed one incentive in favour of using PFI (PFI credits) and has stopped the use of PFI for housing and waste projects. However, other incentives continue in favour of PFI, most notably the European regulations. Under European statistical rules most PFI projects are excluded from departments' capital budgets and the national debt, despite changes to financial accounting rules which now require most PFI projects to be accounted for on balance sheet for accounting purposes.[8] Only 20% of the long term PFI liabilities are recorded as debt in the national accounts.[9]

5. In seeking to take forward PFI projects, most public authorities have used a standard Treasury PFI model under which investors arrange for services such as maintenance and facilities management services to be provided for around 30 years. We are concerned about the value for money of such "bundled" services, which prices and sets in stone some services years before they are needed.[10] The payments the taxpayer is committed to under these arrangements are around £200 billion[11]. It makes no sense for authorities to lock themselves into a particular service for 30 years when the public sector's use of its assets is likely to change more quickly.[12]

6. Contracting for a relatively fixed price for many years ahead can also create financial pressures for public authorities at times when financial cuts are needed. Under the PFI model, each year's payments is determined in advance, except for the effects of inflation

4 Q10

5 Q82, Qq87-88

6 *Lessons from PFI and other projects*, Forty-fourth Report of Session 2010–12

7 Qq2-5, Q43

8 Qq108-110, Q136

9 Q137

10 Q30

11 Q3

12 Q20

which have to be adjusted for annually. NHS Trusts in particular are finding it very difficult to meet their PFI liabilities out of their resources.[13] An example of budgeting difficulties is the Queen Alexandra PFI hospital, Portsmouth where the NHS Trust, in seeking to manage annual hospital running costs of £40 million, has cut 700 jobs and closed 100 beds.[14]

7. Once long term contracts have been signed it is very difficult to make changes. The Government announced in July 2011 its intention to save £1.5 billion from operational PFI contracts in England. The intention of this initiative is that the quality of services should be protected with savings being achieved from more effective management of contracts, making more efficient use of space and by reviewing service requirements. However investors are clear that service cuts are the only way to reduce the public sector's payments in existing contracts.[15]

8. Under the standard PFI model the deals have involved long procurements and high bidding costs. This has acted as a barrier to competition as only a small number of companies can afford to be regular bidders. The high bidding costs have also added to the cost of projects. The Treasury accepts lower procurement times are possible.[16] In France investors have found that more efficient and reliable procurement has enabled them to price deals with a cost of capital which is around 0.5% to 1% lower than in Britain.[17]

9. The Treasury acknowledges that a key issue in creating delay and adding to the cost of procurement is that many PFI contracts are developed and negotiated locally. This inevitably leaves local officials, who generally do not have the necessary commercial experience, exposed to commercially astute private sector counterparts which must impact on the value for money being achieved. Whilst it is reasonable that local officials should be able to influence the development of projects which will deliver local public services the current balance between central and local involvement does not adequately protect value for money to the taxpayer.[18]

13 Q23

14 QQ16-16

15 Q41, Q73, Q167, Ev 23

16 Q83, Qq113-114

17 Q47

18 Qq98-104

2 The role of equity investors in private finance projects

10. Equity investors play an important role in developing deals by bringing together the private sector team, designing and overseeing sub-contracts and securing debt finance.[19] Some investors are contractors who take the initial risks of a long tendering period, and the construction risks, but often sell their shares soon after the asset has been delivered to realise the profits or fund new projects.[20] Other investors retain their initial shares or buy contractors' shares to secure stable returns from a project's operational period. Investors' views on how projects are operating can provide valuable information to inform changes that can improve the procurement and development of PFI projects.[21]

11. There has, however, been little transparency over the returns which investors have made from PFI projects which has damaged the public perception of this form of procurement. The Treasury has not gathered information on a systematic basis to demonstrate that the pricing of equity is optimal.[22] Open book accounting, where the private sector allows full access to their financial information, is not a common practice.[23]

12. We are concerned about the extent to which interests in PFI projects are held overseas and whether Treasury takes proper account of this when they assess the tax implications of PFI. The Treasury believes that all PFI project companies are registered in the UK, but cannot confirm this as it does not hold information on the identity of each project company. The Treasury expects issues relating to corporation tax to be taken into account in assessing the value for money of PFI deals, but does not consider the extent to which ultimate investors in PFI projects may be based overseas and thereby not liable to UK capital gains tax[24].

13. This Committee has previously called for private sector companies to be subject to the provisions of the Freedom of Information Act for work they do that is funded by the taxpayer, to provide proper transparency on the private sector's handling of government projects.[25] The investors we questioned accepted that they should be subject to Freedom of Information but believed this should only happen if the same conditions applied to all forms of procurement. The Treasury expressed reservations about extending the Freedom of Information Act to contractors for reasons of cost and commercial sensitivity but once contracts have been let we are not convinced this argument is valid. [26]

19 C&AG's report, paragraph 7

20 Ibid, paragraph 2

21 Q1

22 C&AG's report, paragraph 10

23 Q89

24 Ev 23

25 *Lessons from PFI and other projects,* Forty-fourth Report of Session 2010–12, Conclusion and recommendation 4

26 Qq77-79, Qq172-173

14. The investors we questioned pointed to difficulties they faced in engaging in PFI projects. These included the significant lead times and procurement costs including time on bids that never come to fruition. Investors take these issues into account in deciding whether to invest in PFI projects in the UK as opposed to opportunities overseas.[27] Carillion told us that they had incurred losses on certain projects although overall they are making a return from PFI projects in excess of 15%.[28] In the case of the Queen Alexandra PFI hospital, Portsmouth they confirmed they were able to sell their investment of £12 million for £31 million within a few years.[29]

15. Nevertheless, the available evidence strongly suggests that, in the main, the returns which equity investors receive from PFI projects are too high for the risks they bear.[30] There are a number of market inefficiencies which contribute to the government paying more than is necessary for equity. These inefficiencies have contributed to some investors having made annual returns as high as 60% on selling their shares in PFI projects. Such high returns also reflect that the Government, in providing the private sector with long term stable cash flows, similar to an annuity, is creating an attractive tradable product once the early construction risks have been dealt with.[31]

16. Most investors achieved greater returns than they expected when they entered into PFI projects which suggests that the risks are not as great as the investors had assumed in pricing the deals.[32] Mark Hellowell of the University of Edinburgh considered that the annual PFI charges paid by the public sector could be 3% to 5% higher than is necessary because of the inefficiencies in the way that equity is priced in the deals.[33] The National Audit Office's detailed analysis of three deals found unexplained profits of around 1.5% to 2.2% of the public authorities' annual payments, amounts which become significant over 30 years.[34]

17. One area of inefficient pricing results from the high cost of bank debt and the influence of bank lenders on profits.[35] We welcome the Treasury's intention to bring in more diverse sources of finance, including pension funds, reducing the amount of bank debt and the banks' influence on investors' profits.[36] This follows our recommendations in our report on *Financing PFI projects in the credit crisis and the Treasury's response*.[37]

18. Doubts remain whether competitions for PFI contracts secure the best price and eliminate investors' opportunities for excess profit. Consequently, the public sector needs to be vigilant in challenging all aspects of pricing in bids. In order to challenge bidders'

27 Q43, Q70

28 Q58

29 Q16

30 C&AG's report, paragraph 11

31 Q144

32 Q105

33 Q2, Q82

34 C&AG's report paragraph 12

35 Q174, C&AG's report paragraph 11

36 Q124

37 Ninth Report of Session 2010–11, Conclusion and recommendation 4

prospective returns, departments require current knowledge of pricing in the market for equity in operational PFI projects.[38] Where there is evidence that investors are making high rewards during the contract period which are out of line with the risks they bear, public authorities need mechanisms for sharing in these rewards. Investors in PFI projects are more likely to accept sharing returns above a predetermined level than to accept a cap on equity profits or a share of gains on share sales. This is because investors may need to benefit from projects which are going well to offset those which may be delivering lower returns than expected [39]

38 Q89, C&AG's report paragraphs 12, 13

39 Qq66-70

Formal Minutes

Wednesday 18 April 2012

Members present:

Rt Hon Margaret Hodge, in the Chair

Mr Richard Bacon
Jackie Doyle-Price
Matthew Hancock
Chris Heaton-Harris
Stewart Jackson
Meg Hillier
Mr Austin Mitchell
Nick Smith
James Wharton

Draft Report *(Equity Investment in privately financed projects)*, proposed by the Chair, 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.

Resolved, That the Report be the Eighty First Report of the Committee to the House.

Ordered, That the Chair 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.

Written evidence was ordered to be reported to the House for printing with the Report.

[Adjourned till Monday 23 April at 3.00 pm

Witnesses

Monday 20 February 2012

List of printed written evidence

List of Reports from the Committee during the current Parliament

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

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Twenty-second Report	Excess Votes 2009-10	HC 801
Twenty-third Report	The Major Projects Report 2010	HC 687

Twenty-fourth Report	Delivering the Cancer Reform Strategy	HC 667
Twenty-fifth Report	Reducing errors in the benefit system	HC 668
Twenty-sixth Report	Management of NHS hospital productivity	HC 741
Twenty-seventh Report	HM Revenue and Customs: Managing civil tax investigations	HC 765
Twenty-eighth Report	Accountability for Public Money	HC 740
Twenty-ninth Report	The BBC's management of its Digital Media Initiative	HC 808
Thirtieth Report	Management of the Typhoon project	HC 860
Thirty-first Report	HM Treasury: The Asset Protection Scheme	HC 785
Thirty-second Report	Maintaining financial stability of UK banks: update on the support schemes	HC 973
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Thirty-seventh Report	Departmental Business Planning	HC 650
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Seventy-ninth Report	Accountability for public money – progress report	HC 1503

Oral evidence

Taken before the Committee of Public Accounts on Monday 20 February 2012

Members present:

Margaret Hodge (Chair)

Mr Richard Bacon
Matthew Hancock
Meg Hillier
Fiona Mactaggart
Austin Mitchell
Nick Smith
Ian Swales
James Wharton

Amyas Morse, Comptroller and Auditor General, **Marius Gallaher**, Alternate Treasury Officer of Accounts, **Gabrielle Cohen**, Assistant Auditor General, National Audit Office, and **David Finlay**, Director, National Audit Office, were in attendance.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

Equity Investment by Privately Financed Projects

Examination of Witnesses

Witnesses: **Mark Hellowell**, Lecturer, Health Systems and Public Policy, University of Edinburgh, **Robin Herzberg**, Managing Director, Carillion Private Finance, and **Nigel Middleton**, Managing Director, Barclays Infrastructure Funds, gave evidence.

Q1 Chair: Welcome. I am sorry that we are running late. I thank all three of you for agreeing to appear before us this afternoon. You are probably aware of the role that you play. None of you is an accounting officer, and it is the accounting officers who are held to account by this Committee. We find it valuable to have some insights from people who are experiencing the policy on the ground before we start questioning the accounting officers. This is a short session—we will try to keep it to about half an hour—and it is your opportunity to help us to frame our questions when we come to the accounting officers. This is a particularly interesting time in this area, because the Government are reviewing PFI, so we would like to think we would have some influence on their thinking during this process.
You are very different people. I am going to start with Mark, who has been following the history of PFI for some time. Particularly looking at the role of equity investment in PFI, what do you think are the key issues that concern you about the current PFI regime? Say anything else that you want. This is an opportunity for you to say what you want.
Mark Hellowell: Perhaps I should start with a review of my research on this topic. I have been concerned with trying to assess the reasonableness or fairness of the return to primary equity investors by reference to the risks being borne. In particular, I have been trying to construct a sort of benchmark or cost-of-capital framework with which to evaluate the return projected in financial models. Constructing such a benchmark is not a straightforward exercise, and it is very difficult to construct a single benchmark that would be acceptable to all constituencies, experts, practitioners and so forth. I have therefore used a diversity of methods: formal approaches rooted in capital budgeting theory, where you try to assess the risk that investors are exposed to and relate that to rates of return that are being earned on financial assets within the same risk class in the markets more generally; looking at the cost of capital discount rates that big investors actually use for valuing their own equity stakes in new PFI projects in construction; and looking at the weighted average cost of capital of the big investors and relating that to the kind of equity returns that are being forecast in financial models. However you do that, you end up with an element of excess return, which can be seen as an element of bad value from the point of view of the public sector that is ultimately providing the revenues from which these returns are extracted.

Q2 Austin Mitchell: How high is that?
Mark Hellowell: It depends on which model you choose, but there is an excess rate of return of perhaps 3% to 5% that is difficult to account for in terms of the risks being borne.

Q3 Chair: So 3% to 5% on £200 billion—just out of the equity investment?
Mark Hellowell: If you are thinking about—
Chair: Across the whole of PFI, we have £200 billion. Are my figures right?
David Finlay: Total payments.
Chair: Is it 3% to 5% of that?
Mark Hellowell: No. It would not be 3% to 5% of the total.

Q4 Mr Bacon: What would it be 3% to 5% of? The capital value and the net present value of the money paid for operating?
Mark Hellowell: This is the above-risk premium on the IRR on equity investment specifically. Of course,

equity investment is only a minority of the total financing.
Chair: Ten per cent. But it is still a few billion or many hundreds of millions.

Q5 Mr Bacon: What do you estimate that that number is: 3% to 5% of what is therefore what?
Mark Hellowell: Well, if you look at the annual unitary charges that the public sector, taken as a whole, is paying at the moment, it is about £10 billion, so you might think this would equate to around £40 million to £50 million in additional revenue per year.

Q6 Ian Swales: Have you done a similar exercise on the loan capital aspect of PFI, or have you only looked at equity capital?
Mark Hellowell: If you are looking at debt capital as well, it is a different kind of analysis, but certainly, looking at the appropriateness of the interest rate on debt is an important priority—
Ian Swales: Against risk.

Q7 Chair: Ian, we are looking to focus this afternoon on equity capital.
Carry on, and I will speed you up a bit, because I want to try to keep this first session to half an hour. You think that there is something like a 3% to 5% excess return.
Mark Hellowell: If you are looking at it in terms of the rate of return, we might look at that—

Q8 Chair: What would you do if you were Chancellor?
Mark Hellowell: Well, I would be looking to analyse the sources of inefficiency in the market that are leading to these excess costs. If you look at the National Audit Office Report, it suggests, for example, that the procurement system is very inefficient. I would be looking to find ways of streamlining that system to ensure that barriers to market entry are lower and that the market becomes much more competitive.

Q9 Mr Bacon: Do you agree that having a lower barrier to entry, enabling more players to take part—instead of this oligopoly, which is effectively what we have at the moment—would, in addition to presumably providing finer pricing, also increase the risk? If the Government contracted with a party that was not so strong financially that it could not take a hit on an entire project or two and not notice, would that not result in greater risk, and would that not, in the end, be reflected in finer pricing? If you ended up having more projects going wrong, the prices would go back up again, wouldn't they?
Mark Hellowell: I think individual public authorities would want to carry out proper due diligence and be satisfied that the companies they were contracting with had the balance sheets to support these projects. It seems to me not unreasonable to think that we could expand the current set of usual suspects and get some efficiency benefit from that without exposing ourselves to additional risk.

Q10 Mr Bacon: You were speaking earlier about benchmarks and said it would be very difficult to find a benchmark with which everyone was happy. I am not sure if this has been done, but do you agree that an obvious benchmark would be to take a typical project, such as a high school or even a cluster of high schools and primary schools in a basket—or a cluster of hospitals or other projects such as prisons—and compare it with a cluster that had very similar characteristics in terms of the approximate total spend, number of pupils or patients served, or number of prisoners housed, and which had been financed conventionally? The National Audit Office building refurbishment was financed conventionally, whereas the Home Office was done by PFI. Then, compare those two baskets after three years, five years and eight years. Do you agree, first, that that would be a sensible way of proceeding, and do you know anywhere where that has been done?
Mark Hellowell: I think that that would be the ideal way of assessing the economics of PFI more generally—more generally than the equity return. That kind of natural experiment is probably implausible, given the overwhelming dominance of PFI in the sectors in which it is operational. In schools, hospitals and those big social infrastructure sectors, PFI has been the only game in town, so you would not be able to find very easily a comparative group of schemes. It would be very difficult to do that kind of natural experiment.

Q11 Mr Bacon: You would have to decide to do it, but it is as implausible or plausible as the Government make it by the stroke of a pen on a contract—or not—isn't it?
Mark Hellowell: I see what you mean, yes. It would be possible for the Government to experiment.

Q12 Mr Bacon: They are, after all, the contractor in all of this at the end of the day.
Mark Hellowell: Indeed. This is not my area, but I suspect it would be difficult to justify experimentation on local communities in that way to learn some lessons.
Chair: James, then I am going to move to Robin Herzberg and Nigel Middleton.

Q13 James Wharton: You've indicated that you get the impression that investors are sometimes getting an excess rate of return. Have you done much to look at the value that equity investors bring to a project: the positive contribution they make and how that can be offset against that, if it can be? Is there a quantifiable additional value that having an equity investor—rather than, say, debt or another way of finding the money—brings to projects?
Mark Hellowell: Quantitatively, I think it is difficult to establish. Qualitatively, I think it is very clear that there is value to having equity in the structure and that equity investors play a very useful role in allocating risk in entering into contracts with contractors and so forth; that is extremely useful. None the less, we would want to engage with equity investors who could perform that function while levying a return that we

would see as appropriate or fair, and judge that against the kind of risks being borne.

Q14 James Wharton: It must be hard to assess what an appropriate return would be if we cannot actually quantify the value that an equity investor brings to a project. If they reduce a cost by a certain amount, then actually they could get a higher rate of returns. Had you done it another way, you would not have saved that money. You don't think it is actually possible to quantify that in a practical way?
Mark Hellowell: I think it is very difficult. The lion's share of the risks of projects is contractually allocated away from equity to the individual contractors carrying out construction, maintenance or service provision and so forth, so the key question to ask is, is the return being charged by equity proportionate to the risks being borne? One way of looking at that is to do what the National Audit Office has done and look at the required rates of return in the secondary market, and use that as the benchmark—the comparator—to assess the reasonableness of returns on primary equity. That seems to me to be an entirely legitimate and attractive approach, and when you do that, even after making reasonable adjustments for big costs and risks, you still end up with this additional risk premium that you cannot account for.

Q15 Chair: Feel free to jump in, but let's move to Nigel Middleton and Robin Herzberg. Can I start with Robin Herzberg first? The Portsmouth example is interesting. That is the one that is always put up: the Queen Alexandra Hospital. I understand that you sold to HSBC for £31 million—correct me if I am wrong—
Robin Herzberg: Correct.

Q16 Chair:—as return on the £12 million that you put into the project in 2006. You made a hefty great profit on that. But, for the hospital, the annual revenue costs of running the hospital are £40 million. They cannot afford it, so they had to take out a loan of £30 million to pay the bills and had to cut 700 jobs and 100 beds, and it still left them with a deficit at the end of that. If that is all correct, can you see why people get angry and think that there are excessive profits being made out of providing a public facility? Can you, A, understand it and, B, how do you think that we can run it more fairly?
Robin Herzberg: Yes, Madam Chairman, I can confirm that the facts are correct, and, yes, I can confirm that I do absolutely understand. In many ways, it is the way that the health service is structured that means we wind up with a situation where our customers are having difficulty paying the bills. There is a very useful analysis in the National Audit Office Report that has been prepared on that particular equity disposal, which shows that the residual amount of the return that we got was about £3 million out of the £31 million. I would say that that project, from a construction point of view, was—

Q17 Chair: But you still run the facilities, so you still get an annual income of £30 million a year.
Robin Herzberg: We still provide the facilities management service, yes.

Q18 Chair: So you make money out of that too.
Robin Herzberg: We do indeed, and we typically make a 5% return on facilities management. We have had to wait quite a number of years to get to that point.

Q19 Chair: So what is your answer? The whole purpose of building these facilities and using this vehicle is to serve the public interest, and then you get this perverse effect.
Robin Herzberg: We incurred additional unbudgeted costs to actually get the thing complete—the construction—which would certainly have outweighed that £3 million and more, so we have effectively made nothing on that analysis in terms of the construction. Our construction return is typically 1.5%. If you look across the construction industry as a whole, the net returns are about 1.75% on PFI, so the return that we ultimately make is largely from the facilities management, and yes, there are opportunities to de-scope the facilities management if the trust is having difficulty. We can absolutely work with a trust. The Treasury has put out very good guidance on how trusts should be managing their contracts closely, how they should be mothballing parts of the hospital, or whatever, that are not needed—

Q20 Chair: But there will be a cost in the contract if they mothball, because there will be a termination. One of the problems with this whole thing—particularly in health, where the nature of the use of assets is changing so rapidly—is that you lock yourself into a particular usage for 30 years. You are servicing Queen's Hospital, my local hospital, and you are locked into servicing in a way that is not appropriate over time.
Robin Herzberg: The availability fee is fixed, yes, and inflexible, but the services element is not. It absolutely can be flexible.

Q21 Chair: Not the maintenance—as we discovered when we did it earlier. I will come to Ian again, but there is something you have not said to me. At the moment it feels like a rotten deal for both the taxpayer and the citizen. You end up locked into massive payments that pre-empt your priorities. Now that the Government are reviewing, what mechanism is there? How you could you reconfigure this thing to make more sense of it?
Robin Herzberg: I certainly think one of the problems is the structure of the NHS. I don't actually think it is efficient to have a trust paying such a large proportion of its income on a single contract. That is not good.

Q22 Matthew Hancock: But you can't blame the faults of PFI on the structure of the NHS, can you? It is broader than that, isn't it? For instance, last week we saw the story that roused public anger—the cost of the 12 fig trees in Portcullis House, in Parliament. That has not got anything to do with the structure of the NHS. People, including me, find it astonishing that each of those costs approximately £35,000 in contract to maintain each year. Given that there is a review, what changes can be made to make such costs more reasonable and not totally out of kilter with any reasonable expectation?

Robin Herzberg: I'm not familiar with that particular contract. It sounds as if that is part of the services element of the contract, so I would have thought that was absolutely up for renegotiation, if the authority can't afford it.

Chair: You haven't really answered. I will bring Ian in.

Matthew Hancock: What do you mean by "can't afford it"?

Q23 Mr Bacon: We did actually look at this years ago, and I am long enough in the tooth on this Committee to have been there on that particular case. The problem was not simply that the authority could not have afforded it; the problem was why they were renting trees at this enormous price when the Treasury over the road was buying trees for a tenth of the price. That was the issue. There was a lack of commercial skill somewhere.

I was interested—Mr Hancock was pursuing this point—that you seem to be blaming the structure of the NHS for some of these problems. You say that you should not have such a large proportion of an acute hospital's total income going on one contract. At the end of the day, the services, whatever they are, have to be provided. The hospital has to be cleaned, the catering staff have to be paid, the food has to be bought, the lifts have to be maintained and all the rest of it. However you put that bundle together, it still has to be done. You could put it all directly under the Secretary of State, but it would still all have to be done. Like Mr Hancock, I do not quite understand why you are blaming the structure. How does that really alter things?

Robin Herzberg: I am merely saying that it is probably not a good thing that an authority is devoting such a large proportion of its income to a single contract.

Chair: So you would cancel the new Bart's £1 billion hospital investment—over £1 billion—would you; or the Liverpool Hospital, at £350 million? Absolutely madness!

Amyas Morse: Is it reasonable to expect that the people who are putting the PFI deals together should do due diligence on a health service's ability to pay for what they say they want to buy?

Matthew Hancock: We are asking a policy question, really. We are asking—given your experience of being on the other side of the table—how this could be better done in the public interest.

Chair: And we haven't really got an answer. Let Ian have another go at it.

Mr Bacon: We are asking you to cut off your nose to spite your face.

Q24 Ian Swales: Can I ask what might sound a fatuous question? Yours is one of those companies able to provide equity, get hold of loan finance, build a school or hospital and provide a service contract. How many of the companies that you compete with when the next school or hospital is coming up can provide the full package that buyers appear to want?

Robin Herzberg: That is a very good question. There was a long list of them when we entered into PFI, and a lot have gone out of business since then. Ballast Nedam, Jarvis, Laing Construction—just to mention three that have gone out of business doing PFI because of the risks concerned.

Q25 Ian Swales: So how many are left that you would regard as your—

Robin Herzberg: It varies from sector to sector. I am guessing 10.

Q26 Ian Swales: Can you explain why it is the right decision for the Government to buy that whole package from one player? In particular, why should they buy a service contract from the same people who are going to build a hospital or school? I have consulted in the construction industry, and the company I consulted would in no way regard itself as a provider of hospital services or whatever. It builds hospitals. Why should we deal with companies that do all those things? As a supplementary question, do you have a strategy of disassembling any of that package once you've got the deal?

Robin Herzberg: To answer your first question, the benefit is clearly the lifecycle aspect. If the contractor is going to be responsible for the maintenance of the contract, it is in their interest to build it in such as way as to keep the maintenance costs down. That is the simple answer as far as that is concerned.

Q27 Ian Swales: We're a team looking at value for money. I guess I can predict the answer, but I will ask this anyway. To what extent do you build high profits from the service element of a contract into your bid? The capital number tends to hit the headlines and be part of the decision making, yet as we know, in the long run the amounts of money involved can often be greater for the service element of the contract. How do you decide how to balance that?

Robin Herzberg: It is an interesting question. Typically, the procurement period is so long that it is seven years out before we get into the service contract. The perception is that we regard the service contract as very important, but in fact we discount it in many ways. We tend to focus more on the amalgam of the equity and the construction.

Q28 Ian Swales: So would we get a better deal?

Robin Herzberg: Once the construction is complete and mature, yes, we do seek to recycle equity so that we have more available for future investment.

Chair: Why?

Q29 Mr Bacon: Is it not also true that you accelerate your rate of return considerably by doing that, just like you did, Mr Middleton, as a shareholder of the Norfolk and Norwich University hospital? You tripled your rate of return—

Robin Herzberg: We certainly bring it forward, yes.

Mr Bacon: It is part of the model, isn't it? You accelerate your rate of return by a quick exit.

Q30 Ian Swales: May I finish this point? Why should we not say to a company such as yours that we do not

want to talk about the service contract until it is finished, and then we will start dealing with how much the gardeners cost and how much the fig trees are? You might not even be the preferred bidder at that point. Would that work?
Mr Bacon: If you discount it, who cares whether it was aggregated or not?
Robin Herzberg: Indeed. Certain PFI contracts have been let that consisted purely of the construction, the equity and the estate service. The soft services are kept completely separate. That can be done.

Q31 Chair: I think Mark should comment on that. In my view, that gets in trouble with Eurostat accounting—it would all come on the balance sheet wouldn't it?
Mark Hellowell: No. It is empirically the case—increasingly it is the case—that deals are let that involve design and build, financing, and some sort of core facilities management, but not the full gamut of service provision.

Q32 Chair: But you need some facilities management to get it off the balance sheet from the national debt.
Mark Hellowell: You would certainly need maintenance of the core asset.
Chair: So you can't divvy it up because you then hit the problem that it comes on to your debt.

Q33 Mr Bacon: Can we just check this with the NAO? Mr Finlay, we are discussing separating off the servicing. As Mr Herzberg said, we largely discount that because we do not get there for seven years, so that is not really part of our thinking or modelling in the early stages. Therefore, as Mr Swales was saying, we are discussing the possibility of leaving that and doing it later. On the basis of the figures that we were discussing—of a £30 billion capital value in present value terms, and £130 billion of the services—if we stopped at the £30 billion and said, "Right, once the project is complete, we then start servicing it, perhaps on a cash basis or maybe on two-year contracts or whatever," would all that expenditure be on balance sheet as opposed to off balance sheet, or is it already on balance sheet?
David Finlay: For accounting purposes, it is already—
Chair: We are not talking about national debt.

Q34 Mr Bacon: The £130 billion is already on balance sheet "for accounting purposes", but what about in terms of the total public debt? Let me rephrase my question. I understand for accounting purposes, because for the whole of Government accounts it is on balance sheet, but for contributing towards the public debt, it is off balance sheet. If we stopped at the capital bit, if we got the construction—the finance—done, and had a project ready to go and said, "Let's let a contract for someone who wants to maintain this," am I right in thinking that all that £130 billion would then be financed by Government conventionally and be on balance sheet for public debt purposes in a way that it currently is not?
David Finlay: Yes.

Q35 Mr Bacon: But the Government have to get the revenue from somewhere—presumably from either taxes or from issuing gilt. Wouldn't the effect be that this £130 billion, which is currently off balance sheet for national debt purposes—that is correct, isn't it?
David Finlay: I don't know the precise answer under the rules, but—[1]
Mr Bacon: This is rather important.
Chair: We will ask our accounting officers—

Q36 Mr Bacon: Can I pursue this, because it is very important? We are talking about roughly £200 billion—£190 billion or £160 billion in net present value terms—£30 billion is capital and £130 billion is the servicing going out many years ahead. Because it is all tied up in this project, we are saying that for national debt purposes, all that is currently is off the national debt, regardless of whether it is accounted for as on the books. For purposes of public debt and public debt calculations, it is off the books. Correct?
David Finlay: Yes.

Q37 Mr Bacon: Right. I am saying that if all those servicing costs were borne year by year instead, as in other contracts, they would all be on the public debt, or paid for through taxation, in a way that they are currently not. Correct?
David Finlay: Intuitively, that sounds correct, but I would like to check—[2]
Chair: Let's move on. Nick was going to ask something.

Q38 Nick Smith: Mr Herzberg, as part of your evidence, you made a wide-ranging criticism of what you called the NHS structure being a problem in terms of PFI investment. It was an odd remark to hear, except, when we had the NHS PFI specialists in here a couple of months ago, it occurred to me that it was a very small section and it was being reduced. We were then worried about managing the quite lengthy and expensive tail for the NHS PFI investments in the medium to long term. Do you have a view about how well that long tail is managed from the centre? How well are you scrutinised as a sector by the NHS?
Robin Herzberg: Very closely indeed—certainly not just by the NHS. It is actually very uncomfortable at the moment. Authorities are quite rightly scrutinising us very closely, and any opportunity to make deductions that should quite properly be made are made. These contracts are closely managed at the moment.

Q39 Chair: Can I ask two quick ones? If the Government were to say to you either that there would be a cap on the return that you can get on your

[1] Services such as maintenance and cleaning are revenue costs. As such they are not part of the capital cost to be accounted for as on or off balance sheet in accordance with financial reporting standards or to be included or excluded from national debt under the separate European statistical rules (ESA 95). If maintenance costs were to be excluded from PFI contract and contracted for separately then it is likely that the capital element of the PFI project would be included within national debt statistics because availability risk, which is a factor in determining this classification, would rest with the public rather than the private sector.

[2] See footnote Q.35

investment or that there would be a sharing beyond a particular level, in the same way that there is through refinancing, would you accept that and still stay in the market?
Robin Herzberg: That would be very problematic for us because of our particular model, which is to sell equity to finance future projects.

Q40 Chair: Have you contributed to the £1.5 billion of savings that the Government have committed to find in existing PFI contracts?
Robin Herzberg: I'm sure that we have. Across a whole series of projects, we are looking to make savings, under considerable pressure from—

Q41 Chair: Can I put it to you that, as far as I know from my local hospital, all that has happened is that the savings have come from a cut in service and a transfer of risk back to the health trust rather than from anything else—rather than from you giving up any of your profitability? Does that sound familiar to you?
Robin Herzberg: It does not sound familiar. From our point of view, we have been cutting scope and profit.
Chair: Cutting scope, which is cutting service.
Robin Herzberg: Yes.

Q42 Chair: My understanding is that the other thing is that the transfer of even a small element of risk on renewals of infrastructure was being put on insurance, which you would pass back to the trust, rather than bearing it yourself.
Robin Herzberg: I do not recognise that, no. Not on the contract.
Chair: Maybe you could write to me on that, because that was certainly my understanding of it.
Robin Herzberg: Yes.

Q43 Chair: Mr Middleton, I am going to come to you. Looking at your very impressive CV, it seems to me that you invented a lot of this and pioneered PFI when you were seconded to the Treasury from wherever you were before. You then went off and made money out of it at Barclays Infrastructure Funds. So you have been on both sides of the fence. What is wrong? Why is it that everybody feels that the current scheme rips us off? What would you now be doing, were you in the Treasury, to sort it out?
Nigel Middleton: Thank you, Madam Chairman. Yes, I have been involved in PFI for a considerable period of time in various roles. Coming directly to your question, I think it is important that we analyse all aspects of PFI on an apples-and-apples basis. Having gone through three phases of PFI—if one is looking at it from returns and costs to the public sector—the first phase, until around 2000–01, had early deals and investors waiting a long time to invest. There was a high degree of uncertainty and very conservative markets taking views on areas where there was considerable uncertainty. That has given rise to high returns on those early deals. I do not think there is any doubt about that. That is what analysis shows, and we agree with that.
Moving forward from 2002 to around 2007–08, competition steps up, and I think it is very clear that the cost to the public sector, and the capital costs of PFI deals, show decreases during that period. Since then, we have the unfortunate effects of the financial crisis, which in particular has led to a considerable increase in the debt finance that finances 90% of PFI projects. If one looks at that background, therefore, let us pick what is good and analyse what is not so good so that we can look for the areas to improve. It is clear that the competition that improved value for money for the public sector was stimulated by good deal flow, the expectation of being able to invest, standardised contracts and a considerable amount of know-how.
I think that has dissipated since the global financial crisis, throughout which people have always commented that the downside of investing in PFI compared with other forms of infrastructure was the significant lead times and procurement costs, both visible in terms of costs aborted by investors such as ourselves and Carillion, and not visible, such as management time spent on bids that never come to fruition.

Q44 Mr Bacon: Is that not in effect priced into future bids?
Nigel Middleton: No, it is not.

Q45 Chair: The NAO report says that it is. The NAO report explains some of the extra equity return.
Nigel Middleton: I agree that, conceptually, the NAO report has recognised that cost. I, personally, do not believe that the estimation of that cost is as high as we have needed to experience in any way to recover the time spent on abortive bids. Procurement is often mentioned, but it is still an area that has to be tackled, as is fluency of deal flow, to stimulate investor interest. All those things add to the efficiency of an investor in the PFI market.

Q46 Mr Bacon: Surely, if everybody is in the same boat—that is to say that everybody is facing a 43-month negotiation period before financial close, or whatever it is; it is a long, long period—everybody is at the same competitive disadvantage or advantage, and it must be reflected in all your costs and, therefore, in all the prices you are prepared to accept from Government. Is it not inevitable that it will be passed on? Because if it were not, you could not operate.
Nigel Middleton: It is reflected in part in our costs. There is a problem with the analysis that is undertaken, in particular looking at financial models that do not reflect all that cost, and then puzzle as to why the apparent cost of capital and price of equity is so high. Not all the costs are recognised in that. Your point is right; when you look at the industry, does the industry price that into its true cost of capital? To a large extent, yes, but that is reliant on confidence at the time that there is a further deal to invest in. Certainly over the past three years, that has not been the opportunity.

Q47 Chair: We are running out of time a bit, and I have got two other people. Very quickly, what would you change? You have analysed why we are where we are, but what would you change?

Nigel Middleton: There are lessons to be learned on procurement, in particular, from similar activities in Europe, for example. We undertake a lot of work in France, bidding in models of very similar risk structure. We are happy to bid there with costs of capital between 0.5% and 1% lower than we do here, really in recognition of the more efficient and reliable procurement. It is very quick once the investor is on the list.
Chair: Were those figures 2.5% to 1.5%?
Nigel Middleton: Sorry, 2.5% to 1.5%?
Chair: You said you were willing to work at a lower—
Nigel Middleton: I said between 0.5% and 1%.
Chair: Sorry, 0.5% and 1%.

Q48 Mr Bacon: That is a lot. To what do you attribute that? Is it that the French contractors on the other side—the French Government—are much more insistent on standard contracts?
Nigel Middleton: No, it is the Government's response. It is the speed, efficiency and discipline of procurement.

Q49 Chair: And—anything else?
Nigel Middleton: There is one other feature in France, which is the means by which they debt finance projects. That does not impact on our return particularly but it generally assists in bringing overall cost of capital down, in that where it is recognised that the Government are providing an implicit guarantee, if they provide an explicit guarantee, debt markets should respond positively.

Q50 Austin Mitchell: The Chair commented on your career. As I see it, you have moved from poacher with PricewaterhouseCoopers to gamekeeper advising the Treasury, and then on privatisation of schools and council premises, and then back to poacher again. I have a more jaundiced eye than the Chair; wouldn't I be inclined to see that as a rather curious and not nice conflict of interest?
Nigel Middleton: We are all caught in what we do by employing our expertise to best effect. It is true to say that I spent an early period in my career during the development of PFI on secondment to the Treasury, then as an adviser both to the public sector and private sector and subsequently as an investor.

Q51 Austin Mitchell: How do we know you were not advising a form of privatisation of the schools that the banks would profit from?
Nigel Middleton: My point is that I do not think that is an unusual path for people to take in pursuing their careers. What I am very clear about is that in no situation have I ever put myself in a conflict where information I knew or work I did advising the public sector was brought to bear in a way that was to the detriment of the public sector in my later career.

Q52 Austin Mitchell: Yes, but how do we know that in advising the Treasury on privatisation of schools you were not slanting the advice in such a way that the banks could profit from it, and then going to the banks to draw that profit?
Nigel Middleton: I will personally tell you that no such thing has ever happened. There is no evidence of that. My involvement with transactions that I may have been involved in peripherally in a public sector capacity, and then as a private sector investor, was separated by a minimum of six years. A lot happened so that that there was no way I could have—
Austin Mitchell: It is nice for me as one persecuted species—politicians—to meet another persecuted species, the banker—
Nigel Middleton: Investor, please.
Austin Mitchell: My question is about how the banks are behaving in terms of lending to small and medium-sized enterprises, industry and so on. Wouldn't it be easier, more straightforward and more beneficial to the taxpayer if the quantitative easing that we are now going in for, whereby the banks buy back public debt from you and give you more money to put in your reserves to sit on, like a monkey sits on its nuts—
Mr Bacon: It's a squirrel.

Q53 Austin Mitchell: Wouldn't it be better if they bought back these contracts?
Nigel Middleton: May I clarify my role in Barclays? I am a director of Barclays Infrastructure Funds Management. We manage funds in which Barclays is a minority investor. Our majority investors are pension funds. Those funds invest in the equity and PFI projects. I have really no involvement in the management of the bank's affairs.

Q54 Chair: Do you have any involvement at all in the loan element of the PFI—
Nigel Middleton: Absolutely not.

Q55 Chair: There is a complete Chinese wall on that.
Nigel Middleton: Absolutely.

Q56 Ian Swales: I have just a quick comment about the secondary market. Mr Herzberg, your CV says that you and your company have been delivering on 58 projects, with a turnover of £11 billion. In how many of those do you still own the equity?
Robin Herzberg: Twenty-five of them now.

Q57 Ian Swales: So you have sold the equity in 33 of them.
Robin Herzberg: Correct.

Q58 Ian Swales: What would you say your average return was on those 33 sales?
Robin Herzberg: Well, we know; we track it. Our target is 15, and we are actually achieving just in excess of that.

Q59 Mr Bacon: What was your highest?
Robin Herzberg: It was probably in the 30s, but there have been some highly negative ones as well. Three have led to losses: Nottingham Express Transit, Exeter Schools—Exeter Schools survived, but we lost a lot of money on it—and an overseas one, the Alice-to-Darwin railway. So there have been some big horror stories as well.

Q60 Ian Swales: Okay. Can I just ask this then? I always remember the people we have in front of us who earn over £8 million a year. We had one a few months ago whose sole business was trading PFI equity stakes, as I understood it. The question was asked then about what really was the potential risk or the value issue of probably quite faceless companies in the end owning huge portfolios of UK assets. The UK taxpayer, having put the money in and bought the school, hospital or whatever, then found that these things were owned by other people. When you are trading these stakes, do you have any rules about that? Do you think about who you sell them to, or is it simply a financial transaction and you would sell—
Robin Herzberg: It is largely a financial transaction.

Q61 Chair: So do you know how much went abroad—offshore?
Robin Herzberg: No, I do not know. We disclose who we sell to, and it has been the main secondary funds, the UK secondary funds, throughout.

Q62 Ian Swales: That is where I was getting to, Chair. May I ask Mr Middleton this question? Are your holdings all held in the UK?
Nigel Middleton: All our funds are English limited partnerships. None of our funds is established offshore.

Q63 Ian Swales: But you may have sold to offshore funds?
Robin Herzberg: I cannot comment—we have been selling completely to the likes of Barclays, HSBC etc.

Q64 Ian Swales: May I just make sure of this for the record? The reason I am asking this question is that in our previous hearing, we were talking about how PFI deals are assessed, and there is no assumption in the assessment that the ownership of those projects might end up offshore, with all the tax implications and so on.
Chair: It is worse than that. In the assessment, there is an assumption that there will be capital gains tax as part of the benefit when you are trying to look at the public value.
Ian Swales: We know this from that previous hearing. We were talking to people who own these shares offshore, so that clearly is a large issue and one that we should have on the record again from this hearing.

Q65 Chair: Have you anything to add to that, Mr Middleton?
Nigel Middleton: No, I don't think so.

Q66 Chair: Just tell me this. If the Government were to put a cap on equity sales or go for a share in the way they do on the refinancing, would that impact on Barclays Infrastructure Funds's view of its investment in PFI?
Nigel Middleton: I think about it entirely from the standpoint of the investors in our funds, what is of interest to them and what will keep them interested in looking at the UK infrastructure market as a good place to invest. I think that if you were to cap returns, there is—

Q67 Mr Bacon: Did you say cap sales or cap return?
Chair: Cap return. You could either cap return or say that, beyond a certain level, you would share return.
Nigel Middleton: Either on sale or generally on return, a cap is a strong disincentive to an investor and that presents them to downside risk.

Q68 Chair: And a share?
Nigel Middleton: A share is different. A share still creates the incentive. There we are talking about what the threshold is at which the share kicks in and how much is shared thereafter. That is certainly something that we are willing to consider. It is much easier for our investors to get their money—

Q69 Mr Bacon: Because they know what their return will be. Even if there is a share, as long as it is negotiated up front, they know what their minimum return has to be.
Nigel Middleton: Yes, but the trouble is that that is rather like thinking about a cap. They do not know what they are going to lose. That is the problem. That is why I think a share is workable and a cap is not.

Q70 Mr Bacon: A cap, presumably, would either scare everybody off—sorry, if there was a restriction on selling it and you made it more illiquid, you would demand a higher price to take part—
Chair: No, you would not.
Mr Bacon: Or would you just not take part at all?
Nigel Middleton: There are other markets looking for infrastructure investment—other countries.

Q71 Chair: Okay. Have you contributed to the £1.5 billion savings that you are supposed to be finding?
Nigel Middleton: Yes, we are looking at that actively with a number of our larger hospital investments.

Q72 Chair: And?
Nigel Middleton: Can I say how much we have contributed to date at the moment? No, I can't.

Q73 Chair: Is it through service reduction?
Nigel Middleton: It is through service reduction.

Q74 Chair: That is my fear.
Nigel Middleton: There is a very good reason for that, if I may. We find the idea, with retrospect and hindsight, of going back and saying that we do not like the deal we did, irrespective of the circumstances we have, very difficult to deal with while maintaining investor confidence.

Q75 Chair: Mark, having heard that conversation, is there anything that you want to add that we should be thinking about?
Mark Hellowell: Coming back to the issue of capping returns, subjecting the equity return to a lot of scrutiny but neglecting the other aspects of the deal that might be a bigger contributor to the cost of the deal overall might be a little bit dangerous, particularly when you are talking about a fairly concentrated oligopolistic market.
You would anticipate that if you cap the profit margin on one aspect of the deal, you might find that

additional margins are built into other bits of the deal that are not given the same level of scrutiny. I go back to the issue of the level of competition in the market. Despite the fact that PFI has been around for 20 years this autumn—during that whole period, as far as I am aware, there have been attempts to try to do something about the procurement process and lower the barriers to entry—we are still in a highly concentrated market and we are still experiencing procurement timetables that are very long by comparative or international standards. That is where effort needs to be directed, in my opinion.

Q76 Chair: Do either of you want to add anything?
Robin Herzberg: Just on the subject of PFI and improving PFI generally, it would be helpful to introduce greater diversity of funding, to reinvigorate the bond market and all that. There is an awful lot, as Mark was saying, that can be done to improve efficiency. These long procurement periods are not good. In Canada it is done an awful lot better. There is a lot of criticism on transparency, but it would be good for you to consider the Government investing in equity. On flexibility, there is quite a lot to be done to reduce gold-plating of contracts.

Q77 Chair: You just reminded me of one last thing, which is one of the bees in my bonnet. If it is public money that is being invested, it is my view that we ought to be able to follow the taxpayer's pound. To the extent that you are employing public money, should you be subject to the Freedom of Information Act in relation to that?
Robin Herzberg: Yes, and I have appeared in front of the Public Administration Committee and said that.

Q78 Chair: Do you agree?
Nigel Middleton: I—

Q79 Chair: Good.
Nigel Middleton: I do. I think that one should think about that in relation to all forms of procurement. Let's not unlevel the playing field. If one is going to think about following the taxpayer's pound in relation to PFI, follow it as assiduously through FOI in relation to other forms of procurement.

Q80 Chair: I agree with that entirely.
Nigel Middleton: Then there is nothing to argue about at that point.

Q81 Chair: I think we should be following it in all sorts of organisations.
Nigel Middleton: But let's not prejudice or burden PFI unduly.
Chair: Okay. Thank you all very much indeed.

Examination of Witnesses

Witnesses: **Geoffrey Spence**, Chief Executive, Infrastructure UK, and **Sharon White**, Director General, Public Spending, HM Treasury, gave evidence.

Q82 Chair: Welcome. Thank you. We are rather later than we thought. I particularly welcome Sharon, who is making her first appearance before us.
Mr Bacon: No she isn't. It is her first appearance as a Treasury official.
Sharon White: I appeared with Lesley Strathie in the previous incarnation of the Committee.
Chair: On tax?
Sharon White: No, on Jobcentre Plus advisers.
Chair: Well, welcome back then. Let's go to the nub of it. Mark Hellowell, in his evidence, talked about there being an excess return on equity investment in PFI, which he reckoned was between 3% and 5%. Do you accept that?
Sharon White: We are certainly concerned—which is one of the reasons why the Government are reviewing the whole of issue of PFI—to maximise value for money for the taxpayer. Obviously, the Report, which we welcome from Amyas and his colleagues, also provides some indicative but not definitive evidence that suggests that costs might come down. Also, as Mark says, it is slightly problematic to look only at the equity element of the contract.

Q83 Chair: I should say to you that this is—I think—even in this Parliament, the third look we have had at PFI. You will have seen our previous work. We decided to focus on this because we had looked at other areas earlier, so it is in the context of our wider review.
Sharon White: I understand completely. As you know, and as Mark has reiterated, the Treasury's approach has been to ask, have we got the best possible price? Have we got the proper competition? Is the playing field level, and so on? At the same time, as you know, the call for evidence that we have undertaken suggests that there are ways in which we can bring the costs down.
Some areas have been covered by previous witnesses, around the length of procurement—25 months for schools, and up to 38 months for hospitals and other complex projects—so there are definitely elements where we think there ought to be a means to provide better value for money for the taxpayer. Whether the precise numbers are in the right sort of order—as I say, they are good indications of areas for us to explore when we come to reframe our PFI policy.

Q84 Chair: Lots of questions arise out of that. First, do you support greater transparency? Would you support an open-book approach?
Sharon White: I am not sure what you mean by an "open-book approach". We definitely support more transparency, and the Committee probably knows that as part of the context of £1.5 billion of savings, we have been developing a voluntary code of conduct with investors, to provide more transparency.

Q85 Chair: I meant an open-book approach during the bidding process, so that we—or you, on our behalf—could make a better assessment of whether it is a realistic, acceptable profit margin, and whether an excessive margin of safety is being put in, given the stability and certainty of the return for the investor. An open-book approach to actually cut price and get better value.
Sharon White: We would definitely support more disclosure and more transparency in the process, and that is one of the things we are looking at with Ministers. I think there is an issue—as came up in the previous session—regarding cases involving commercialism in confidence, where we may need to work these things through. But as an issue of principle, we would definitely be looking to discuss with Ministers more disclosure in the context of the new policy.

Q86 Chair: The problem is that it seems to us that you have assumed that competition will give you best price and best value. What we have heard is that there is now a concentration as an oligopoly, and not a competitive market, which of itself is probably militating against us getting best value and best price. Presumably you agree with that. That was the evidence we had.
Sharon White: It depends what your benchmark is. If you look at some of the previous NAO Reports on whether PFI compared with public procurement had delivered more projects, such as buildings, in time and at broadly the right cost, it is interesting that overall—it is not all glossy—most PFI-funded projects are providing better value for money than the public sector.

Q87 Mr Bacon: That is a very broad statement. What you were trying to say is that more of them are delivered on budget and on time, which is not the same thing.
Sharon White: Yes, exactly. I'm sorry.

Q88 Mr Bacon: If you have a four or five-year lead-in period, you are just getting your cost overrun and your time overrun in advance, aren't you? Instead of having a Scottish Parliament, you have your hidden Scottish Parliament bit beforehand with 45 months or whatever it is, and you finally close the deal, so that bit is not in the public eye; and then you say, "We'll have a hospital", and you get that bit done on time. That's the difference, and it is not the same as value for money, is it?
Sharon White: Perhaps I was being loose, but the question was, "What's the benchmark?" Certainly, regarding the benchmark and whether funding a piece of infrastructure through PFI has generally, but not always, delivered an asset for the public purse broadly on time, with the facilities management—there are issues that we need to come back to—and broadly acceptable customer satisfaction, we are satisfied. Are we satisfied that there isn't more value for money to be gained for the taxpayer? No we are not, which is why the Chancellor announced the call for evidence. We think there is more to be done to bring costs down for the taxpayer.

Q89 Chair: Let me push you on the areas where you think there is more to be done. I agree with Richard that the assumption is that at the price they have set they have delivered on time, but is the price right and does it give us value? You have said we want more transparency. You have half gone for open book. You think there is enough competition in the market, as I understand it. Will you be looking at mechanisms to encourage more competition? I don't know, and perhaps I should ask you that first.
Sharon White: As an evidence-based Department, we are looking at the evidence. As you know, our call for evidence closed on 10 February.

Q90 Chair: Is this an issue?
Sharon White: Yes. All I want to say is that the set of issues that have been raised—we have had 150 responses—has been very broad. There are three or four sets of issues where there is a general sense that costs could be looked at more forensically. One that we have discussed is procurement time and whether it is too long.

Q91 Chair: What are you going to do about that? That was identified as an issue yonks ago. My colleagues who would know are not here, but you might know.
Sharon White: One of the issues is about commercial capability within Government. I know that the Committee has looked at that in the past, and we are actively looking to do more, so we have, in the jargon, the major projects learning academy.

Q92 Chair: I have to say with the greatest respect that, with a 28% turnover in the Treasury in one year, I don't know how you will build that in.
Sharon White: That is mostly for the Cabinet Office. The efficiency and reform group which is specifically bringing in—

Q93 Chair: What is its turnover?
Sharon White: Luckily, I don't know the numbers.
Matthew Hancock: The point about lack of capability, and complaining about turnover, could work either way.

Q94 Chair: Yes, I know, but what is concerning me is that we have all known for a long time that one of the ridiculous costs of PFI is the length of procurement, so we have always said that we want to cut it. All I'm doing is asking what will be different this time to make sure you really cut it to pull out the efficiency.
Sharon White: As I said, there needs to be a much stronger focus on trying to get the right commercial skills in Government.

Q95 Mr Bacon: Why has it taken so long? We had the Royal Institute of British Architects in front of this Committee. I was just trying to look up the date and I will let the Committee Clerk know in due course, but it was probably about five or six years ago. The president of RIBA told us then that the cost of bidding for a PFI hospital was £11 million. That was when £11 million was a lot of money. Five or six years later,

what has actually been done? You say that we need to get better at procurement. We have heard some very interesting evidence from some of the contractors: they do it so much better in France and it saves half a percentage point on the whole deal, perhaps even as much as a percentage point, and they do it better in Canada. Why are we so slow at grasping this and getting better at it?
Sharon White: It has been a work in progress. I will ask Geoffrey to come in as well. He has more direct experience of the procurement issue over the last few years. I do think that the Cabinet Office beginning to get some central capability on this is rather important—

Q96 Mr Bacon: Hang on a minute. I remember the private finance unit in the Treasury in 1994. There has been central capability for nearly 20 years, Miss White. There really has. It might not have been the right capability and maybe some of the people who went out the door were the right people to leave—I don't know. We also know that there has been a bit of a revolving door. Richard Abadie was the last head of PFI policy but three. He was a partner at PricewaterhouseCoopers. He came in and advised the Treasury as a civil servant—admittedly a temporary one on secondment, and that was years ago—to provide central capability. So I go back to my question. We know what these issues are: why is it taking so long to grasp them and do something?
Sharon White: As I say, I do think we are grasping them proactively.

Q97 Mr Bacon: But why has it taken so long?
Sharon White: Geoffrey may want to come in on some of the detail. I do think that progress has been made.

Q98 Mr Bacon: I am not sure my question is at the level of detail. My question is at the level of top down from 30,000 ft, looking down at it over a long period of time. I have watched these projects. I keep a log on my computer in Norfolk of how many projects we look at. We have looked at 62 or 63 PFI projects since I have been on this Committee over the last 10 years. So perhaps, Mr Spence, you could answer this question: why is it taking so long to grasp some of these issues that everyone knows about and has known about for a long time in terms of improving the processes of procurement, standard contracts and all the rest of it? We know about it all. Some of it has been happening. Why has it taken so long?
Geoffrey Spence: At the heart of the issue is the balance between localism and centralism. It is getting those decisions right. In many cases, if you look at the PFI programme here in the UK compared with France or Canada, one of the difficulties between the two in terms of procurement is that there has been far more central involvement in a direct procurement of a major facility—

Q99 Mr Bacon: In France?
Geoffrey Spence: And in Canada—

Q100 Mr Bacon: Than here?
Geoffrey Spence: Than here. So when we come to hospitals, there is a commitment here in the UK. There has been a commitment in the UK fully to involve doctors and nurses in the design and delivery of that hospital, and at a local level, not even at a central level. So one of the reasons why you have the sort of procurement timetables you have here in the UK is that it is a far more complex process which involves far more consultation—

Q101 Mr Bacon: I am not sure that I buy this and I will tell you why. First, the Norfolk and Norwich hospital, which admittedly was one of the early PFI contracts, were very clear that they wanted a refinancing clause included within their original contract so that they could benefit from the refinancing. The chief executive of the hospital sat there and said so. It was the centre that told them they could not. So it wasn't a lack of interference.
As for involvement in design, admittedly it is a school example, but not irrelevant to what you were just saying, I visited two schools in Northern Ireland that had roughly the same number of pupils and the same budget—Wellington College and St Thomas Aquinas grammar school. St Thomas Aquinas grammar school had a conventional procurement. Wellington College had a PFI; they were halfway through the process you describe of the involvement, the consultation and all the rest of it, and suddenly the contractor came along and said, "I'm sorry, here's your L-shaped school." All the consultation was thrown out the window, presumably because the contracts that they had with the Departments said that they could do that.
It is one thing to talk about consultation delaying things; it is another to actually do it. What we end up with are projects that do not deliver what they are supposed to—that is to say, if you go to Wellington College or if you go to the Norfolk and Norwich hospital you will see that the shareholder, including Mr Middleton, accelerated his rate of return threefold, from 18% to more than 60%, through financial engineering and through getting at it quickly—so we do not get what we want in terms of taxpayer value, and we still end up paying more overall. Why is it that they are able to get further down the field more quickly in Canada and France than we do here?
Geoffrey Spence: In Canada, they have set up a separate agency—in Ontario, for example—that is solely responsible for delivering all of their PFI schemes, and they do not involve, to the extent that we do, the local authorities. That means that you employ a professional body of people, slightly distant from Government, who deliver that facility time and again. Historically, our choice has been to say that we should have the full involvement of local people in a trust to procure that facility and, when you look at that, you realise that they are doing it once in a lifetime.

Q102 Mr Bacon: They do not have the expertise, so you then have to advise them.
Geoffrey Spence: And there are limits to how far advice can go.

Q103 Chair: But, Mr Spence, given this Government's emphasis on localism, that is going to continue.
Geoffrey Spence: What I am saying is that the key issue Ministers have to face is the balance between what is important to be done locally and what is important to be done centrally, and those are the decisions Ministers face.

Q104 Chair: Your view would be to do it more centrally to save money.
Geoffrey Spence: My comment is more to the effect that that is the issue, and you can see it clearly if you compare our processes with other countries.
Mr Bacon: That has a cost, and it is this 50 to 100 basis points that we are talking about.

Q105 Austin Mitchell: I can see why politicians, particularly Gordon Brown, went crazy on this scheme, because it is a means of getting the hospitals and the schools now—live now, pay later; or get the hospital now, and let somebody else pay later. I can see that, but I cannot see why the Treasury was so dim in dealing with it. You were like naive innocents going into a pool of sharks in dealing with this oligopoly.
You got the initial price estimates all wrong. On figure 8, if you had been right on the forecast project returns, you would have had as many forecasting a low return as forecasting a high return, but they all forecast a high return. Similarly, on figure 10, "Exit rates of return showing the size, and dates, of equity sales": here it is—enormous. In some cases, it is up to 60%. This is ludicrous. The Treasury must have been extremely naive or totally ignorant to have made so many mistakes in its estimates of what the return was going to be, what this was going to cost the public and what profits were being made by selling on the contracts. Why was the Treasury so bad?
Sharon White: One of the things that the Report usefully does is very much to highlight the equity element. Where the Treasury has been more satisfied is that, if you look at the contract in its entirety, broadly speaking PFI has been a good deal for the taxpayer. That is not a naive view.

Q106 Austin Mitchell: But it was not a good deal for the taxpayer. It would have been cheaper to borrow the money as public sector debt—you pay a lower rate of interest—than to go in for all this elaborate paraphernalia, with all the lawyers' costs, the contract costs and everything.
Sharon White: That is absolutely true, so when we do the calculation of whether it makes sense to do a PFI procurement rather than a direct public procurement, one of the things we do is to balance the additional cost of borrowing for the private sector against its ability to manage the risk of things going wrong better than the public sector. That is the calculation we make.

Q107 Matthew Hancock: I will let Austin come back on this, but I just want to challenge you on that point. In a previous Report by this Committee, we found instances when PFI was chosen rather than direct public procurement, despite the fact that it was more expensive. The response you have just given to Mr Mitchell—that PFI is, on average, cheaper—is not good enough. When deciding whether to go for a PFI contract or for direct public procurement, to get value for money it should always be that the cheaper of the two options is chosen—once all the on-costs are taken into account and the risk transfer is done in as reasonable a way as you can find. Can you comment not on the average of whether it has been cheaper—there is dispute over that—but on why there have been instances where the less good value for money option has been taken, and on how the reforms you have been talking about will change that?
Sharon White: On an individual case-by-case basis, the way in which the Treasury provides guidance to Departments is that, for individual PFIs, there ought to be an additional benefit to going through the private sector. I know that there have been various reports by the NAO that have looked at whether, on different benchmarks, individual projects may not always have been value for money. Certainly, going forward, the Treasury's very strong approach is that, for the individual project, it needs to be better value for money.

Q108 Ian Swales: Have you had any cases recently where you have said, "No. We go the public route this time"?
Sharon White: Can I give you a couple of instances to illustrate that? Geoffrey may be able to come in on particular examples. In the spending review of 2010, the Treasury got rid of something called PFI credits, of which I am sure the Committee will be aware. They basically ring-fenced bits of capital budget, which meant that there was definitely a predilection to take a decision on PFI rather than the public sector. Similarly, on particular sectors—both housing and waste—we have also taken the decision, based on past evidence, that public procurement has, on average, been better value for money, and we have excluded those areas from PFI for the future.

Q109 Ian Swales: Can you just clarify that first comment in the light of the Treasury Committee report of last July, which said: "Government departments can use PFI to leverage up their budgets without using their allotted capital budget—the investment is additional and not budgeted for"? Is that still the case?
Sharon White: That comes back to the discussion we had on how the national accounts treats—
Ian Swales: No, sorry, this is Departments.

Q110 Chair: It would be interesting to get the answer to that. Let's just get the answer, because are we right that if you separated out the capital from the—
Sharon White: You are sort of half right. The whole of Government accounts, which is very useful, has added transparency. This is the £131.5 billion figure, which is a combination of capital and future income streams. The future income stream, for which the Government pay the unitary charge, is already on budget. It is already on the balance sheet. What the Office for Budget Responsibility calculated, looking

at the £131 billion, was what proportion of that would be counted as debt—that is to say capital, which is currently off balance sheet—and they calculated that at about £33 billion or 2.3% of GDP.

Q111 Mr Bacon: I have always had a bit of a problem with this. I think I now understand the position relating to the discussion we were having earlier, but, to me, a debt is an obligation to pay something. Am I right in thinking that annual unitary charges are contractual obligations that the Government must fulfil?
Sharon White: Yes.

Q112 Mr Bacon: So when it comes down to it, whether it is a coupon on a gilt or a payment, it does not really make a lot of difference, does it?
Matthew Hancock: A coupon on a gilt is not part of that debt. It is the face paint on the gilt.
Chair: Do you want to come back on that question?
Geoffrey Spence: When it comes to the operating costs of a hospital, we will continue to have to pay the operating costs of all of our hospitals going forward. In that sense, that is a liability that we cannot avoid, even if we do not account for it. It would be a mistake to account for that differently under a PFI regime from under a normal regime. They are both a liability that we face, and it would be wrong to include those as a specific PFI liability, because they would be faced anyway.

Q113 Mr Bacon: Can I just ask you a question in the opposite direction about, for example, hospitals? You were stressing the importance of consultation. It is possible that the French method—"Here is what you will have", and then saving 0.5% to 1% of the total cost each time—results in a whole load of people across France having not what they really wanted, and that what we are getting, although we are paying a bit more for it, fits better to what people want. In your call for evidence, are you, with the advice and help of Infrastructure UK, looking at that whole question of whether actually it might be worth it, because what we are getting has greater value?
Sharon White: It is interesting that one of the issues that came out from the call for evidence, alongside the procurement issue, is flexibility. There are differences of views. One of the bits of feedback that we have had is that we should actually be building in more flexibility in the contract, because how can anybody know, over 25 years, how often they are going to want the windows cleaned at their local hospital? So, can we build in more flexibility on the maintenance side, even if that potentially means a higher cost? We will definitely be looking at those trade-offs with Ministers.
Chair: I have a list of people. Amyas wants to come in first, then Ian and Matt.
Austin Mitchell: I have Matthew's permission to do my questioning.
Chair: Okay, let me have Amyas first.
Amyas Morse: A couple of quick points. First, with one of our most recent past reports, we found that often the roll-up of maintenance contracts in the private sector was negotiated with—sometimes—one person in the hospital whose job it is to try to represent the interests of the hospital. I do not think the result of that was very surprising. There was some part-time person trying to negotiate, dealing with someone who was very expert, who understood the contract well and was a very effective negotiator, improving the value of the contract. I think that is a factor. There are plenty of other factors besides equity, I agree.
Secondly, I think you made a very good point, Mr Spence. I want to understand what your capacity is to deal with that point. If you are saying the problem is a very long procurement period—because we are constrained to allow everybody to make their own mistakes, if I can put it that way—and time is money and, if you want to do this much more quickly, you need a more standardised model, all that makes perfect sense to me. Have you the ability to deliver something at the end of the consultation period that will have some effect on that, or not? Either of you.
Geoffrey Spence: I think that it too early to say. After all, we have only just got the consultation back over the past week because quite a lot of responses were late.
Amyas Morse: Whatever it says, have you got the capacity to do it?
Geoffrey Spence: Let's face it, if the French and the Canadians can do it, I am sure we can.

Q114 Chair: We can do it, from what you said, if we centralise and don't localise.
Geoffrey Spence: There is still the debate to have as to what extent it is appropriate in this country to have central versus local, what the appropriate balance should be. I am not prejudging what that balance is. If you want to look at the difference in procurement times, that is why we have the difference. That is the biggest reason; there are other reasons as well. An important decision for Ministers to make is how they want to move on that issue.
Chair: We can do it if we agree to centralise, is how I take that.

Q115 Austin Mitchell: To conclude my question on the ineptness of the Treasury. On figure 10 we have two situations where the return on resale is 60%. One of them is a multiple figure and the other is a single figure. Why didn't the Treasury anticipate that big profits would be made from reselling it on; and why didn't it anticipate that those profits could be as high as 60%?
Sharon White: The averages from the report suggest that the return on equity has been significantly lower than that. The figure of 60% is very much an exceptional case.

Q116 Austin Mitchell: But you caught up with that only late on, didn't you?
Sharon White: Yes, but there are some things that we have done in recent years. We touched a bit on the issue around refinancing on the debt side. Our big focus has been to try to ensure that there are enough people in the market to ensure an overall competitive pricing. We have not looked specifically at equity

returns in isolation, not least given that this is 10% of the overall financing.

Q117 Chair: But will you? Will you, given this report? It has got to be a contributory factor.
Sharon White: We will certainly be looking at this. There are questions, for example, about whether we ought to bring in more institutional investors, more pension funds, and the points that were picked up in the earlier session. It is not straightforward whether we go for capping or some sharing.

Q118 Mr Bacon: When you talk about bringing pension funds in, Mr Middleton is a fund manager who has institutions, including pension funds, give him their money to manage. What would bringing in more pension funds consist of?
Geoffrey Spence: The issue is that equity in these projects is regarded by the City as quite high risk. It is classed as an alternative asset in exactly the same bucket, if you like, as private equity investments and hedge funds, though it is not regarded as mainstream, because it is illiquid. The principal reason it is regarded as quite risky—

Q119 Mr Bacon: Is it? Why then did *Investors Chronicle*, about 10 years ago, call it the secret golden egg, because it had so many of the characteristics—
Chair: Let him finish the argument.
Geoffrey Spence: I think they say that about everything.

Q120 Mr Bacon: It is not fair just to put this in the same bucket as private equity, is it?
Geoffrey Spence: My point is how institutions look at this, not whether this is fact or fiction. They look at this in exactly the same bucket as private equity and as hedge funds—as an alternative asset class they can put limited amounts to. The principal reason for that is that it is a very highly geared investment: about 90% debt is in the investment envelope. One of the reasons why we have got very high exit rates is because of that gearing effect, and that produces—

Q121 Mr Bacon: I'm sorry, you're talking about exit rates from crystallising equity sales? The reason for that is that's how you get your money out quickly and accelerate your return. Mr Spence, it is simply not true to say that this is in exactly the same asset class as private equity. I used to act for a private equity house. I used to act on a lot of both purchases and sales when investments were being crystallised. The big difference in all those I was involved with was that in no case was there standing behind it a nice fat Government contract with a steady income stream. They are fundamentally different in character, aren't they?
Geoffrey Spence: The important thing for this discussion is that the institutional investors do not think it is different.

Q122 Mr Bacon: Really? Are you telling me institutional investors don't really know what they are doing?
Geoffrey Spence: I think they look at this type of investment quite differently from their normal investments. Therefore the challenge is—

Q123 Mr Bacon: It might be a separate asset class, but it is just nonsense to say it is like private equity.
Geoffrey Spence: The challenge is to find a model that actually fits far better, and more cheaply, their way of investing into this sort of asset. The fund manager option that we have discussed in previous evidences is a model that is based on a private equity model; it is remunerated on a private equity model. We should see whether—I do not know whether we will be able to—we can move away from that to have these sort of investments more mainstream for these institutions and that will be at a lower cost. Also, it will be institutions that are prepared to hold these for the very long term, because they are looking for long-term yield without having to sell them at completion, or near to completion.

Q124 Mr Bacon: If you were to succeed in doing that, would it be by bundling up large numbers of projects together? Or what?
Geoffrey Spence: Maybe. It may also be by reducing the leverage that is in these particular structures.
Chair: Reducing what?
Geoffrey Spence: Reducing the amount of debt in these structures to leverage them less.
Mr Bacon: So more equity capital goes in.
Geoffrey Spence: That has got to be cheaper.

Q125 Ian Swales: May I come back to a point I made in the previous part of the hearing on the religion, if you like, of bundling these whole things together, including the maintenance contracts? That leads to a couple of problems. Why would we think the same organisations would be the best at each aspect of the deal, from financing to construction to ongoing maintenance provision?
That leads to another point, which I think comes from something Mrs White said a moment ago. We want to expand the number of people who can bid against this work. If I wanted to find somebody to maintain the fig trees in Portcullis House, I would not have given Carillion, or whoever it is, a contract x years ago. I would go and find somebody in the Westminster area who does that kind of stuff. It beggars belief that that part of that deal was given the right level of scrutiny whenever it was done. Not only are we not expanding the number of people who provide the different parts, we are also probably hung up on the headline cost of finance and the headline capital projects. Certainly, if you look at most PFI assets—we have that absurd example just now—it seems that the major irritation is the ongoing maintenance, with absurd stories from every school and every hospital that you talk to. My question is about bundling versus unbundling.
Geoffrey Spence: It is legitimate to look at whether we have the right mix in the services being provided within this model, I agree.
Ian Swales: It means that you have a very limited pool of people who can bid against these contracts, doesn't it?
Chair: I think we are getting agreement.

Q126 Matthew Hancock: I have a short question to follow up the line of questioning we were on before somebody else came in with a better question.
You were saying how the Treasury is now issuing very strong recommendations to have good value-for-money reasons to go for PFI, and abolishing pension credit has helped—
Sharon White: PFI credits.
Matthew Hancock: PFI credits—my goodness. A person has moved things in my diary. I am sure that *Hansard* heard the correct statement.
Given the incentive of spending Departments to spend, do you think that the new approach that you have from the Treasury on the accounting classification of PFI, alongside the Department's approach to it, means that an incentive to push for PFI on the part of a spending Department for accounting or any other reason has now been removed?
Sharon White: Yes, I do. There are a couple of things to say. PFI is 10% of all capital investment. It is a useful context to remember. It is actually a relatively small proportion of the money going into our capital in this country. The other thing is that the Treasury has pretty strong strictures and approvals, so the vast majority of PFI contracts have to go through the Treasury at various stages of the business case to be ticked through. There are some very, very small contracts where there is sufficient delegated authority, but broadly speaking, the broad majority come through my teams for signoff at various stages.

Q127 Chair: I have to come in on this, because that surprises me. The whole of the schools building programme is going to be funded through PFI, isn't it?
Sharon White: Academies won't be. The academies are non-PFI.

Q128 Chair: Which bit of the schools programme will be funded through PFI?
Sharon White: Building Schools for the Future—

Q129 Chair: No, Building Schools for the Future has gone. I certainly know from my authority, which is absolutely desperate for schools—we have the highest increase in school numbers—that it is all coming through PFI. No option.
Geoffrey Spence: The academy programme is not and neither are some of the other Department for Education capital schemes.

Q130 Chair: So what is?
Geoffrey Spence: There is a group of schools that the Department has identified as needing quite a lot of capital investment because they are in a poor state.

Q131 Chair: What about schools for extra numbers?
Geoffrey Spence: No. This is existing—
Chair: No? I tell you they are.
Matthew Hancock: You should start a free school, Margaret.

Q132 Chair: If you go by the will of the local people, what they need are more primary and secondary schools, and we are being told that the only way to do that is through PFI.
Geoffrey Spence: And that programme will have to take account of the changes that come out of this consultation.

Q133 Chair: Let me just ask you another question, because I am so sceptical. You are now telling me that the schools programme will be funded through capital. You have cut the capital, haven't you?
Sharon White: Academies are being funded as a normal public investment.

Q134 Chair: What budget has that come out of? Has that budget for schools capital been kept or cut?
Sharon White: As you know, the schools budget within the Department for Education has been relatively protected compared with other elements of the—
Chair: But it is lower than it was.
Sharon White: Exactly, and the capital—
Chair: The whole of the capital budget for the whole of Government spending is down 20% or something—I cannot remember.
Sharon White: Yes, it is about 20%.

Q135 Chair: If you are saying that you are limiting the ability of PFI, you are actually also telling us that infrastructure investment will be cut.
Sharon White: There is a general issue that the spending review for 2010, broadly speaking, means that almost every Department has a smaller capital pot to play with. The autumn statement from 2011—
Chair: Put in a bit more.
Sharon White:—basically says that for the two years of the next Parliament, capital will be held in real terms, so there is a relative buffer.

Q136 Ian Swales: Can I just clarify that? The Treasury Committee note from last July says, "departments can use PFI to leverage up their budgets without using their allotted capital budget". Is PFI included in the capital spending budgets of Departments or not?
Sharon White: PFI will be included to the extent to which we had the discussion on the accounting, so, because Departments' budgets are recorded on a national accounts basis, the future income payments and the unitary charge will be counted. The capital payment will not feature until it becomes—

Q137 Ian Swales: So you have changed the system since last July?
Sharon White: No, I am trying to say two things. In the spending review for 2010, partly responding to feedback, we wanted to do as much as we could to ensure that there was a level playing field between PFI and public procurement, which is why the ring-fenced capital money, the PFI credits, were abolished and why we said that particular sectors—housing and waste—cannot do PFI any longer.
There is a separate issue about how PFI is treated in the national accounts under European rules, which means that—not always, but broadly speaking—the cash on stream that we pay out counts and the capital does not, although about 20% gets recorded on the national accounts.

Q138 Ian Swales: Just to clarify that: if I am running a Department, I have no incentive either way to build my school or hospital with PFI or public procurement, and it is entirely down to the value decision at the time?
Sharon White: That is exactly right. More than that, you need to come to my spending team, in 90% of cases where you are using PFI, for us to tick through that you have made the value-for-money judgment correctly.

Q139 Chair: Let me give the example of the Royal Liverpool university hospital, which has been approved by this Parliament. My understanding of the approval process is that there was an original assessment that showed that it was not value to do it under PFI. People then went back to change one of the assumptions in the evaluation, the so-called optimism bias, which is the assumption that, if the public sector delivers it, it would cost more. Suddenly and miraculously, it became viable. That seems to me—
Austin Mitchell: A fiddle.
Chair: Yes. I was trying to be more polite.
Sharon White: I do not know the details of the Liverpool scheme, and I do not know whether Geoffrey does; otherwise, we would be very happy to—

Q140 Chair: It seems to me absurd to say that, at present, no decisions are being taken where you cannot prove that it is better value to be a PFI and that there is no incentive to do so. The Barts hospital site, which I keep banging on about, is more than £1 billion. The revenue costs of that will completely destroy Whipps Cross university hospital, which is Iain Duncan Smith's local hospital, and, I think, possibly Homerton university hospital—another hospital is involved—because of the revenue implications of meeting that £1 billion debt for building the hospital. No way has that been a value-for-money decision. I cannot see it at all.
Sharon White: We are very confident that we would not have sent the approval, particularly for a project of that size and contentiousness, had it not satisfied our strict calculations.

Q141 Chair: It is going to lead to closures. It is the issue that we have already raised: because the revenue costs of meeting that capital investment become the first call on the revenue budget of a trust, you squeeze out services and force cuts in services. I say this as an old defender of PFI, but I now think that, in the current climate of constraints on public spending, it is potty to do the projects that you are doing. I cannot see any common sense, value for money in it. I really find the argument you are putting incredible when I look at the projects on the ground.
Sharon White: As I say, we are confident—indeed, more confident since changes in the spending review—that the approvals process is only putting forward projects that are value for money.

Q142 Chair: I do not think you know what is happening.
David Finlay: One of the points that we made in our Report on the use of debt finance is that, because debt finance has gone up by 20% to 33%, it is now much more difficult to justify using PFI on value-for-money grounds compared with conventional procurement.

Q143 Mr Bacon: When you say debt finance has gone up, do you mean that the cost of debt finance has gone up?
David Finlay: Yes, the cost has gone up. One of the key areas for the Treasury to consider is whether it is able to demonstrate that PFI is better value than conventional procurement, or whether we are in a situation where the Treasury needs to rely on private finance, in which case it is about getting the best possible deals. What this Report tries to bring out is: are we getting the best pricing for the risks involved, bearing in mind that these are Government contracts?
Sharon White: David, your point is that if the Government were to have a predilection for PFI as a first call, the question is how we get the best price. I guess what we are saying is that we do not have a first principle of PFI. We are genuinely looking at whether PFI versus public procurement is a better deal. As you say, since 2008, when debt finance has become more expensive, inevitably some deals that would have been value for money before the financial crisis have become either more marginal or indeed not value for money for the taxpayer. One of the issues that we will be looking at in the review of PFI is how we go about potentially replacing long-term bank finance, which now looks to us structurally more expensive.

Q144 Chair: I really feel so sceptical about whether the assumptions underpinning that judgment are honest, and that is the problem—you can play around with the assumptions to make the case that you want. Those assumptions are things such as optimism bias or the issue that we raised last time about an assumption that you will get in capital gains tax when a lot of these things are offshore, so they do not come into that category. It is those assumptions that give you the answer you want in the first place.
Amyas Morse: I wanted to get back to the discussion that Mr Spence was having. I know it is irritating that we looked at equity, but the reason why we did so is that we wanted to have a discussion about risk and the appropriate payment for risk, and we thought that was probably the best way of focusing it.
In other words, as we look at most of these projects, of course there is a bidding risk. We have talked about that very fully. There is then the actual construction or asset provision risk, if you want to call it that, and we have already heard from the other witnesses that much of that is laid off in contract. After that, there is a period where you have got a mature, performing investment, where the risk is vanishingly low, for the most part. We just want to make sure that the apparent payment for risk really follows the reality of the profile of that risk.
The reason why we wanted to have that discussion is not just about PFI but about whatever other models may come forward, because we are well aware that, quite rightly, you are looking at alternative models. We wanted to get on the record that anything that

creates an annuity—anything that creates a tradable annuity value in a risk that has really gone away—is, not surprisingly, subsequently sellable at a premium.

What we are trying to do is to make sure that whatever models you are thinking of in future do not contain that—or, as far as possible, are adjusted to control that feature. If I can speak very clearly, that is what we are interested in.

Geoffrey Spence: What is the value of equity in these deals, anyway? What is the value of debt? The value is that it brings disciplines that are very hard to reproduce in the public sector. It brings disciplines in terms of equity of ownership; if you own something, you look after it better, and ownership is something that these firms have brought to these particular projects. If you are lending to it, you make absolutely sure that it is going to happen to time and to budget, if that risks losing your money. Banks have a culture, and part of that culture is extreme risk aversion. What they bring to it is a set of skills and a culture that guarantee you, to the extent that that will ever be possible, that the out-turn, particularly on completion, is going to happen, and that it is going to happen to time.

Those are the two things you get from this, and you have to trade off whether it is of value to get those benefits at the cost it is. The cost of that is going to be determined by what the markets that provide those two things are actually willing to provide it. I am sure constantly what we have to look at is: does the fluctuating cost of the benefits always match the benefits, or does it exceed them? That is something that Government should regularly do if they are going to maintain a programme such as that. In that sense, I am agreeing with you. These things should always be looked at and be considered in relation to whether circumstances have changed so that the analysis has shifted. I suppose that is what we are doing.

Q145 Ian Swales: Building on what you have just been saying, it is ironic that the Government commission a load of projects that are treated one by one, but, as Mr Morse has said, are then tradable almost as annuities or bonds. A secondary market has grown up that is highly lucrative for the people who are playing in it. We have had witnesses here who have talked about that.

My question builds on Mr Morse's about how we can extract value, but also, what do you learn from how the secondary market has been able to leverage value? Secondly, should we be concerned about the fact that a secondary market has built up? Thirdly, we know that quite a lot of the assets have moved offshore. Is that factored into our decisions about PFI deals in terms of future tax revenues and so on?

Geoffrey Spence: On secondary markets, first, we do not know whether they have priced this risk correctly. Even if we look at the figures in the NAO Report, we can see that before 2007, the prices that were being paid were really high and were therefore probably a reflection of the boom conditions that we were seeing at that time.

We have already seen the indications. Whether these have been lucrative practices by the secondary market is open to question. Given the nature of life cycle maintenance costs, which arise later on in a project's life, and the fact that these are fixed and are a private sector risk in the majority of transactions, neither do these investors know yet whether they have turned out to be lucrative investments or not. It is hard to know whether the investors have priced their risk appropriately.

Whether it is a good or bad thing, under the current model it is an important aspect of PFI, because it gives balance sheet-constrained companies—such as Carillion and Balfour Beatty—the opportunity to recycle their investments and compete for further deals down the line. In that sense, it must be of value to help increase competition.

I will not comment on the tax aspects, but on offshore investors, one of the unique things about the UK is that we welcome investors from all over the world. That gives us, overall, lower costs of capital in the projects that we take forward and it gives us access to expertise, which should be welcomed rather than denied.

Q146 Chair: So have you removed from the equation an assumption that you will be getting capital gains tax?

Sharon White: I was going to make a brief comment on the tax point. When we do our value-for-money calculus in setting the initial price of the contract, we do look at tax, particularly in the calculus between PFI and alternative public procurement. We discount by somewhere between 3% to 8%. Obviously, we cannot know at the beginning of a contract whether an equity investor—

Q147 Mr Bacon: That is a huge amount—3 percentage points to 8 percentage points. We were talking about a difference because of the cost of the increase—

Sharon White: It is on the tax.

Q148 Mr Bacon: Didn't you just say 3% to 8% on the cost of the project?

Sharon White: Between 3% and 8%.

Q149 Mr Bacon: Of the cost of the project?

Sharon White: Yes.

Q150 Mr Bacon: Right. Well, that is an enormous amount of money. We have just been talking about how 3%—300 basis points rise in the cost of debt finance—has thrown into stark relief, right up to the threshold, whether it is worth doing many of these projects any more. You are saying that the tax implications alone are at a minimum of 300, and possibly up to 800, basis points. To start with, you do not know whether—like Mapeley did with HMRC buildings—they are going to run off to Bermuda.

In parenthesis, is the Exchequer partnership number one PFI project for the back half of the Treasury building offshore?

Sharon White: I have no idea.

Q151 Mr Bacon: We looked at the competition for the financing of it seven or eight years ago—perhaps longer.

Geoffrey Spence: Can we come back to you on that, because I do not have a recollection—

Q152 Chair: The point that we would make, Sharon, is that when we looked at this last time, in calculating whether to go down the PFI route, an assumption was made. You are now telling us about 3% to 8% of the value in terms of the tax benefit to the Exchequer. Nobody monitored whether that tax benefit occurred in practice. That was the shocking finding from the previous evidence that we got. If you make the assumption that you're going to get it, is there anybody around looking at whether we do, given that so much goes offshore?
Sharon White: The 3% to 8% will be based on our experience of tax revenues that have been gained.
Chair: It was not.

Q153 Mr Bacon: The Chair's question was this. Was anybody watching to see whether the money actually came in as predicted, so that there was the degree of value for money predicted?
Sharon White: Geoffrey will have more detail, but we will certainly be looking, for example, at whether capital gains tax will have been payable when a primary investor sells up to a secondary investor. That will certainly be one of the things that we will be looking at.

Q154 Chair: So do you know? Could you tell us, project by project—
Geoffrey Spence: What we cannot do, because of HMRC client confidentiality, is tell you the individual tax charge on an individual investor.

Q155 Mr Bacon: That was not the question. The question is this. Did a project turn out to be value for money or not, based on the assumptions that the Treasury made when it agreed to it in the first place? That is the question. Did it turn out to be value for money or not? Presumably, you can go through each of the projects with a spreadsheet and say, "That one is onshore, that one is onshore, those two are offshore" etc. Have you done that?
Geoffrey Spence: The one thing I would say is that it doesn't really matter whether it's onshore or offshore for the purpose of corporation tax.

Q156 Chair: Capital gains tax.
Geoffrey Spence: If it's offshore, what you have is that corporation tax has to be paid—

Q157 Chair: Capital gains tax, capital gains tax.
Geoffrey Spence: Most of the adjustment that was put in place for tax is to do with corporation tax.

Q158 Mr Bacon: Yes, but most of the gain is through capital gains. To give you an example, the internal rate of return on Norfolk and Norwich hospital, as you know, rose from 18.5% or 18.4% up to 60%. That was a capital gain. I have no idea what Octagon Healthcare did in relation to its tax position, but the point is that most of the gain in many of these projects has been a capital gain, not an income gain for the corporation that then gets taxed through corporation tax.
Geoffrey Spence: But the tax adjustment that was made for the purposes of value for money was largely predicated on corporation tax, not on capital gains tax.
Mr Bacon: Even though most of the actual gain to the private equity investor is gained through capital gains.
Ian Swales: It's only 10% of the value, though, isn't it?

Q159 Mr Bacon: That's true. Mr Spence, may I ask you a couple of questions relating to something you said earlier? You were talking about the need to shift away from debt finance and towards more equity finance. Conventionally, when one thinks of the two, one thinks of equity capital being put into a project. It's higher risk and higher reward: you could lose the whole lot, but the reward, if you succeed, is higher. One thinks of debt finance as being lower risk and lower reward. You put the debt in. It's senior. For many of these structures we've seen, it's described as senior debt or mezzanine or whatever it is, but it's higher up the tree than the equity, right down at the bottom, and correspondingly the return is lower. One of the things you said earlier—I'm certain that I heard you correctly—was that you wanted to get more equity in, with a lower risk. You wanted to put more equity into these projects to lower the risk. Won't the investors want a better return if they're going to be putting more equity in, rather than the predictable return you get from a bond or from financing what are effectively loan repayments?
Geoffrey Spence: This is one thing that we should look at. I'm not saying that we've made decisions or Ministers have made decisions, but it's one thing we have to look at. Corporate finance theory suggests that if you have a lower risk project, the equity return should be lower than in a more high risk project. The second thing to say is that it is also probably the case that some of the issues about flexibility and PFI have arisen because of the highly leveraged structure that we have at the moment with the current model. So there are two key elements of value for money for PFI that have something to do with gearing. We have to reflect the fact also that we live in different financial markets and the debt options that have been available historically look as though they're going to be very difficult to take forward in the future. So if we look at capital market issues, which could be the cheapest form of long-term debt finance that is available going forward, increasingly they will have to be A-rated bond issues. If they're A-rated bond issues, it's necessary for the leverage of these entities to be lower than it has historically been.

Q160 Mr Bacon: So you are saying that maybe investors will be looking for other things to put their money into that previously they might not have, like what the CAG has described as vanishingly small risk, long-term performing assets? Even if technically it is equity, they would potentially be happier to do that going forward than they might have been in the past? Is that what you saying?
Geoffrey Spence: It is just because it moves the classification of these investments in the way the City looks at this, from an alternative asset bucket, which has the issues we have discussed earlier, to a more

mainstream type of investment with lower gearing, which they feel more comfortable with. These are different institutions.

Ian Swales: I can well understand what you are saying about these being high risk. Mr Bacon makes a good point about the overall schemes. But if you are exposed to 10% of a public project, and you are basically taking the risk of the whole project for 10% of the capital, I can see why that feels very high risk. I know it is outside the scope of this discussion, but my question would be more along the lines of whether the providers of the 90% are actually getting the right risk and reward. But I can understand why the 10% is high risk because you are exposed.

Q161 Mr Bacon: Can I ask you a question about competition? We have talked quite a lot about that. The word "oligopoly" has been mentioned a number of times. Do you think it is realistic to suppose that this type of market where enormous projects are being contracted for—clusters of hospitals, clusters of prisons, clusters of schools—will end up being anything other than an oligopoly? Is it realistic to expect a lot more competition returning to this marketplace, and if so where is it going to come from and for what reward?

Geoffrey Spence: I do not like the word "oligopoly" to describe this market, largely because if you participate in it on the private sector side, people are killing each other to win these projects.

Q162 Mr Bacon: That is because the risks, once you get it right, you know how to do it and you are very good at it, are so vanishingly small, whereas the rewards are still a lot better than you get putting your money on deposit at Barclays.

Geoffrey Spence: No. The reason why you participate in it, if you are Carillion or Balfour Beatty, is because you want a major share of the UK construction market. They have strategic, short-term business reasons for winning these. To be honest, if there are two or three of them competing with each other for these contracts, they will compete very aggressively to win.

Q163 Mr Bacon: But it is still fair to say that it is not perfect competition. You have huge costs of entry. There are only a small number of players who could come to the table and whom the Government would take seriously. It has a lot of the characteristics of oligopoly, doesn't it, even if you don't like the word?

Geoffrey Spence: For any large infrastructure or PFI project, the scale itself will mean that the balance sheets that can manage that project effectively and have the staff available effectively have to be larger companies.

Q164 Mr Bacon: And there won't be that many of those. So back to the other part of my question: if there is going to be more competition—you said that you would like to see more competition coming—where is it going to come from and for what reward?

Geoffrey Spence: We talked earlier about whether we had the right level of services in these contracts. It may be possible that competition can increase simply by changing the mix of what services are provided within these contracts because it is easier for other companies, maybe smaller companies, to participate in the services contract by competing outside the PFI envelope. So that is one example of how competition can increase, not necessarily within the PFI envelope but in aggregate overall.

Q165 Mr Bacon: Could we have a note on the question I asked earlier about Exchequer partnership? Make it Exchequer partnership 1 and Exchequer partnership 2 because I know they were done separately.

Sharon White: Yes, certainly.

Q166 Mr Bacon: Finally, Miss White, the Committee asked the Treasury to provide us with a note last November on the exercise you were undertaking to achieve savings from PFI contracts already in operation. Can you tell us why we have not had it yet?

Sharon White: A couple of things. We heard in the evidence session before that some of the savings are already coming on stream but we are still in the process of putting together a team of ourselves and the Cabinet Office to help and support some of the local PFI schemes. We would be very happy to give you an update, but it has taken us more time to get together the relevant expertise.

Q167 Chair: The intent was to find efficiency savings. The reality is that you are finding financial savings from service cuts.

Sharon White: We take that very seriously and your point about Romford is obviously very well made. Our big push is whether there is gold-plating on the maintenance that can be stripped out without affecting quality. Those are local decisions. The issue with Romford is about whether the level of clinical service has been affected. Thinking about the Treasury PFI building, there are two things we have done. One is obviously to bring into the building many other departments that are now chargeable customers. The Cabinet Office is occupying two floors in the building. The second thing is to look at items such as window cleaning. Do we need to have our windows cleaned twice a week, as opposed to once a month? That is not fundamentally the service.

Matthew Hancock: Once a week? I get mine cleaned once a year.

Sharon White: This is illustrative. Once every five years, as opposed to once a year.

Chair: I have to say to you that in Romford hospital I have been to A and E and seen blood on the floor. That hits you with the fact that the current cleaning standards aren't very good.

Q168 Mr Bacon: It is not obvious that the contractor would be maintaining their obligation to a gold-plated standard, is it? They would be trying to do what they needed to do, what they said they were going to do, so that they did not get penalties, and then make a profit. That is what they would be trying to do.

Sharon White: It is the issue we talked about of flexibility. How was the contract first set up? At the date the contract is set up you might think that you need your windows cleaned every year. Once you come into it, it might be an area you can change, without affecting the quality of your work and staffing. The issue about whether we need to bring in more flexibility as we refocus PFI is very serious. We want to learn the lessons from Romford and the other pilots.

Amyas Morse: What really happens is that people get ripped on variation clauses in the contract. That is how it works. You can make an awful lot of improved return on these contracts by having tough variation clauses and using them very explicitly. It can make it almost impossible to get out of something. Or to pay a huge price for something quite minor that you thought couldn't possibly cost much. It does get done in a very hard-nosed way. If you don't have someone capable of negotiating on the other side, you lose out every time.

Sharon White: That is one of the reasons why we are trying to build up a bit more central capability and support.

Amyas Morse: Can I ask another, Chair?

Chair: I have Austin and then one final question. I think we are there, okay?

Austin Mitchell: Just briefly, Chair. My optimism quotient has diminished in the course of the session. Can you supply us, since future tax returns are going to be part of the calculation, with a list of how many of these contracts have been migrated overseas?

Mr Bacon: You do not have to say which ones.

Austin Mitchell: No, 700.

Mr Bacon: Just the value; the number and the value.

Austin Mitchell: How many and what value?

Q169 Mr Bacon: That cannot be breaking any kind of taxpayer confidentiality; neither is it likely to be a small enough pool that they could all be identified—out of 700 or 800, it wouldn't be, would it?

Sharon White: We could look into the feasibility of providing the information, but we would need to look at whether we are compromising taxpayer confidentiality. We can commit—

Austin Mitchell: Not the individual contractor. The number.

Q170 Chair: If you talk to the new permanent secretary at HMRC, she is looking at providing us with much more generic data. I think you should follow her example.

Sharon White: We can commit to looking at the question.

Q171 Chair: I wanted to ask a final question. I have a bee in my bonnet about FOI. We made a recommendation in our last report in July that contracts provided by taxpayers' money ought to be subject to FOI. We obviously have Carillion who are happy with that. What are you doing? We haven't heard from you on this.

Sharon White: At the beginning of this hearing we talked about transparency. As you know, our position to date has been quite sceptical about whether FOI in these commercially sensitive contracts is appropriate. We will obviously, along with a whole set of other questions as part of the PFI review, need to have—

Chair: But Carillion seemed quite happy with that.

Sharon White: I think there were definitely mixed views in the previous session. It is another question about which we will have a conversation with Ministers. I don't want to pretend that this is an area where we don't see some big difficulty.

Q172 Ian Swales: We want to hear the commercial reasons, not the civil service reasons. That is a key point, isn't it? We should get commercial reasons for not having FOI, whereas there seems to be some hesitancy from the procurement end. If the Chair's comment isn't accepted, we need to be clear why, because it is part of our value-for-money work here.

Geoffrey Spence: I think you will find one reason is cost. Because of the uncertain costs to the private sector of what that would mean, it would probably want some arrangement whereby those costs could be passed back to the public sector.

Chair: I think that is iffy.

I want to ask a final question on the debt finance of PFI, which is such a large component. Have we had conversations with the banks to see whether we cannot bring down those rates, given what is—for me—the security of the investment?

Geoffrey Spence: We have had discussions about those rates. The issues that the banks face are basically to do with their funding costs, which are quite in excess of quoted rates, for example for LIBOR. So it may be a temporary phenomenon, or it may not be, related to the difficulties that the banks have in funding themselves and related, of course, to the eurozone crisis.

The second reason, which is longer-term and which we do not yet really know the full impact of, is the costs associated with lending long term—that is beyond, say, seven or 10 years—as a result of Basel III and the regulations that it is introducing. They could very well mean that the long-term costs of bank finance will be significantly higher than they have been historically, in terms of the margins over LIBOR that will be charged.

Those are the problems that we face. I do not think that it is a question of the banks assessing the risk of these projects differently from a credit perspective. However, they have assessed the risk on the economic basis of these projects being significantly higher than they originally thought. So they have changed their view, partly because recently quite a number of banks have sold their loan portfolios and, in some cases, they have faced very heavy haircuts to their PFI loans of 20% or more, largely because of the pricing agreed in the early part of the 2000s, which was too low.

Q173 Ian Swales: Are you suggesting that a bank has bought PFI debt and had to write off 20% of the debt?

Geoffrey Spence: They have lost 20% of the face value of the debt; it is around that mark. That is not because of a credit loss but an economic loss, because if you sell the portfolio at 60 basis points, which some of these margins were at before 2007, and today's price is at 350 basis points, the difference in that margin over the life of the loan is the scale of the loss.

Q174 Ian Swales: Why would it have gone from 60 to 350? Is it because of their assessment of risk, or because of something else happening in the market?
Geoffrey Spence: Largely because of the financial crisis and the consequences. But the knock-on effect of that is that they have assessed this business as a riskier business, particularly to carry on in the long term, because of the economic risk rather than the credit risk.

Q175 Mr Bacon: May I ask two final questions that are not strictly related? First, the press is full of stories about large corporations having huge amounts of cash; they are hoarding cash, because they have not got anywhere good to put it. Other things being equal, PFI would seem a fairly good place to put that money. Are you looking at the corporate sector itself as a possible source of cash or investment, or not?
Geoffrey Spence: On their own, I think that the corporations would only wish to use that cash in these circumstances in areas where they had a direct commercial influence, so the corporate sector is unlikely to be a direct source of investment for PFI.

Q176 Mr Bacon: Finally, who is in charge of the PFI review in the Treasury?
Sharon White: I think that is you, Mr Spence.
Mr Bacon: You?
Geoffrey Spence: Yes.
Mr Bacon: Right. Good. Thank you.
Amyas Morse: I just want to be clear about something in my mind. Surely any time that you enter into a long-term fixed loan instrument, you know that the ruling market rate will move. You do not say it is a loss just because—I do not see how that works. Would you not put matching funding in place at the beginning? I just do not see why. I recognise the ruling market rate has moved.
Geoffrey Spence: It is fine if you hold it to maturity, but what we are talking about here are banks that have sold their loans to other parties.
Ian Swales: It is a fixed rate investment.
Amyas Morse: I am not trying to find fault with what you are saying, but as a lesson that there is something terrible about this, and that it could happen in the future—it is just perfectly evident that whatever rate you enter a loan instrument at, that is the rate you enter at.
Geoffrey Spence: I am not expressing sympathy. All I am saying is that because of this experience, they are looking at this sort of transaction in a different way. What they are saying is, “We want the ability to change the price every so often and therefore not lend long term, because we need to protect ourselves from this happening again, and to sell these assets.” It has an effect.
Amyas Morse: Would they be offering you a comparable set of deals if it went the other way?
Geoffrey Spence: No.
Amyas Morse: But that would be reasonable, if they said, “Look, in that case, if the interest rate moves in a more favourable direction for us, we will share that with you if you want”.

Q177 Matthew Hancock: Surely they should be able to hedge that.
Geoffrey Spence: Not on an onward sale. I am just telling you what has happened to affect the banks’ attitude—not that it is right or wrong; it is just the reality.
Chair: I am going to stop you guys, otherwise you will go on, and it is 20 to 6. Thank you very much indeed.

Written evidence from Carillion

Thank you very much for inviting me to give evidence to the Public Account Committee on the subject of Equity Investment in Privately Financed Projects yesterday. I thought the National Office Report was a useful contribution to the debate and gave additional transparency to certain issues particularly returns from equity.

You asked me to write to you on a point of detail regarding the transfer of an element of risk on renewals of infrastructure to insurance, which would then be passed back to the Trust. I can confirm that as far as I am aware, Carillion has not sought to insure the risks associated with the renewal of infrastructure or otherwise pass such risks back to NHS Trusts. That is not to say that we would not consider such a proposal if one of our customers requested it and it was considered to be good value for money.

21 February 2012

Written evidence from the Director General Public Spending, HM Treasury and Chief Executive, Infrastructure UK

HEARING ON EQUITY INVESTMENT IN PRIVATELY FINANCED PROJECTS ON MONDAY 20 FEBRUARY 2012

We are writing to make two corrections to the evidence we gave when we appeared before the Committee on 20 February.

In the context of Treasury’s approval process (Q 108), Ian Swales MP asked if there had been any cases recently where the Treasury had said, “No. We go the public route this time”?

Sharon White replied that the housing and waste sectors have been excluded from PFI for the future because public procurement has, on average, been better value for money. It was right that it was decided at the Spending Review 2010 that certain DCLG and Defra PFI projects would not go ahead. Funding did not proceed for a number of housing and waste projects, because these schemes were either unaffordable or not judged value for money. There was no blanket decision to use public procurement in these sectors.

In relation to housing, the decision was taken by DCLG to withdraw support for thirteen pipeline housing PFI projects, as following the ending of PFI Credits and of ring-fenced funding for these projects these schemes were judged to be unaffordable. Defra took the decision to cancel funding for seven PFI waste projects because, on reasonable assumptions, these projects would no longer be needed in order to meet the 2020 landfill diversion targets set by the European Union and consequently the projects were judged not to be value for money.

Secondly, the Chair of the Commitee asked whether the whole of the schools building programme is going to be funded through PFI (Q127). In response we responded that Academy schools are not funded through PFI. Since the hearing, it has come to our attention that Academy Trusts were (in addition to local authorities, dioceses and voluntary bodies) able to submit applications to the Priority Schools Building Programme, which is privately funded.

Schools, including academies, receive capital funding through a number of streams, including over £4 billion of basic need (pupil place) funding to local authorities over this Spending Review period and a mixture of PFI and capital investment legacy commitments for schools and academies that will build over 600 schools over this Spending Review period.

We are sorry that these errors of detail slipped into our evidence. We would like to assure the Committee that there was no intention to mislead.

29 February 2012

Further written evidence from HM Treasury

FOLLOW UP NOTES—PAC HEARING ON EQUITY IN PRIVATELY FINANCED PROJECTS, 20 FEBRUARY 2012

Q150 Mr Bacon: Right. Well, that is an enormous amount of money. We have just been talking about how 3%—300 basis points rise in the cost of debt finance—has thrown into stark relief, right up to the threshold, whether it is worth doing many of these projects any more. You are saying that the tax implications alone are at a minimum of 300, and possibly up to 800, basis points. To start with, you do not know whether—like Mapeley did with HMRC buildings—they are going to run off to Bermuda.

In parenthesis, is the Exchequer partnership number one PFI project for the back half of the Treasury building offshore?

Sharon White: I have no idea.

Q151 Mr Bacon: We looked at the competition for the financing of it seven or eight years ago—perhaps longer.

Geoffrey Spence: Can we come back to you on that, because I do not have a recollection—

Q165 Mr Bacon: Could we have a note on the question I asked earlier about Exchequer partnership? Make it Exchequer partnership 1 and Exchequer partnership 2 because I know they were done separately.

Sharon White: Yes, certainly.

RESPONSE FROM HM TREASURY ON EXCHEQUER PARTNERSHIP PLC

HM Treasury's PFI contract for 1 Horse Guards Road is with Exchequer Partnership plc. Exchequer Partnership plc is a UK registered company, company registration no. 03810527.

RESPONSE FROM HMRC ON EXCHEQUER PARTNERSHIP (NO.2) PLC

HMRC's PFI contract for 100 Parliament Street is with Exchequer Partnership (No.2) plc. Exchequer Partnership (No.2) plc is a UK registered company, company registration no. 4426513.

FOLLOW UP NOTES—PAC HEARING ON EQUITY IN PRIVATELY FINANCED PROJECTS, 20 FEBRUARY 2012

Q166 Mr Bacon: Finally, Miss White, the Committee asked the Treasury to provide us with a note last November on the exercise you were undertaking to achieve savings from PFI contracts already in operation. Can you tell us why we have not had it yet?

Sharon White: A couple of things. We heard in the evidence session before that some of the savings are already coming on stream but we are still in the process of putting together a team of ourselves and the Cabinet Office to help and support some of the local PFI schemes. We would be very happy to give you an update, but it has taken us more time to get together the relevant expertise.

PAC REPORT LESSONS FROM PFI AND OTHER PROJECTS—FROM HEARING ON 15 JUNE 2011

6. The Treasury must address the scope for greater efficiencies from PFI projects. Any savings on existing contracts will be dependent on voluntary agreements by the private sector which may involve service cuts. The Treasury should update us by November 2011 on the extent of the savings to be achieved, where and how they have been achieved, and how it is minimising the risk of compromising service quality in individual PFI projects and across the programme. We wish to be advised of any companies that do not agree to make savings and expect the Treasury to consider whether the Government should continue to do business with these companies.

RESPONSE:

The Government as a whole has taken significant steps to improve the cost effectiveness and transparency of Private Finance Initiatives (PFI), supporting the commitment to deliver £1.5 billion savings across operational PFI projects in England. These savings will be fully recycled back into frontline services by the contracting authorities. This operational savings programme will drive the sharing of good practice across public sector authorities, recognising that local delivery capability is essential both to deliver savings now and to ensure better value from the use of private finance in public infrastructure in the future.

Operational savings guidance was published by HM Treasury on 19 July 2011 following pilot cost saving reviews of operational PFI projects. Following the conclusion of the pilots the Government announced on 19 July 2011 that it intended to make £1.5 billion of savings across the stock of operational contracts in England.

HM Treasury has almost completed forming the Operational Savings Programme team with skills in contract renegotiation, commercial, financial, legal, technical and programme management to support the identification and delivery of savings by public sector bodies with PFI contracts. The team will be made up of around eight full time equivalent staff. The team will work alongside HM Treasury's current activity to reform the PFI model, into which lessons learnt from the reviews of current projects will be fed.

The programme will aim to protect the quality of services by targeting savings from the effective management of contracts, making efficient use of space and reviewing soft service requirements. These areas were identified by pilot reviews as providing the best opportunities for savings in operational PFI contracts. This will ensure that the public sector is not paying for more than it needs.

It will be for each authority to make final decisions on how best to make savings in their PFI contracts, including the level of services they require. However, at this stage we are not excluding any potentially beneficial areas for investigation.

The programme's role is to create momentum, to identify good practice and develop processes which can be implemented at a local level. The team has engaged with departments and will build on the existing relationships with contracting bodies and the supplier markets, to support the effective use of scarce resources, avoid re-creation of the wheel and minimise the cost and effort of the activities.

In addition the team will monitor delivery and realisation of potential savings and support intervention to remove blockages.

HM Treasury has developed a voluntary code of conduct which it is discussing with investors, contractors and funders. As part of this programme the code of conduct will continue to evolve over the next couple of months as further information and data is gathered by the operational savings team. Amongst other things, the code will seek agreement from industry to introduce measures to enhance the financial transparency of existing PFI projects. It covers implementing current cost transparency provisions and fit-for-purpose change procedures to older contracts which do not have them, will provide greater flexibility and improve value for money when variations to contracts are required in order to achieve savings.

The team will work with elements of the Efficiency and Reform Group in Cabinet Office, including the Crown Representatives, to engage with suppliers across their portfolios of PFI contracts, and with those teams carrying out cross cutting savings activity on areas such as Energy and Consumable Commodities.

Significant levels of activity are already underway within departments, local authorities and NHS Trusts and the initial focus of the team will be to consolidate and co-ordinate the work, gather market information and build stakeholder commitment, so that the greatest savings are achieved across all potential categories in a consistent and cost effective manner, and in a realistic timescale.

At this time the team is still in the process of gathering data on savings from current activity and it is not possible to provide numbers on specific savings achieved to date. As part of the current work programme this data will be collated and validated and, together with the forward outlook based on the wider review programme, give a rolling view of progress and future expectation.

The team is still developing a detailed programme plan. In outline, the intention is to carry out in-depth engagement activities, embed information collection and management strategies, create standardised processes and develop first stage implementation plans between now and early summer with first stage rollout over the following months. This will allow early lessons to be taken on board for full programme commencement during the third quarter of this year and to progress in stages thereafter.

FOLLOW UP NOTES—PAC HEARING ON EQUITY IN PRIVATELY FINANCED PROJECTS, 20 FEBRUARY 2012

Austin Mitchell: Just briefly, Chair. My optimism quotient has diminished in the course of the session. Can you supply us, since future tax returns are going to be part of the calculation, with a list of how many of these contracts have been migrated overseas?

Mr Bacon: You do not have to say which ones.

Austin Mitchell: No, 700.

Mr Bacon: Just the value; the number and the value.

Austin Mitchell: How many and what value?

Q170 Mr Bacon: That cannot be breaking any kind of taxpayer confidentiality; neither is it likely to be a small enough pool that they could all be identified—out of 700 or 800, it wouldn't be, would it?

Sharon White: We could look into the feasibility of providing the information, but we would need to look at whether we are compromising taxpayer confidentiality. We can commit—

Austin Mitchell: Not the individual contractor. The number.

Q171 Chair: If you talk to the new permanent secretary at HMRC, she is looking at providing us with much more generic data. I think you should follow her example.

Sharon White: We can commit to looking at the question.

RESPONSE:

For each PFI project, a special purpose project company is established by the private sector equity sponsors. It is with this project company that the public sector authority contracts under PFI for the delivery of an asset and services over the project term. However, for most sectors, the project contract requires the project company to confirm that it is a UK resident company, and to undertake that it will remain so for the duration of the contract. Private sector investors have told us that their project companies are UK registered companies and subject to UK corporation tax, and central government departments have also confirmed to us that they believe this to be the case. Treasury does not hold information on any PFI contracts that would indicate that project companies have migrated overseas, however Treasury and HMRC cannot verify this as the Treasury does not hold the names of the special purpose project company for each PFI project—this information is held by each procuring authority.

UK resident PFI contractors, facilities management services and fund management companies, regardless of their shareholders' registered jurisdiction, are within the charge to UK corporation tax on profits earned within the UK.

The Committee expressed the view that the tax assumptions made in the value for money appraisal of PFI projects had subsequently proven incorrect due to a change in outcome over the project life. The Treasury does not agree that this is the case. The Green Book sets out guidance for the appraisal of alternative options when considering public spending proposals, including PFI projects and programmes. It recommends that the adjustment of market prices is appropriate where it may make a material difference to the appraisal decision. Where the differential corporation tax receipts that arise from the use of PFI, compared to traditional public sector procurement, are expected to make a material difference to the appraisal decision, a tax adjustment should be made in order to ensure a like-for-like comparison.

The adjustment is only made in relation to assumed corporation tax receipts from the special purpose project company. It does not consider capital gains tax or seek to reflect the tax position of investors. As capital gains tax receipts are not part of the value for money assessment, a subsequent change to investor liability for capital gains tax would not impact on the original value for money judgement.

The issue that the ultimate ownership of some PFI projects lies with offshore investors, meaning that capital gains are not subject to UK taxation, has been raised by the Committee. However, UK based investors also benefit from a number of capital gains exemptions. For example, the substantial shareholding exemption for UK trading companies is available for PFI companies where they meet the relevant tests, and UK pension plan schemes who invest in PFI are exempt from tax. This reflects UK tax legislation applying to all UK based activity, it is not a PFI specific issue

The Government is committed to effective anti-avoidance rules to ensure that profits arising on UK activities are not artificially diverted to low tax jurisdictions. At the same time, it needs to ensure that the tax system is competitive for all companies and has set out its plans to make the UK an attractive place to do business while retaining this proportionate anti-avoidance protection. The Treasury recognises that investors will seek to legitimately minimise their liabilities to tax and may use non-UK entities to do so. These points are not unique to PFI but apply equally to non-PFI companies and investors.

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