



House of Commons  
Treasury Committee

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**Private Finance Initiative**

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**Seventeenth Report of Session 2010–12**

***Volume II***

*Additional written evidence*

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## The Treasury Committee

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# Written evidence

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## Written evidence submitted by North Yorkshire Waste Action Group

### EXECUTIVE SUMMARY

1. NYWAG believe PFI is inflexible, expensive and inherently wasteful of public resources. In waste management, it tends to lead to large capital-intensive projects that lock Local Authorities (LAs) into long-term (~25 year) inflexible contracts. This locks out technical developments, discourages greener options and freezes out cheaper solutions such as providing services through a multiplicity of local providers who would create many more jobs.

2. In PFI there is a conflict of interest between the desire to make the best use of the skills and knowledge of the private sector, the inevitable self-interest of firms motivated by profit and the democratic wishes of local communities. Separation of responsibilities between waste management consultants and the eventual contractor could help address this issue. This is especially important where the public sector lacks sufficient experience to act as an informed customer.

3. PFI projects are generally more costly; private debt always costs more than public debt and PFI incurs additional transaction and financing costs. In long PFI contracts managing the quality of service is difficult.

4. The psychological impact from greater transparency and visibility of debt would have reduced the use of PFI. Problems with lack of transparency render bringing PFI debt on to the balance sheet imperative.

5. Under PFI, public bodies are expected to develop interdependent relationships with suppliers that allow risk to be transferred. This often leads to asymmetrical relationships where the private body holds much of the power so risk isn't transferred. Moreover, risk is often factored into the original cost so facilities cost markedly more than if funded directly. As the public sector wants the project to do the intended job, if the contractor faces real difficulties in meeting the PFI terms then the state is likely to bail them out. This implicit guarantee renders risk transfer to the private sector somewhat illusory.

6. Observing the decision-making process locally makes us doubt whether PFI is a suitable vehicle for LAs, particularly for large projects where the LA has little or no experience (eg MSW incineration). There are also dangers in many LAs taking similar decisions at about the same time (a classical "bubble" situation). An immediate decision to remove PFI support for incineration projects would reduce this risk and save the taxpayer £billions.

### *Introduction*

1. NYWAG believe PFI is inflexible, expensive and wasteful of public resources. In municipal solid waste (MSW) management, it tends to lead to large capital-intensive projects that lock Local Authorities (LAs) into inflexible long-term contracts which lock out technical developments and discourage greener options. This is particularly unfortunate as rapid technical progress is being made in MSW management in several competing technologies. This is contrary to the current opportunity to create an environmentally sound strategy for MSW management. This would reduce the amount of waste produced, maximize re-use and recycling and avoid incineration with its inflexibility, high capital costs and financial, environmental and health risks.

2. Our evidence derives largely from the perspective of MSW management following the Landfill Directive. While PFI may impact differently in other areas, some of the factors concerned are common.

### *Strengths and weaknesses of public procurement methods*

3. We cannot review all methods of public procurement. Instead we examine some of the tensions involved in using PFI:

- (a) There is a conflict of interest between the desire to make the best use of the skills and knowledge of the private sector, the inevitable self-interest of firms motivated by profit and the democratic wishes of local communities. Moving towards a "zero waste" economy requires public acceptance, making it crucial that LAs use waste management consultants guided by strong "green" central government policies to derive their waste strategies. Only after doing this with full public consultation should waste management firms be brought in. Separation of responsibility between those who design the strategy and those who implement it is essential. PFI doesn't provide this safeguard.
- (b) In MSW management, some LAs have insufficient knowledge to design a viable, cost-effective strategy that meets local needs. When moving away from a landfill-based strategy, this makes them over-reliant on private sector advice but without the experience to act effectively as informed customers. Reliance on their PFI partner during public consultation risks a "sham" consultation with commercial interests playing too strong a role.
- (c) There is a democratic deficit. Small local (eg parish) councils can object strongly to major developments in their area but have no effective say in whether they go ahead. They (and local people) should be given a much stronger say.

4. PFI projects cost more than direct-funded ones due to financing costs which a public sector alternative would not incur; Pollock et al (*BMJ*, 342: 1205–209, 2002) found that on average financing costs for NHS PFI schemes in three areas added 39% to total capital costs. More generally:

- (a) Private debt always costs more than public debt. Even before the credit crunch, private finance interest rates were 2.5%–4% above public borrowing rates (Audit Scotland, 2002: 58, Pollock and Price, *BMJ*, 341:7175, 2010). The PAC’s 2010 report on financing PFI projects found PFI has become less affordable following the credit crunch; banks lending to PFI projects have increased their interest rates by 20–30% since the financial crisis. This means higher annual repayments; the PAC (op cit) said increased bank charges “added £1 billion to the contract price, payable over 30 years, for the 35 projects financed in 2009.”
- (b) The amount of capital raised under PFI is inflated by financing charges such as professional fees and the “rolled-up interest” due during the construction period when the PFI consortium is not yet receiving any payments. Additionally, there are fees for preparing the PFI bid and contract negotiations (not always identified in advance).
- (c) PFIs/PPPs suffer from increased transaction costs arising from the complexity and long duration of the relations between the diverse actors. This may be exacerbated by culture gaps between the two sectors.

5. When LAs use PFI, central government gives them PFI “credits” to meet the capital element of funding (with which LAs pay the private sector). The LA selects a private company and transfers detailed control of the project, and in theory the risk, to them. This can mean both the taxpayer and council taxpayer unwittingly accepting financial risks:

- (a) Some LAs lack the experience to carry out proper sensitivity analysis and risk assessment and do not carry out a proper discounted cash flow analysis. Instead, they use a very limited range of assumptions, some of which are implausible (eg landfill tax will rise in real terms every year in perpetuity; waste quantities will increase despite national trends to the contrary) to make a case for their “preferred” (PFI) solution. The latter can be selected at a very early stage and the financial implications of newer competing technologies and greater waste reduction, reuse and recycling is never taken into account.
- (b) PFI typically involves large contracts. In MSW management, this means a preference for expensive technologies like incineration. Cheaper options through variety of smaller, local providers are not considered because they don’t fit well with the PFI model as a multiplicity of smaller contracts (often using a range of different technologies) would be involved. This adds unnecessarily to costs. The table compares North Yorkshire’s preferred PFI option at Allerton Park (featuring a large incinerator) with alternative independently costed options (others exist, also without incineration).

Option	Cost	Saving vs option	
		1	2
1 Continue to landfill	£1.8bn		
2 Proposed Allerton Park facility.		£320m	
3 Use small to medium local companies with their own facilities and using their own capital to build new plant as required, capable of digesting and mechanically sorting black bag waste. Meets permitted levels of landfill, involves no risk for taxpayers and offers potential for future developments and local jobs.		£958m	£638m
4 Working towards “zero waste”, implementing a waste hierarchy relying on Reduce, Re-use and Recycle. Realistically achievable in 5–10 years; many regions and cities across the world have exceeded the 60% recycled rate envisaged here.		£1.2bn	£880m
5 Bio-drying (variant of Mechanical Biological Treatment), which has low capital costs and is technically simple. First step: dry and clean black bag waste, reducing weight by 30–40% (hence reducing landfill by ~40%) and making it easy and safe to sort. Next, sort and bale materials such as plastics, metals and other recyclables leaving a residue that can be sold as RDF or put into landfill.		£545m	£225m

*Why has this substantial saving been ignored?*

- (c) The planning process and selection of preferred bidder take a long time. In a fast-moving field, the chosen technical approach can be out-dated even before final approval. Yet no-one reviews the decisions made to check they remain appropriate and no subsequent risk assessment is made. Thus an inappropriate choice becomes probable.

6. PFI is inflexible as contracts are typically 20–25 years. This “locks-in” any erroneous choice and places reliance on obsolescent technology for some, or all, of the contract. Government should advise LAs to include break clauses in long-term contracts (eg every five years) so they periodically have the opportunity to get out of commitments they no longer see as sensible

7. PFI leads to excessively high capital costs and unnecessarily high interest rates that place an undue burden on the taxpayer. It can distort the market, eg by preference for large-scale facilities at the expense of a multiplicity of smaller, local facilities at lesser cost. PFI contracts frequently create fewer jobs than the local alternative. In MSW management, PFI tends to favour multi-national giants and incineration (which is inflexible, capital-intensive and creates relatively few jobs) and runs counter to smaller local providers (who offer flexibility and would employ many more people).

*Should PFI debt be on-balance sheet?*

8. Financial problems can arise from lack of transparency (c.f. the banking crisis). Currently, the public sector can “hide” debt by taking it off-balance through PFI making it appear less “real”; this risks spending decisions being taken too lightly. This debt can be ignored when considering further PFI deals so the portfolio of hidden debt builds up without anyone noticing. Keeping it on-balance would increase awareness of the debts and perhaps influence decision makers.

9. Failure to realise there is a price to be paid for any transfer of risk to the private sector reinforces the effects of the lack of transparency arising from PFI debt being off-balance. For LAs, this may be further exacerbated through the PFI “credit” which may “hide” the PFI debt, further reducing transparency.

10. The increased awareness from greater transparency and visibility of debt would probably have reduced the use of PFI. Problems with lack of transparency make bringing PFI debt on to the balance sheet imperative. It would alert Government and LAs to the true extent of their debt.

*Risk transfer to the private sector?*

11. PFI should transfer risk to the private sector. Under PFI, public bodies are expected to develop interdependent relationships with suppliers that allow risk to be transferred. However, engineering such relationships isn’t always possible and public bodies will often find themselves asymmetrically locked-in to their supplier. This leads to private sector suppliers becoming dominant in those relationships, allowing them to pass back risk and obtain greater returns. Whether risk can be transferred under PFI comes down to timing and the nature of the relationships involved.

12. An example of this type of skewed relationship is the imposition on LAs to supply and pay for a certain amount of MSW in Energy from Waste (EfW) incineration plant and to pay for it even if they don’t supply it; a form of “take or pay” contract that places most of the risk on the LA. LAs should avoid such clauses which place them in a weak position; the incinerator operator can effectively force changes to planning consent and the types of waste treated in ways that may be contrary to the original tender documents.

13. Under PFI, transfer of risk to the private sector can be illusory in that the public sector pays an inflated price. Pollock *et al* (*op cit*) found that before risk was costed, the hospital schemes they studied would have been built much more cheaply with public funds, even with a high discount rate (which favours PFI). Thus risk transfer was critical to proving the vfm case. While they found considerable variation between schemes in the absolute and relative value of risk transferred, in all cases risk transfer almost equalled the amount required to bridge the gap between the public sector comparator and the PFI. (Even after this manipulation, the difference was marginal often under 0.1%). They concluded that the function of risk transfer is to disguise the true costs of PFI and to close the difference between private finance and the much lower costs of conventional public procurement. They felt this both raises questions about the reliability and validity of the methods used and about why the government is using an unevaluated method of procuring critically important services.

14. Risk can be a matter of differing perceptions and this can lead to wrong technology choices. Councils seeking a long-term alternative to landfill were attracted by PFI to secure private funding. However, the *Sunday Times* has reported that bankers were only prepared to lend the large amounts of money involved in return for a very low risk. They believe only incinerators offered such low risks so the choice of PFI skews the LA’s technology choice.

15. PFI can introduce additional risks:

- (a) Poor service is hard to manage when locked into a 25 year contract, eg facilities management in a lease-back building may be the responsibility of the property company. Poor service would be hard to manage because there is little real incentive to improve it.
- (b) Private sector organisations respond to commercial pressures which may exacerbate environmental and/or health risks. For waste incineration, there is a need for strong independent monitoring to counteract commercial pressures.

*Risks and projects suited to PFI?*

16. It is perhaps easier to say what should not be dealt with under PFI. Observing the local decision-making process makes us doubt whether PFI is a suitable vehicle for LAs, especially for large projects where the LA has little or no experience (eg incineration).

17. Many LAs may take similar decisions at about the same time without giving consideration to national or international factors; eg the Landfill Directive has led to a large number of MSW incineration projects at

various stages of development. This could mean overcapacity, something already seen in some European countries. A past president of the Chartered Institution of Waste Management thinks the UK has benefited from not currently having too many EfW plants in operation, saying. "It has been useful in having Kyoto targets and also funding mechanisms for projects. But, in some ways we have avoided the problems that the Germans and Dutch are facing, ie over-capacity as far as their EfW facilities are concerned. In the UK we have the possibility of other options in developing other sustainable sources of energy as well, such as biofuels rather than just incineration".

18. Perhaps this view is over-optimistic—there is a risk that PFI could kill other options. An immediate decision to remove PFI support for incineration would reduce this risk and save the taxpayer £billions.

#### *Implicit and explicit state guarantees*

19. Ultimately the public sector wants the project to do the job intended. Hence, if the contractor faces real difficulties in meeting the PFI terms the state may bail them out in some way. Hampshire overestimated waste volumes, resulting in the construction of three large incinerators. The original planning consents allowed only waste from within Hampshire to be burnt. However, the high capital cost means incinerators need a high load factor and hence an adequate and regular supply of waste. By April 2006 Hampshire's incinerators were being topped up with residual waste material from household waste recycling centres. By October 2009 BBC Radio Solent reported that Veolia (who run Hampshire's incinerators) was asking Hampshire to allow importing waste from surrounding counties. Today, despite local opposition, it is obliged to import waste from outside Hampshire to remain fully operational. There is now a risk that the Hampshire Council Taxpayers could be penalised due to the inaccuracy of the original project figures.

20. Transfer of risk is considerably less than it might appear. Also, if the project is too big or too important to be allowed to fail, there may be an implied guarantee of the project, or even the PFI partner.

#### *When are PFI deals suitable?*

21. PFI typically leads to long-term contracts which offer benefits to the private sector supplier(s) but lock the public sector into facilities and services that may become obsolete or uncompetitive during their lifetime. This is especially true in fast-developing fields where there are a number of competing choices, rendering PFI unsuitable in such fields. PFI shouldn't be allowed to stifle the possibility of innovation and development and the concomitant benefits.

22. PFI is suitable only for long-term capital projects (eg offices) where innovation appears slow and for any development which can be properly future-proofed. For the latter, risk must genuinely lie with the private sector.

#### CONCLUSIONS

23. PFI typically leads to long-term contracts which offer benefits to the private sector supplier(s) but lock the public sector into facilities and services that may become obsolete or uncompetitive during the lifetime of the contract. PFI is costly, leaves too much risk with the public sector, makes management of the quality of service delivery unnecessarily difficult and stifles technical innovation. The practice of PFI debt being off-balance sheet leads to lack of transparency about the scale of debt and may have led to unsuitable projects proceeding. PFI is unsuitable for many large projects by LAs. Government should take a decision that waste incineration will no longer be supported by PFI. This includes any projects for which approval has been given but construction work has not yet started.

April 2011

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### Written evidence submitted by Nick Collard

#### 1.0 MANAGEMENT SUMMARY

##### 1.1 Introduction

1.1.1 The attached paper sets out issues related to inadequacies in PFI methodology as applied to a specific PFI project, Nottingham Express Transit (NET) Line 1 and the proposed Phase 2 extension. Although the points raised are specific to this PFI project, they may also be applicable to other projects.

1.1.2 In this instance PFI has not delivered value for money, but despite this the Phase 2 project seems to be going ahead. However Phase 2 has yet to receive final approval from the PFI Project Review Board and should not be given approval until a new funding structure for PFI can be agreed, incorporating the issues and recommendations set out below.

##### 1.2 Summary Issues and Recommendations

Summary issues and recommendations are set out below and provided in more detail in the attached paper.

1.2.1 Issue 1—Lack of tie in of PFI credits to promised benefits

Recommendation 1—PFI credit payments should only be made by Central Government dependant upon monitoring and achievement of the benefits set out and promised in the original business case. In the case of NET this would be hitting patronage mileage targets.

#### 1.2.2 Issue 2—Lack of Clarity in Special Purpose Vehicle (SPV) Accounts

Recommendation 2—A consistent reporting format should be adopted to distinguish between PFI credits and other income. Also costs, for the benefit of the SPV but borne by other entities, should be disclosed in the SPV accounts.

#### 1.2.3 Issue 3—Incorrect Prioritisation of Infrastructure Requirements

Recommendation 3—PFI activities should be treated as *on balance sheet* and considered along with all other projects with the associated cost/benefit cases. This will ensure a level playing field exists and projects do not get priority simply because of an accounting treatment.

#### 1.2.4 Issue 4—Willingness to extend PFI contracts without a full evaluation of existing PFI performance

Recommendation 4—A full review of any existing investment should be undertaken before providing additional funds.

#### 1.2.5 Issue 5—Willingness to accept business cases in isolation for PFI extensions rather than comparing to existing performance

Recommendation 5—Any new business case should be compared to existing performance of the nearest equivalent service. This is especially important in the case of a business case to expand or extend an existing PFI project, which may not be performing well.

#### 1.2.6 Issue 6—Willingness of government to increase PFI credit levels because of funding rate increases

Recommendation 6—If funding rates increase projects should be re-evaluated; credits should not simply be increased to allow projects to proceed. Allowing projects to proceed in this scenario seems directly opposite to the government objective of reducing the national debt and the interest burden thereon.

## 2.0 FURTHER INFORMATION

### 2.1 Background

2.1.1 NET is a single line tram structure operating within Nottingham funded by PFI credits from central government (NET Line 1).

2.1.2 The PFI credits are paid to both Nottingham City and Nottingham County Councils, these are then paid by these Councils to Arrow Light Rail Limited (the special purpose vehicle set up to operate the tram system) based on availability performance.

2.1.3 Arrow Light Rail also receives farebox income from customers to cover the operating costs of the tram system.

2.1.4 Nottingham City and Nottingham County Councils are the Promoters of the current Line 1, although the County Council has expressed its intention to withdraw from this operation.

2.1.5 Both Councils initially promoted an extension to this system, NET Phase 2. However the County Council has now formally withdrawn as a Promoter leaving the City solely responsible for Phase 2. Phase 2 is to be funded via PFI and the new PFI agreement will include a re-financing of NET Line 1.

### 2.2 Issue 1—Lack of tie in of Concession to Business Case

2.2.1 The operation of the tram network is mainly funded by the payment of PFI credits based on the timely operation of the network. The balance is funded by farebox income.

2.2.2 For Phase 2, 96% of the benefits put forward in the Public Inquiry business case relate to getting people onto the tram. By tying PFI availability payments to punctuality rather than patronage there is no direct link between the benefits put forward and the authorisation of PFI payments made by central government.

2.2.3 For NET Line 1 passenger mileage targets were missed by 28% in the 12 months to end March 2010 (see 2.5.1), therefore it is key that any PFI payments made are linked to the outcomes put forward to support the business case, in this case patronage levels.

2.2.4 There is a very limited risk to the Concession because of the farebox income. However this small risk will not deliver the benefits required.

### 2.3 Issue 2—Special Purpose Vehicle (SPV)

The use of SPVs to operate PFI structures can lead to many concerns.

2.3.1 In the case of Arrow Light Rail Limited there are several key issues.

1. Up until the 2009 accounts Arrow failed to split income between farebox income and PFI payments.

This masked the operational performance of the tram. The Promoters consistently maintained (including at the Public Inquiry into Phase 2) that Line 1 ran at an operational profit, whereas it can now be clearly seen from the accounts it generates an operating loss (Availability Payments 2005–07 are derived from Nottingham City and County Council Accounts).

Operating costs are not covered by Farebox income (see below). It is of great concern that the lack of a breakdown of income prior to the 2009 Accounts led to the Promoters giving incorrect evidence to the Public Inquiry into Phase 2.

2. The accounts disclose that the Concession has also loaned monies to the SPV at a fixed rate of interest of 12.7%. The PFI grants are being used to service this excessive rate of interest.
3. The losses of the SPV are treated differently by different consortium members, ranging from incorporation of the losses in group numbers to a simple note to the accounts. However all recognise the interest income mentioned above.
4. The consortium members can charge or not as they see fit to try and improve the bottom line result, for example the members stopped charging directors fees in 2007.
5. The heavy advertising promotion of the tram is undertaken by Nottingham City Council (from public funds) and is not passed on to the SPV.

### 2.3.3 Analysis of Arrow Light Rail Financial Performance 2005–09

	2005 £000	2006 £000	2007 £000	2008 £000	2009 £000
Costs	-8,870	-9,387	-9,831	-9,731	-9,849
Farebox Income	7,070	7,516	7,867	8,186	7,845
<b>Loss on Operations</b>	<b>-1,800</b>	<b>-1,871</b>	<b>-1,964</b>	<b>-1,545</b>	<b>-2,004</b>
Availability Payments	19,813	20,256	20,675	20,924	21,267
Depreciation	-7,593	-7,583	-7,947	-7,483	-7,606
Interest Payments	-16,994	-16,849	-16,681	-16,399	-16,187
<b>Loss on Funding</b>	<b>-4,774</b>	<b>-4,176</b>	<b>-3,953</b>	<b>-2,958</b>	<b>-2,526</b>
Other Income	163	149	157	47	-38
<b>Total Loss</b>	<b>-6,411</b>	<b>-5,898</b>	<b>-5,760</b>	<b>-4,456</b>	<b>-4,568</b>

### 2.4 Issue 3—Incorrect Prioritisation of Infrastructure Requirements

2.4.1 In the case of Nottingham the most pressing transport project is the widening of the A453 from the M1 into Nottingham. The priority is recorded on the Derbyshire and Nottinghamshire Chamber of Commerce website. Widening the A453 also has all party support.

2.4.2 The cost of this development is between 1/3 and 1/4 of NET Phase 2, however the A453 was put on hold for at least the second time at the latest spending review. Indeed Net Phase 2 did not make the top three regional priorities.

2.4.3 NET Phase 2 is only wanted by Nottingham City Council, the County Council has withdrawn, considering the project too risky, and expensive. Yet NET Phase 2, costing three to four times more than the Region's most important infrastructure need, gets the go ahead simply because of PFI. It will also just serve the population along the tram corridor rather than the significantly greater number of people using the A453.

### 2.5 Issue 4—Willingness to extend PFI deals without due consideration of initial PFI performance

2.5.1 In the case of NET Line 1 there has been considerable shortfall both in terms of patronage targets (set out below) and farebox income levels (as shown in 2.3.3 above).

	Target	Latest	Shortfall	Shortfall %	Increase to hit target %
Number of Passenger Journeys (million per annum)	11.0	9.0	2.0	18	22
Average Journey Length (Kilometres)	4.9	4.3	0.6	12	14
Passenger Kilometres Travelled	53.9	38.7	15.2	28	39

2.5.2 Freedom of Information requests have confirmed that there has been no formal evaluation of Line 1 performance against the initial business case. A need to improve on throughput by 39 % to meet target should set alarm bells ringing.

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*2.6 Issue 5—Willingness to accept business cases in isolation for PFI extensions rather than comparing to existing performance*

2.6.1 In the case of NET phase 2 the business case assumes an effective doubling of the operational performance of Line 1. Simple ratio analysis shows this.

2.6.2 As shown in point 2.3.3 the ratio of farebox income to operating cost (after 6 years of operation) is 0.80. The Public Inquiry business case for Phase 2, in isolation, over its lifetime shows a ratio of 1.49, this is a near doubling of performance (see attachment 1).

2.6.3 The patronage levels these revenues are derived from are also highly questionable. The initial business case for Phase 2 was produced at around the same time as the introduction of NET Line 1. The case was then consistently re-modelled (upwards) to produce the final patronage levels in the final Public Inquiry business case (see attachment 2).

2.6.4 This re modelling was undertaken totally in isolation from the actual performance of Line 1 which has shown a significant underperformance against target over its life. Indeed it is 28 % short of its passenger kilometre target.

2.6.5 Taking the patronage levels in the final case for Line 1 and the initial case for Phase 2 as 100% (as a constant point from which performance can be assessed over time) it can be seen that Line 1 now sits at 72% (using the 28% shortfall shown at 2.5.1) and the re-modelling of Phase 2 sits at a minimum of 127%. This again does not make sense; you would expect the re-modelling to take account of actual performance (see attachment 3).

2.6.6 This further lends support to the proposal to tie PFI credits to patronage levels.

*2.7 Issue 6—Willingness of government to increase PFI credit levels because of funding rate increases*

2.7.1 The initial level of PFI credits available to NET Phase 2 was approximately £450 million. After the financial crash this was increased to £531 million. This additional expenditure and debt burden on the public generates no additional benefits, and effectively assumes the risk that the original PFI concept placed with the contractor. This also seems directly opposed to the government objectives of reducing public debt and the interest burden thereon.

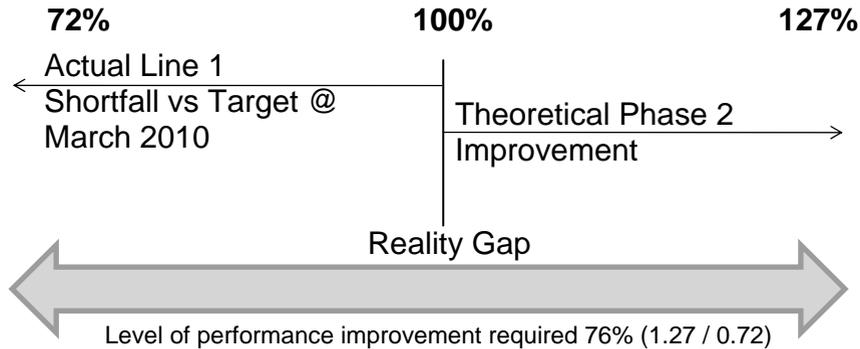
2.7.2 The level of credits now proposed is £399 million which has been put forward as a 25% saving. In reality the saving to Central Government is no more than around £50 million compared to the original proposal. A 25% saving should be based on the original award at original rates which would equate to credits approximately of £337 million—an additional £60 million saving should be requested.

*April 2011*



### Attachment 3

## NET Phase 1 and NET Phase 2 Passenger Kilometre Comparatives



- Comparative is how patronage models prepared at approximately equivalent dates have progressed.
- Actual Line 1 kilometre shortfall is 28%, this is a true outcome and should have been used to rebase Phase 2 performance whereas ever increasing passenger volumes has been assumed.
- The 27% increase may be low and understate the performance improvement required. This may need to increase to 49% if 2002 is used as base volume data (see Phase 2 patronage), this would equate to a required performance improvement of 107% (1.49/0.72).

### Written evidence submitted by the British Medical Association

The British Medical Association (BMA) welcomes the opportunity to respond to the Treasury Committee inquiry into Private Finance Initiative.

The BMA is an independent trade union and voluntary professional association which represents doctors from all branches of medicine all over the UK. It has a total membership of over 144,000. We promote the medical and allied sciences, seek to maintain the honour and interests of the medical profession and promote the achievement of high quality healthcare.

#### EXECUTIVE SUMMARY

(i) The BMA submission focuses on Private Finance Initiative (PFI) projects in healthcare. Under PFI, the public sector enters into a long term contractual arrangement with private sector companies to design, build, finance and operate an asset such as a hospital. At the end of the contractual period, the buildings then pass to the public sector. The NHS does not make an upfront capital payment but is contractually obligated to pay an annual leasing and maintenance payment to the private sector for the use of the facilities.

(ii) BMA policy has been consistently opposed to the use of PFIs to develop healthcare facilities since its introduction in the early 1990s. The main objections to the use of PFI schemes have been the high cost, associated low value for money, the lack of flexibility that results, and the transfer of public funds into private sector profits. The BMA has significant concerns about their long-term affordability, and their impact on local health economies and service delivery. This is particularly relevant today as huge pressure on public finances sits alongside the Government's current proposals for major structural change and demands for savings from the health service.

(iii) The NHS is being tasked to find efficiency savings of £20 billion by 2014–15, whilst continuing to face the demands of an ageing population and the rising costs of medicines and new technology. Cuts in spending in other areas, such as welfare benefits and social care, will have a knock-on effect on demand in the NHS. However at the same time (during the next spending review period from 2011 to 2014) repayments for NHS PFI projects will reach £4.18 billion, an increase of almost £1 billion from current levels.<sup>1</sup> As a legal contract

<sup>1</sup> Donnelly L and Ball J "Hospital to cut services to pay for £60bn private finance deal". *Telegraph*, 8 August 2009. Available at <http://www.telegraph.co.uk/health/healthnews/5995025/Hospitals-to-cut-services-to-pay-for-pay-60bn-private-finance-deal.html>

PFI removes discretion in capital spending<sup>2</sup> and it is likely that hospitals will be forced to make cuts to health care services to make their ongoing PFI repayments.

(iv) The BMA believes that, in the current financial climate and in light of mounting debt repayments, the Government should renegotiate all health PFI contracts in the UK, to counter any particularly unreasonable terms they may contain. This should be part of the policy change brought about for the rest of the public sector by the current economic climate.<sup>3</sup> Furthermore, the PFI method of financing new hospital buildings should be stopped.<sup>4</sup>

(v) The BMA's position was reinforced by a 2011 report from the Public Accounts Committee (PAC), which found no evidence that PFIs offered better value for money than other types of funding for large projects. Like the BMA, the PAC called on Government departments to do more to ensure they get the best out of existing PFI contracts, accusing the Department of Health of failing to use its leverage in the market to secure the best possible deal for taxpayers.<sup>5</sup>

## 1. What are the strengths and weaknesses of different public procurement methods?

1.1 The BMA is committed to supporting an NHS that is publicly funded through central taxes, publicly provided and publicly accountable, that seeks value for money but puts the care of patients before financial targets, and significantly reduces commercial involvement.<sup>6</sup> The smart use of public procurement of public services would be one step in ensuring that public money was being used to provide quality healthcare to the benefit of patients and the public, and not profits for shareholders.

1.2 It is inevitable that the NHS Estate will need upgrading and ongoing maintenance into the future. However, instead of relying on the unnecessarily costly and short-sighted procurement method of PFI, we would like to see the introduction and delivery of a policy of public ownership of all future NHS hospitals. Further, we call on the Government to bring PFIs into public ownership.

1.3 Underpinning the approach to private sector involvement in public services such as PFI is the assumption that public procurement is slow and expensive, whereas private companies are faster and more efficient than the State. Consequently, it has been argued by PFI supporters that PFI is cheaper than public procurement. However, Government claims that PFI has reduced cost and time overruns have not stood up to scrutiny. Research<sup>7</sup> has found that five reports often cited by the Treasury are each flawed.<sup>8</sup> For example, only one report claimed to compare PFI with conventional procurement.<sup>9</sup> Further research has shown that this work suffered from a sample bias with selected public projects involving a disproportionately large number of very complex schemes which are particularly vulnerable to cost and time overruns.<sup>10</sup> The report also measured time and cost overruns on public procurement projects from an earlier standpoint than PFI projects thus resulting in incompatible comparisons.<sup>11</sup> It can be concluded that the performance of PFI projects in comparison to publicly-procured projects appears overstated and not evidence-based.

## 2. If PFI debt had been on-balance sheet rather than off-balance sheet would pfi projects have been used as much? How should PFI deals be accounted for?

2.1A powerful motivation for Government's approval of PFI over the years is that it enables the Treasury to borrow money without the debt appearing on the public balance sheet. The BMA has previously called on the Government to "include future debts to PFI companies when calculating the NHS deficit."<sup>12</sup> In principle, the BMA believes that Government finances should be transparent and accountable to tax-payers. The Government should ensure the public has a proper account of the rates of return and profits of PFI contracts and it must reveal the true scale of PFI debt and current and future liabilities. As the Economist has written, the case for PFI "would be more convincing without cooking the books."<sup>13</sup>

2.2 The financial crisis has had a significant impact on launching new PFI projects<sup>14</sup> and the Government should rethink its involvement in such schemes. The traditional source of PFI finance came from the international bond market which has since contracted. The other alternative to raising finance is via a bank loan but the financial crisis has also adversely impacted on the banking industry and the availability of credit.

<sup>2</sup> Greener I. *Healthcare in the UK: Understanding continuity and change*. 2009.

<sup>3</sup> Consultants conference. BMA, 2011.

<sup>4</sup> Annual Representative Meeting. BMA, 2006.

<sup>5</sup> *PFI in Housing and Hospitals*. Public Accounts Committee, 2011.

<sup>6</sup> For more information regarding the Look After Our NHS campaign visit [www.lookafterournhs.org.uk](http://www.lookafterournhs.org.uk)

<sup>7</sup> Pollock A, Price D, and Player, S "An Examination of the UK Treasury's Evidence Base for Cost and Time Overrun Data in UK Value-for-Money Policy and Appraisal", *Public Money and Management*, 2007; 27 (2):127-134.

<sup>8</sup> These are: Modernising Construction (2001) and PFI Construction Performance (2003), National Audit Office; Benchmarking Stage Two Study (1999), Agile Construction Initiative; Treasury internal research project report (2002); Review of Large Public Procurement in the UK (2002), Mott MacDonald.

<sup>9</sup> Review of Large Public Procurement in the UK. Mott MacDonald, 2002.

<sup>10</sup> Public Money and Management (2007) Op cit.

<sup>11</sup> *Ibid.*

<sup>12</sup> Annual Representative Meeting. BMA, 2007.

<sup>13</sup> "PFI deals in recession: singing the blues". *The Economist*, 4 July 2009.

<sup>14</sup> Wright S "Is PFI funding built to last?" *Health Service Journal* 2009.

Given recent volatility in global financial markets, banks appear reluctant to lend for long periods of time, which is an essential element of PFI.

2.3 It could be argued that it would not have made a great deal of difference in how often PFI projects were used if debt had been off-balance sheet, as governments' preference for PFI means it has been viewed as "the only game in town" for the last decade. In theory, projects are value tested against what the project would cost under public finance. If this process concludes that private finance does not represent value for money, a public procurement method is supposed to be chosen. In a context where PFI is the only funding available and many NHS hospitals are in need of capital works, managers have faced "perverse" incentives to "manipulate" their assessments<sup>15</sup> and subsequently we have seen a proliferation of PFI projects.<sup>16</sup>

2.4 Additionally, PFI projects still involve substantial public sector investment by the Government just as public procurement would. While PFI alters the timing of payments to creditors by having private companies meet the upfront capital cost of the infrastructure, it does not reduce or eliminate payments.<sup>17</sup> The Government still has to make repayments over the life of the PFI contract. Rather than a way of increasing investment, PFI projects are an expensive and short-sighted means of refurbishing and building new hospitals.

### 3. How far can risk really be transferred from the public to the private sector?

3.1 Since governments are unlikely to default on their repayments and become bankrupt, they are able to borrow money at more attractive rates than private companies.<sup>18</sup> Consequently, as PFI deals involve the private sector borrowing at higher rates, the cost of financing a new hospital is greater. Nonetheless, supporters argue that PFIs are value for money because risk and associated costs (which would have been shouldered by the public sector) are transferred to the private sector. The BMA is not convinced that there is significant risk transfer to the private sector and consequently, this argument is fundamentally flawed.

3.2 The structure of PFI makes it difficult to evaluate risk. The private sector companies involved in PFI projects establish a separate company often known as a Special Purpose Vehicle (SPV) which then contracts with the public sector. The SPV transfers risk to its constituent parts (for example the construction company or the facilities management provider), making it unclear where the risk and ultimate responsibility lies.

3.3 Arguments as to the importance of risk transfer are further undercut by research which found that hospital trusts were paying a "risk premium"—conservatively estimated at 30% of the total construction costs—to ensure projects are running to time and budget.<sup>19</sup> So while it is true that the private sector absorbs the cost of overruns etc, additional charges are written into the contracts to account for this.

3.4 PFI has failed to shift the risk of project failure onto the private sector. If a project runs into serious trouble, the Government has to take action to secure its viability because "the political consequences of letting most PFI contracts go to the wall are usually too great."<sup>20</sup> Hospital projects are simply too important to be allowed to fail. This has been demonstrated recently with the Government setting up a new unit within Treasury to provide capital funding to PFI schemes frustrated by the lack of credit available in the current financial climate.

3.5 There are also significant risks for the public sector relating to the long-term affordability and inflexibility of PFI loans. PFI contracts legally bind NHS Trusts into making substantial payments over 25 to 30 years in a difficult financial period. This presents risks to local health economies and result in reduced services for patients. It has already been reported that the PFI scheme at the Queen Alexandra Hospital in Cosham, which has already closed wards and cut 700 jobs as a result of being in a "challenging" financial position, is costing the hospital £43m per year.<sup>21</sup>

3.6 The inflexibility of PFI also limits the ability of NHS trusts to strategically plan for the future as they are contractually bound to pay for a building and a pattern of service provision which could later prove inappropriate and unfit for purpose. It is interesting that this is occurring at the same time that the Government is encouraging service redesign and is attempting to move more health care services from secondary care into the community and primary care sector. The relationship between these changes and hospitals that have been built or are planned under PFI is unclear. What we do know is that the duration and inflexibility of PFI contracts limits the available options for future strategic planning which could put the delivery of patient services at risk.

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<sup>15</sup> Hellowell M and Pollock A "The Private Financing of NHS Hospitals: Politics, Policy and Practice". *Economic Affairs*, 2009. 29, (1) :13–19.

<sup>16</sup> Greener I. *Healthcare in the UK: Understanding continuity and change*. 2009.

<sup>17</sup> Economic Affairs (2009) Op cit.

<sup>18</sup> Economic Affairs (2009) Op cit.

<sup>19</sup> Edwards P, Shaoul J, Stafford A, Arblaster L *Evaluating the operation of PFI in roads and hospitals research report no84*. The Association of Chartered Certified Accountants, 2004. Available at <http://www.accaglobal.com/publicinterest/activities/research/reports/accountability/rr-084>

<sup>20</sup> The Economist (2009) Op cit.

<sup>21</sup> "Queen Alexandra Hospital expects to make more cuts". *BBC*, 10 March 2011. Available at <http://www.bbc.co.uk/news/uk-england-hampshire-12702048>

## Written evidence submitted by Colin Raynor<sup>22</sup>

### EXECUTIVE SUMMARY

1. The submission goes beyond central and local government balance sheets by calling for clarity on how PFI partners should account for their interests. The submission also calls for open and systematic monitoring of key financial and related targets for individual projects against independently verifiable data to better inform taxpayers and assist public expenditure decisions. The submission uses the Nottingham tram project as an example of where open and systematic reporting has fallen short of expectations and raises the question of whether promoters and their counterparts in government departments can be trusted to report disappointing project performance and if not what can be done to remedy this.

2. The examples of the Nottingham tram's Special Purpose Vehicle Arrow Light Rail Ltd and the publicly owned tram operator Nottingham City Transport Ltd—a key partner in the SPV—are used to show how well intentioned politics may give rise to a lack of transparency in accounting arrangements that in turn can mask taxpayer risk and give rise to exaggerating project performance. This can then unduly influence decisions regarding more of the same.

3. The submission closes by reporting how difficult it is for members of the public to challenge accounting arrangements where they believe these may have been wrongly applied. Underpinning the submission is the folly of not openly monitoring the financial performance of a project and hastily planning to expand without first undertaking an independent review to establish whether financial and associated business plan targets have been met and what lessons need to be learned before proceeding with more of the same. Responses to Freedom of Information questions are used as evidence to substantiate points made.

### RECOMMENDATIONS

4. The Select Committee should consider the following recommendations:

- (i) To assist with the understanding of financial performance by non finance experts including government inspectors, financial and related targets such as unit costs should be derived from approved PFI business cases and systematically monitored and reported by HM Treasury. Targets should be independently verifiable to ensure credibility (paragraph 10).
- (ii) To improve transparency, Government guidelines for PFI accounting should be reviewed and revised to ensure receipts from government or local authorities such as the capital grant and other discretionary payments are separately identified in the body of SPV accounts. This would also help to identify short term government subsidies and to form a reasonable view of the sustainability of projects whose long term survival rely on external revenue sources (paragraph 17).
- (iii) If the government is serious about accounting for PFI debt and potential risk, it should consult with the relevant professional accounting bodies to ensure that international accounting standards are applied within the UK in a manner that requires appropriate shares of losses and debts incurred as a result of any involvement with a PFI project to be reported in the body of private company accounts. This can best be ensured by publishing reporting expectations immediately following closure of PFI agreements (paragraph 21).

### BACKGROUND AND ARGUMENT

5. Transparent accounting of PFI is not only about recording debt on HMG's or even a local authority's balance sheet—this is “no brainer” as this is clearly necessary for planning public expenditure at the macro level as is the need to introduce credit ratings for local authorities. The government needs also to look at the complex accounting arrangements for individual PFI projects to see how the public can be assisted in interpreting results. For example, PFI accounting arrangements invariably involve a Special Purpose Vehicle (SPV) and in some instances publicly owned “private sector” companies as an SPV partner. Each SPV and its constituent partners produce their own audited accounts and some will show PFI debt and losses. Yet project promoters can routinely dismiss debt and losses as merely paper transactions. The public would be greatly assisted with interpreting project related accounts if clear information on key financial and related targets were made available so that a considered view by the non finance expert could be made on whether a project has delivered value for money in meeting objectives.

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<sup>22</sup> Colin graduated from Sussex University with a degree in economic and social geography. He is an associate member of the Chartered Institute of Management Accountants and a member of the Institute of Risk Management. He holds qualifications in anti-corruption (awarded by the Chancellor Michelson Institute, Bergen) and in international compliance (awarded by the International Compliance Association). During a long career in the UK and international civil services he held a number of positions including HM Treasury Accountancy Adviser, Head of Resource Management and Finance in the Department for International Development, Senior Adviser in the United Nations Industrial Development Organisation, Anti-corruption analyst, Head of DFID's Private Sector Infrastructure Team and audit management posts in the Department for Health and the FCO/ODA. He currently does voluntary charity work on behalf of the Environmental Law Foundation. As a concerned citizen, Colin takes an active interest in local development issues and promotes transparency on behalf of his local community at every opportunity.

6. The example of the Nottingham tram—often referred to as the Nottingham Express Transist (NET)—is used to illustrate the need for improved financial and related information.<sup>23</sup> For illustrative purposes only, two key players in the Nottingham Tram project are selected, namely Arrow Light Railway Ltd (Arrow) and Nottingham City Transport Ltd (NCT). Arrow<sup>24</sup> is the SPV formed “to design, build, fund, operate and maintain Line One” of the tram. Previously part of Nottingham City Council (NCC), NCT is Nottingham’s major transport operator and was set up to operate along commercial lines as a private limited company in 1986. NCC is NCT’s major shareholder and is able to exert significant influence on its operations.

7. Government approval for the Nottingham tram was based on a business case founded largely on the economic value of so called non monetised benefits ie Pound sterling values were attributed in the business case to assumptions regarding how much journey time could be saved by non tram users getting in and out of the city of Nottingham as a result of reduced traffic congestion. Lesser values were attributed to other assumed economic benefits such as the creation of new jobs. Attempts to measure and report on non monetised benefits have not been made although some service performance data—compiled by the promoter—is reported in order to justify continuation of the capital grant. However, this submission puts to one side these and the non monetised benefits and focuses on the tangible but surprisingly forgotten financial and related targets hidden in the business plan.

#### NO SYSTEMATIC REPORTING AGAINST FINANCIAL AND RELATED BUSINESS PLAN TARGETS

8. In large measure the public has not been well served by financial performance reports for the Nottingham tram. Possible targets relating to farebox revenue and patronage were set out in appendix B to the original business case (copy at Annex A—[annexes not printed]). Taken together these produce a crude unit cost (about £0.59 per journey in 2000 prices) which management accountants would regard as a good efficiency measure:

**Figure One**

#### FINANCIAL AND RELATED TARGETS FOR SUGGESTED MONITORING TAKEN FROM THE ORIGINAL BUSINESS CASE FOR THE TRAM

	<i>Annual estimated patronage (millions)</i>	<i>Annual estimated revenue (£millions)</i>	<i>Unit Cost (£)</i>
2003–04	4.4	2.32	0.53
2004–05	9.94	5.86	0.59
2005–06	11.12	6.55	0.59
2008–09	11.34	6.69	0.59
2013–14	11.86	7.0	0.59
2018–19	12.37	7.3	0.59

9. Repeated Freedom of Information requests for progress reports against revenue and patronage targets were made to the promoters and DfT. Each drew a blank. Two responses received from DfT (copies at Annex B) will be of particular interest to the Select Committee. It proves not only that such targets have not been monitored but that officials apparently don’t seem all that bothered that they have not been monitored. It is also worth noting that prior to receiving this response I had complained to the Secretary of State for Transport that an earlier request for a copy of the business plan could not be met because officials informed me they did not have a copy. Having then found a copy it seems their copy didn’t have any annexes! Just as worrying is that the same officials do not consider ANY independent assessment of the tram’s financial performance is necessary before proceeding with more of the same by way of line extensions (evidence at Annex C).

10. The availability of systematic reports against agreed financial and related targets would be invaluable. For example, it was pretty obvious during the Public Inquiry for tram extensions that the government inspector considering the case had little financial expertise. Given the difficulty trying to get the information on financial performance from the project promoters and their “minders” at DfT there are concerns that left to their own devices there may be a reluctance to produce such information should it shed the project in poor light. For this reason it is recommended that to assist with the understanding of financial performance by non finance experts including government inspectors, financial and related targets such as unit costs should be derived from approved PFI business cases and systematically monitored and reported by HM Treasury. Targets must be independently verifiable if they are to be credible

#### SUSTAINABILITY IN TERMS OF OPERATING COSTS AND REVENUES IS CRITICAL

11. Given the absence of financial monitoring reports, the taxpayer is reliant on the accounts of the SPV Arrow for tracking success. Furthermore, it is not unreasonable when reviewing these accounts to have in mind the final paragraph of page 10 of the main body of business case for the tram (Annex D) that states “a further requirement of the appraisal process is that, in operating terms, the scheme is financially self supporting, with operating revenues exceeding operating costs.” This implies—to the lay person at least—that money received

<sup>23</sup> Some service performance data—apparently compiled by the promoter and the operators—is reported presumably in order to justify continuation of the capital grant/availability fee.

<sup>24</sup> Latest shareholdings in Arrow comprise the tram’s operating partners NCT (14.3%) and Trandev PLC (12.5%) plus Innisfree (36.4%), Galaxy SARL (24.3%) and Bombardier Transportation (12.5%).

from the fares of passengers might be expected to cover basic operating costs. This scenario would also support claims by the project's promoters that the introduction of a tram will significantly increase the number of fare paying passengers using local public transport. Indeed such increases were deemed necessary to achieve the desired operating surplus.

*The operating profit reported by the spv could also be reported as a loss*

12. There are guidelines for the production of SPV accounts but in practice the tram's promoters have a high degree of flexibility which could intentionally or unintentionally be used as in the case of the Nottingham tram to give the impression that money received from the fares of passengers have covered basic operating costs and to claim, if this is the case, that the tram is a profit making sustainable enterprise. These concerns are best considered by comparing the results of Figures two and three below.

13. Figure two shows an extract taken from Arrow's audited profit and loss account for the year ended 31 December 2009 (full copy at Annex E). We can see the accounts give an impression that everything is going according to plan as they show an operating profit before depreciation for the year: This bottom line is regularly quoted as the headline result by the promoters to demonstrate the success of the project. The promoters openly dismiss depreciation as a paper transaction. More worrying is the fact that financial analysts may routinely take the reported operating profit as the basis for comparing performance with private companies which may have different reporting policies. This potential inconsistency needs to be addressed.

**Figure Two**

EXTRACT FROM ARROW'S P&L ACCOUNT, YEAR ENDED 30 DECEMBER 2009

	2009 (£000)	2008 (£000)
Turnover	29,074	29,157
Other external charges	(9,849)	(9,731)
Operating profit before depreciation	<b>19,225</b>	<b>19,426</b>
Depreciation	(7606)	(7,483)
Operating profit	<b>11,619</b>	<b>11,943</b>
Net interest payable	(16,187)	(16,399)
Loss on ordinary activities before taxation	(4,568)	(4,456)

*Lobbying for improvements to arrow's accounts*

14. Pre 2009, turnover as presented in the 2009 p&l account was described in Arrow's accounts as "farebox revenue" because Arrow's accounting policy was to lump together money received from fare paying passengers with money received from the local authority for concessionary fares and the capital grant received from government. Members of the local community felt this lacked transparency and that the presented accounts could mask losses and unreported subsidies. These concerns were dismissed as irrelevant by the project's promoters and the government inspector considering the case for extensions.

15. After a full two years of lobbying the Financial Reporting Council, DfT and the local press to have the constituent elements separately identified, Arrow produced for the first time a partial breakdown in note one to the 2009 accounts. This was very much welcomed although it doesn't go far enough because the amount received by way of concessionary fares has still not been separately identified. This is important because payments made for concessionary fares are understood to be discretionary and therefore subject to possible change eg some local authorities have recently stopped making payments for concessionary travel during peak travel time. If such a change were to be applied to the tram it could have a detrimental and material impact on revenue. There is also no way of knowing whether the unit cost applied to such journeys for payments by the local authority is "reasonable" or comparable to that used in the business case.

*Reorganising Arrow's p&l account to give a fairer view?*

16. The partial breakdown of receipts in note one to Arrow's 2009 accounts has enabled Figure three to be produced. This comprises a p&l account for Arrow in which farebox revenue is directly compared with operating costs and matches the capital grant/availability payment with the interest payable on the PFI loan. This seems more consistent with public expectations vis-à-vis reporting progress towards meeting the business case requirement that "the scheme is financially self supporting, with operating revenues exceeding operating costs." Furthermore it is seen that after 6 years of operation the tram does not appear to have met this objective and that the availability fee may include an element of subsidy ie the availability fee certainly exceeds interest payable on the PFI loan. Figures two and three also illustrate how accounting policy can influence public perceptions ie the promoters have chosen to show a profit as opposed to what others may regard as a loss. This may have influenced decisions on extensions.

**Figure Three**AN ALTERNATIVE VIEW OF ARROW'S P&L ACCOUNT, YEAR ENDED  
30 DECEMBER 2009

	2009 (£000)	2008 (£000)
Farebox revenue	7,845	8,186
Other (expense)/income	(38)	47
Other external charges	(9,849)	(9,731)
<b>Operating loss before depreciation and availability fee/ capital grant</b>	<b>(2,042)</b>	<b>(1,498)</b>
Availability fee income/capital grant	21,267	20,924
Net interest payable	(16,187)	(16,399)
<b>Operating profit before depreciation and after payment of availability fee/capital grant</b>	<b>3,038</b>	<b>3,027</b>
Depreciation	(7,606)	(7,483)
<b>Loss on ordinary activities before taxation</b>	<b>(4,568)</b>	<b>(4,456)</b>

17. There are at least three reasons why the alternative view or something very similar would be more transparent and useful than the present view:

- The accounts would show clearly on the face of the accounts how the government's capital grants are being dispensed.
- The accounts would better facilitate a comparison with financial projections set out in the original business case for the tram.
- Reconciliation between claimed passenger numbers and fare box revenue would be facilitated. This is currently not done in spite of apparent anomalies.

It is therefore recommended that to improve transparency, Government guidelines for PFI SPV accounting should be reviewed and revised to ensure receipts from government or local authorities such as the capital grant and other discretionary payments are separately identified in the body of SPV accounts. This would also help to identify subsidies and for those reviewing accounts—possibly with a view for bidding for future PFI contracts—to form a reasonable view of the sustainability of projects whose long term survival relies on external revenue.

*Different interpretations of international accounting standards give very different presentations of results and can be misleading*

18. NCT adopted international accounting standards for the first time when reporting its financial performance for the 2005–06 financial year. According to the Chairman of NCT, the reason was “to ensure that the Group is using the same reporting framework as their corporate shareholder and other Arrow investors which improves the comparability of the Group results”. But has this really been the case? The Select Committee can take a view on this by comparing how NCT and its corporate shareholder Transdev PLC—both with similar shareholdings and representation on Arrow's board—apply international accounting standards in reporting their interests in Arrow. The approaches are radically different.

*NCT uses international accounting standards in a way that keeps its share of arrow's losses off the p&l and aalance sheet whereas transdev does not*

19. The difference between the way in which NCT and Trandev interpret international accounting standards in reporting their interest in Arrow can be best summarised in Figure four below. Figures are indicative and have been taken from NCT's audited accounts for the period ending March 2010 (copy at Annex F). It should be noted that NCT's statements are produced for a period commencing three months later than the financial statements of Transdev thus allowing ample time for consultation between the parties on a consistent application of accounting standards—consultation that is necessary in order to meet NCT's stated objective of improving “the comparability of the Group results”. It is also worth noting that Trandev has chosen to “take a hit” in respect of Arrow's losses on its p&l account and balance sheet whereas NCT has decided on an alternative interpretation on the basis that Arrow should be deemed an associate of NCT because of its input to strategic decision making.

**Figure Four**

TO SHOW HOW DIFFERENT INTERPRETATIONS OF INTERNATIONAL ACCOUNTING  
STANDARDS CAN PRODUCE RADICALLY DIFFERENCE  
RESULTS FOR NCT

	£000
Reported profit before taxation year ended March 2010	3,329
Share of Arrow's losses as reported in note 14 to accounts	(4,568)
The loss that would have been reported if NCT had applied the same interpretation of international accounting standards as Transdev.	<b>(1,239)</b>

20. Alarmed by the radical difference in approaches, complaints were made to the international accounting Steering Board, HMT and DfT. DfT advised that I refer my concerns to the Financial reporting Council (FRC) as presumably DfT experts could see nothing wrong with the different interpretations (evidence of DfT's advice is at Annex B). The pursuit of transparency has been a long slog. Following correspondence with FRC over a period of two years it seems that both interpretations may be acceptable depending on the terms of the PFI agreement as this may not treat each party equally. Nevertheless, on 6 March 2011 FRC advised that it would write to NCT to "help it determine the status of its investment in Arrow". Disappointingly, FRC has not yet advised whether it will also contact Transdev to ask the question whether it believes its input to Arrow's strategic decision making is equal to NCT's.

21. Part of the delay has been caused by my failure to properly articulate concerns although FRC also failed to appreciate Arrow was an SPV. The deliberation by FRC is thus eagerly awaited. In the meantime, if the government is serious about PFI debt and potential risk it should seek greater clarity with regards to PFI accounting within the ambit of international accounting standards as soon as possible. It is therefore recommended that HMT should consult with the relevant professional bodies to ensure that international accounting standards are applied in the UK in a manner that requires appropriate shares of losses and debts incurred as a result of any involvement with a PFI project to be reported in the body of private company accounts (p&l account and balance sheet) especially those "owned" on behalf of the taxpayer by local authorities. This can best be ensured by publishing reporting expectations immediately following closure of PFI agreements thus reducing any chance of confusion and opportunity for a "pick and mix" approach.

April 2011

**Written evidence submitted by T Martin Blaiklock, Consultant, Infrastructure & Energy Project Finance**

INTRODUCTION

The Treasury Committee has requested comments with respect to issues relating to the use of PFI. This paper represents my response to that Inquiry.

I have been a consultant, banker and practitioner in infrastructure and energy project finance,—PFI, PPP and the like,—for the last 35 years or more, with both UK and wide overseas experience. I also regularly give seminars on these topics internationally, eg World Bank/IFC, EBRD, etc.

1. *What are the strengths and weaknesses of different public procurement methods?*

PFI V. CONVENTIONAL GOVERNMENT PROCUREMENT  
[OF CAPITAL ASSETS FOR PUBLIC SERVICE DELIVERY]

<i>PFI Advantages</i>	<i>PFI Disadvantages</i>
<ol style="list-style-type: none"> <li>1. Embraces private capital (equity) resources for public investment</li> <li>2. Can be structured as "off balance sheet" for Government (see below)</li> <li>3. Facilitates technological and operational innovation by PFI concessionaire</li> <li>4. Ensures cost control of investment (public sector projects historically have cost over-runs).</li> <li>5. Locks-in asset maintenance regime over project life-cycle</li> </ol>	<ol style="list-style-type: none"> <li>1. Complex structure &amp; documents for PFI</li> <li>2. PFIs take twice as long to arrange</li> <li>3. High up-front costs for PFI: twice as much as conventional procurement. Hence, PFI only suitable for investment projects exceeding, eg £40 million. (NB some up-front costs can, on occasion, be capitalised into the funds raised)</li> <li>4. Reduces competition: high costs and complexity means only major companies can afford to bid for such concessions</li> <li>5. Not suitable for PFI concessions when the underlying output specification may change over time, eg IT</li> <li>6. Demands significant senior staff attention</li> <li>7. Difficult to resolve in the event of default or failure</li> </ol>

2. If PFI debt had been on-balance sheet rather than off-balance sheet, would PFI projects have been used so much? How should PFI deals be accounted for?

#### SUMMARY

- The underlying accounting rules as to what is “on” and “off” balance sheet are unclear, but the problem is not UK-specific. International initiative is required.
- The UK Government has employed a flawed methodology for determining whether to support PFI-type deals or not. This has led to PFI deals being undertaken, when conventional analysis would not have supported PFI.

2.1 There are two main types of PFI (or, now generically termed, “PPP”s):

- (a) the delivery of a public service by a private (PFI) concessionaire, when the Government or its agents purchases the service, often in the form of an “availability” payment, eg an NHS hospital or a school; and
- (b) the delivery of a public service by a private concessionaire, when the user or consumer pays for the service delivered, eg a cash toll-road.

In both cases, lenders will typically contribute 70–90% of the funding for such deals. Further, lenders, under conventional project financing techniques, will take a lien over the project assets, for as long, at least, as their loan is outstanding.

Hence, if the concessionaire fails to perform, the lenders technically can take over ownership of the assets. Alternatively, they will demand repayment of their loans, if the Government wishes to take the assets back into public ownership. For international PFI/PPP-type deals, lenders will insist on international arbitration provisions to bolster their security.

2.2 Overall, therefore, PFI deals can create:

- a contingent liability for Government under structure (a) above. In other words, PFI is being used like a credit card for Government. It removes the financial obligations for the purchase of an asset from Capital to Current Account (.....and we all know how easy it is to overspend on one’s credit card!!); and
- a contingent liability under both (a) and (b) above, if the underlying project is an essential service, which Government cannot fail to deliver to the public, funded either as a PFI or conventionally.

2.3 The question arises as to whether such contingent liabilities should be recorded in National Accounts. Unfortunately, the accounting rules are a mess! It is also ironic that the architects of PFI/PPP have been the international accountants, who have made fortunes from creating such obfuscation in the first place, failing to adjust the accounting rules to meet modern corporate and financial structures, and then advising proponents of such structures how to avoid tax!!

*An anecdote:* in 1995–96 I applied for a post in the PFI Executive and subsequently was interviewed by HM Treasury officials in Whitehall. At the end of the interview I was asked if I had any questions for them. I responded: “who is to count up the contingent liabilities of all the PFI deals (being promoted at that time)?” Embarrassed smiles all round. Silence! End of interview. No job offer!

2.4 In February 2004, Eurostat published a Decision, which stated that:

If a PPP Concessionaire carries both the construction/completion and demand or “availability” risk, then the transaction can be considered “off” balance sheet for the host government. If not, then the transaction will be deemed “on” balance sheet for the host government.

2.5 In the above, it is clear that the determinant for this on/off decision is the interpretation of what “represents “risk” in any situation. Unfortunately, risk,—uncertainty,—is a subjective, not objective, value!!

2.6 Secondly, the determination depends on a judgement,—not an objective measure,—as to how much risk is transferred from the public to the private concessionaire. As a result, the basis for this Decision is flawed, notwithstanding that many non-EU, as well as EU, countries now use this definition for PFI!!! [It is a convenient definition for governments!].

2.7 As to whether a transaction should be deemed “on” or “off” balance sheet is in essence a financial decision, so should be based on financial, not physical or commercial, criteria. It comes as no surprise, therefore, that many governments (including the UK!) by using the current Eurostat definition have hidden many transactions “off” balance sheet, whereas they surely should be “on”!!

The classic case has been Network Rail, which receives 80% public subsidy for its operations, yet whose £20 billion—odd of debt is considered “off-balance sheet” by HM Treasury on the grounds that its debt is a contingent liability for Government, which only becomes a direct liability, if Network Rail defaults.

2.8 Many commentators have recognised the problems, but no agreed answer has emerged, not even to at least publicly record the data. Just as banks have been asked to clean up their balance sheets in recent times, so one might claim governments should do so too.

2.9 However, if this is to include the contingent liabilities arising from PFI/PPP, so it also should cover government participation in para-statal organisations and their debt, eg Manchester Airport; Electricité de France, Schipol Airport, etc., which represent contingent liabilities for national/regional governments.

2.10 Whatever is decided, it certainly would be prudent for all Governments and their agencies, which they control financially or corporately, to publish such contingent liability data as a start.

2.11 Finally, it should be noted that Greece, Spain, Portugal and Ireland have all in recent years been very active in PFI/PPP. Germany have not!.

2.12 The Inquiry asks whether UK Government has been influenced by balance sheet issues in promoting PFI/PPP. Possibly. Only Whitehall can confirm this.

However, what has influenced the decision in the past has been the flawed methodology used by HM Treasury to assess whether to pursue conventional or PFI-type procurement for a particular public service investment.

2.13 When undertaking investment analysis of a range of project opportunities, the conventional method for determining the value of one opportunity against another is to calculate the Present Value of each option. As PFI opportunities can often span many years, eg 20–30 years, the discount rate chosen to bring future values back into today's terms is key.

2.14 Conventional investment theory dictates that the discount rate to be used is the opportunity cost of capital, eg the interest rate for 30 year government bonds, by way of example. It is, of course, important to choose a discount rate which reflects the overall period of the analyses.

2.15 A second issue is how to treat inflation. Inflation exists in every jurisdiction come what may! If one is undertaking investment analyses of options which include finance, eg PPPs, then the cost of finance (eg interest rate) has to be included. As market interest rates reflect actual, or nominal, rates, the analysis should be undertaken in nominal terms too. This reflects reality, as we all see it.

2.16 The UK Government, when it undertakes analysis of investment options for public service asset projects, uses data in the calculations quoted in “real” terms, ie ignoring inflation and the cost of money. In this respect, the UK is out of step with most, if not all, other countries.

2.17 Via the “Green Book” HM Treasury determines the discount rate to be used to express future values in today's terms. From 1991 to 2003 the discount rate was 6% “**real**”, which, with inflation through that period being, say, 2–3%, gives an approximate equivalent “**nominal**” rate of 8–9%.

From 1991–2003 the cost of 30 year UK Government bonds (“gilts”) varied, but on average was 5.5–6%. This, of course, is a “nominal” value.

Hence, one can see that, by using a 6% “real” discount rate for such analyses, the UK Government was imposing a higher rate of discount than conventional investment analysis would suggest, ie 8–9% versus 5.5–6%; a differential of 3–3.5%.

2.18 The consequence of using a too high discount rate was twofold:-

- firstly, this choice favoured PFI options against conventionally funded alternatives. In cash-flow terms under a PFI the payments to be made by the purchaser (ie Government), which include the cost of funding the underlying asset, are later in the Concession period than for conventional funding, just like for a credit card.

If one calculates the value of a 3–3.5% differential in Present Value terms over 30 years, this shows an advantage to the PFI option amounting to 35–37% of the Present Value purely by using such artificially high discount rate. The result was that a number of deals, eg West Middlesex Hospital PFI, were undertaken as PFIs, when in cost terms it would have been cheaper to fund them conventionally; and

- secondly, if the underlying cash-flows from the analysis are used for budgeting purposes at a later date, they will underestimate the payments to be made to a PFI Concessionaire as they exclude the impact of inflation. This may well be the main reason why many NHS Health Trusts, who undertook PFI projects some years ago, now find they are very expensive, ie the Trusts have under-budgeted.

Fortunately, inflation has been relatively low in recent times, so this impact has been limited. But when inflation is high, under-budgeting arising from the use of a high discount rate could be very significant.

2.19 In 2003, Government changed the discount rate from 6% to 3.5% “real”. Given inflation was low at 2–3%, this discount rate thereafter reflected nominal rates prevailing at the time.

To counterbalance this abrupt change, HM Treasury introduced the concept of “Optimism Bias” to reflect, as they thought, the inherent under-estimation of costs that Government departments had demonstrated over past decades. A consultant report on a number of major projects undertaken previously showed various grades of cost over-runs, and so the empirical concept of Optimism Bias was introduced as a multiple to be applied to departmental cost estimates (the Public Sector Comparator) to cover this possibility. The minimum multiple was 1.24, ie a 24% increment for simple projects, whereas for complex projects the multiple could be 1.5–1.6 reflecting 50–60% cost over-runs.

2.20 It is well known universally that Governments often over-spend on projects. However, no other government has formalised the over-runs into a “cross the board” regulation as has the UK through the application of Optimism Bias. Other governments prefer to evaluate these possibilities through conventional sensitivity testing on “base case” cost estimates.

Arguably, the project data used to develop the UK Optimism Bias multiples was an inconsistent sample. Furthermore, if a multiple of 40% were to apply to any project estimate, could not a strong project manager be employed to control costs for 10% of the cost, plus paid another 10% as a bonus for success, and the sponsor would still be better off by 20%?

[Another flaw in the methodology was identified in that HM Treasury applied Optimism Bias before risk analysis, whereas some agencies, eg Network Rail, applied Optimism Bias after risk analysis. Mathematically the answers are different. When this anomaly was raised via the Regulator with HM Treasury and Network Rail, they both claimed they were right and that the answers were the same anyway!!]

2.21 The overall net effect of the introduction of Optimism Bias was to largely compensate for the errors which arose through the use of an erroneous discount rate for the years 1991–2003.

Today, there is greater realism in the UK Government’s approach to this topic, but there is, on occasion, a reluctance to use these quantitative tools. Nevertheless, the UK Government remains out of step with other governments on this methodology, which, while not perfect, is probably the best that can be derived. **70–80 countries worldwide now are considering PPPs, but evaluate the opportunities in “nominal” terms.**

2.22 Obviously, other factors such as efficiency, innovation, etc., have to be taken into account before arriving at a final figure for “Value for Money”.

[NB. when the UK’s new Green Book was published in 2003 there was an error in a quoted discount rate. The error remained for a further five years!]

### 3. *How far can risk really be transferred from the public to the private sector?*

3.1 The private sector will be happy to assume the risks they can manage and control, eg design, materials, construction, operations. There will, however, always be some risks which Government has to shoulder, eg land purchase for a PFI road project. Should the private sector be asked to take risks outside their control, the cost to Government is likely to be high.

### 4. *Are there any particular kind of risk which are particularly appropriate for transfer through PFI deals, or particular projects suited for PFI?*

4.1 See above comment in Sec 3.

### 5. *What state guarantees are explicit in PFI deals?*

5.1 See Sec 2 above. Technically, state (financial) guarantees play no part in PFI transactions. Investors and lenders look to the cash-flows for repayment of their capital. However, on occasion, when the creditworthiness or financial sustainability of the Government counterpart in a PFI transaction is in doubt, the PFI concessionaire may require explicit “guarantees” from Central Government underpinning the commercial undertakings of such PFI counterpart.

### 6. *In what circumstances are PFI deals suitable for delivery of services?*

6.1 Certain types of project are more suitable for PFI procurement than others. Much depends on the inherent project risks. Typically, “accommodation”-type projects, where the underlying demand and service output over 30 years does not change, are suitable for PFI treatment, eg hospital accommodation; schools; university accommodation; prisons; Government offices. Interestingly, in the years 1995–2003, more than 50% of UK PFI’s were in this sector.

6.2 Other sectors can be characterised as follows:

Metros	—	not suitable as PFIs; too many risks
Light rail	—	possibly, as Availability payment PFIs.
Motorways	—	yes, as Availability payment PFIs
Estuarial bridges & tunnels	—	suitable for PFI, either as toll projects or against Availability payment

Urban roads	—	not suitable for PFI
Waste treatment plants	—	suitable as PFIs
Water treatment plants	—	suitable as PFIs
High-tech buildings [eg NPL]	—	not suitable for PFI
Airports & ports	—	potentially PFI, but high infrastructure costs [NB. need access infrastructure]
Hospitals including clinical services	—	not suitable for PFI.

April 2011

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### Written evidence submitted by the Royal Institute of British Architects

#### ABOUT THE RIBA

The Royal Institute of British Architects (RIBA) champions better buildings, communities and the environment through architecture and our members. It has been promoting architecture and architects since being awarded its Royal Charter in 1837. The 40,000-strong professional institute is committed to serving the public interest through good design, and represents 85% of registered architects in the UK as well as a significant number of international members.

#### INTRODUCTION

The RIBA has long argued for changes to the current process of procuring public buildings, particularly schools and health buildings, under both Private Finance Initiative (PFI) and its recent derivatives such as the Building Schools for the Future (BSF) programme.

Our concerns initially stemmed purely from the perceived lack of design quality in buildings procured under traditional forms of PFI procurement processes. There was evidence that even after 15 years of PFI experience, although buildings are more often delivered on-time and on-budget, the quality of the buildings delivered through PFI schemes remained poor in many cases.

The poor quality of the buildings' design lead to a number of issues, such as rising maintenance costs over the lifetime of the building, public and professional scepticism regarding the value of public procurement programmes, and poor buildings actively constraining health and education service delivery.

Furthermore, the process was also felt to take an unnecessarily long time, further impacting on the costs of procurement, and delaying both the start of construction and project delivery when compared to similar projects delivered via alternative procurement routes used in other sectors.

#### PRINCIPLES OF GOOD PROCUREMENT

There is no one preferred model of procurement and different methods would be appropriate for different projects. In our view, the core principles to achieving good outcomes through public procurement are:

*1. There should be close engagement between designer and user-client in the development of a brief*

Meaningful consultation should take place between those designing a building and those who will use it, in order to create the right brief, based on the information that the demand side brings but the supply side doesn't possess. This engagement needs to be structured properly, so that it does not become unnecessarily onerous. This does not mean that an entirely bespoke design will be the end product but just that the brief fits the needs of the user.

*2. There should be a strong, expert client*

It is imperative that the public client has access to the right expertise in managing major construction projects and a good understanding of the procurement process. It is essential that clients are able to produce well researched and developed project briefs at an early stage, prior to being put out to tender in order to avoid unnecessary delays and rising costs further along the line.

*3. There should be a genuinely integrated construction team*

As highlighted in the Government's recent Innovation Growth Team (IGT) Report led by the Chief Construction Adviser Paul Morrell, there is a need for properly integrated, cross-professional teams in public procurement projects. Government should seek the procurement of properly integrated teams, of designers and contractors, in order to encourage joined up thinking both in definition and execution of a project, through continuous positive engagement through the duration of the project. This would ensure that construction team have shared goals leading to better outcomes.

#### 4. *There should be clarity of budget from the outset*

Many of the buildings procured under PFI to date have not had a clear and designated budget from the outset. It is our view that the most effective means of procurement would be the target-cost method, which results in designs to fit a budget rather than a budget to fit the design. We believe that the public client would gain greater value-for-money if contractors competed on quality rather than price. This encourages competition on the quality of a design for that designated budget and promotes innovation. The specification of a building will therefore be arrived to through the process of design, rather than it being pre-determined at the outset.

#### 5. *The process and costs should be transparent*

The Government could and should insist on open-book transparency for public procurement projects across all levels of the supply chain. The public should be able to see where money is being spent and the spurious contractor confidentiality clauses in previous PFI contracts should be removed.

#### 6. *Public procurement should encourage competition and innovation and avoid monopoly capture*

Procurement processes dominated by a few large firms inhibit innovation and the incentive for those working on public projects to improve practices and compete on both cost and quality. . This reduces the pool of talent working on projects reduces innovation imported from other sectors, limits the application of local knowledge from locally-operating firms, and circulates work around a small and decreasing number of firms

### PROBLEMS WITH EXISTING PFI/PPP MODELS

#### *What causes the problems?*

The quality of the design of a building directly affects its long term operating and maintenance costs, the standards of service provision, and the building's sustainability. The main causes of substandard design quality are:

- Under-prepared clients—Often “first-time” clients, with too little experience or professional resource available “in-house”, and too little financial support at the very early stages, preventing them from buying in sufficient professional advice, and little requirement to do so.
- Insufficiently tested and under-detailed design briefs—Due to a lack of professional advice and resources in the preparatory stages (the Strategic and Outline Business Case stages), and no requirement for the client to undertake early conceptual design work or a sufficiently detailed design scheme before putting the project out to tender, poorly detailed and unresearched project briefs cause uncertainty, delay and make re-interpretation of the original brief unavoidable during the procurement process.
- Barriers to entering the market—Many architectural practices are prevented from even bidding for work, due to the limited entry routes to the market—the lack of design frameworks, or open competitions—as well as the fact that contractors are required to have a design team on-board before bidding for the work, meaning they frequently use their own in-house design teams, and a small number of practices that they have worked with previously. This reduces the pool of talent working on school design, reduces innovation imported from other sectors, limits the application of local knowledge from locally-operating practices, and circulates work around a small and decreasing number of practices.
- In addition, European procurement regulation, due both directly to the rules governing the OJEU procedure, and their interpretation and application in the UK, severely restricts access to the market for a huge number of professional practices.
- Too much control of the design process by contractors—Currently, the contractual client of the architect is usually the main project contractor or constructor, not the public body responsible for procuring overall project (eg the Local Education Authority). As a result, we find that direct communication between designer and user-client is limited, and constrained by the contractor. It is this direct relationship between architect and true client that enables an understanding by both parties of the requirements, aspirations and philosophy for the project. In most sectors, particularly in private sector projects, best practice requires that the architect team has the end-user or commissioner of the project as their client, creating a direct and open relationship. This enables the architect to work in the direct interest of the commissioner/user.
- Insufficient weighting for Design Quality—The relatively low scoring given to design quality in the evaluation of bids and the lack of relevant skills and experience on the part of many evaluation teams has a direct impact on the quality of building design.

- Value-engineering by contractors—There is strong anecdotal evidence of contractors limiting the amount of information, provided by their architects working to the specified brief, made available to clients. This information typically concerns quality specifications, finishes, and materials, thereby enabling the contractor to “value engineer” the project, essentially reducing the intended quality and cost of the project compared to that specified by the architect, to the detriment of the finished building, without the knowledge of an unaware client. This is done in order to maintain the contractor’s preferred levels of profitability, but can be to the detriment of the finish of the building, and its functionality, and can add considerably to its long term maintenance costs over the period of its lifetime.
- Simultaneously developing the design and choosing the contractor—Undertaking the selection of the major contractor at the same time as the design being developed almost from scratch to a fully developed design proposal is detrimental to the design quality. It means that multiple competing contractors and their design teams are seeking equal access to the end users, public client and other technical and public individuals/groups involved in the consultation process, at the same time, during what is a constrained period in the procurement process. This duplication of effort limits the availability of the consultees, and the quality of their engagement with the process, and this detrimentally impacts on the design quality.
- High bidding costs deter competition and add to the overall cost of procurement, while delays further increase project costs while delaying public service improvements. The main causes of unnecessarily high costs and delays are:
- Duplication of effort—Made worse by the requirement of the Competitive Dialogue Procedure, many public sector procurement routes require that up to three bidders work up fully detailed design proposals simultaneously. We feel that much of this work—particularly the early and crucial conceptual design work—should be carried out by the client before going to the market. Instead, the current requirements mean that efforts are wasted by bidders duplicating the design and consultation process. The requirements result in three separate, highly expensive and detailed plans being developed. The considerable cost of providing access to consultees and providing cover for staff, etc. are borne by the procuring public authority. The associated design costs are initially borne by the bidders, but eventually the huge cost of failed bids (the cost of a failed bid is on average upward of over £2.5 million per school, and over £12 million per PFI hospital—2005, Major Contractors’ Group) are returned to the tax payer through future successful bids.
- Delays to procurement—Procurement takes too long, and often suffers from unexpected and unplanned for delays during vital stages of the process. This is due to a number of reasons, including unnecessary duplication of effort by bidders, inadequate or poorly tested specifications for projects in the briefing documents, failures to address policy issues at the outset, and a lack of negotiating and professional project management skills within the procuring authority.
- Bureaucracy and the amount of information required from bidders—The information required of applicants under the OJEU process is excessive and acts as a deterrent to small practices, which may not even have the necessary information. The frequent requirement for management and human resource strategies are a boost for larger firms, which have both the resources and need to put such policies into place. Small practices have neither the resources required nor the practical need to have such policies in place. The bureaucracy and cost of the European route to procurement also discourages clients from seeking separate specialist contractors or consultants through a number of OJEU notices, instead finding it easier, cheaper and quicker to select one large multi-disciplinary provider, or, as is the case in most public building procurement, a single main contractor.

April 2011

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#### Written evidence submitted by Lisa Smeaton

I write as a member of the public. I have had grave concerns about the use of PFI since its inception. My concerns are wide-ranging and include the following key points:

1. The use of PFI appears to be a government “credit-card” where expenditure can be put despite it being an expensive form of borrowing particularly in the current climate and consequently offers very poor value for money to the tax payer.
2. PFI also is “off the books”. I think this is a foolish and unprofessional way for a Government to operate its finances. It is used to avoid this debt showing on deficient figures. It seems ludicrous to make substantial cuts in all areas of government in the current climate and at the same time to continue using PFI because it “hides” the debt.
3. PFI represents a millstone around the necks of the children of this country who will be forced to pay off this debt for years to come.
4. Politicians may feel that PFI means that risk is shared and construction costs reduced but, I can assure you, that construction companies are far more financially savvy than most politicians and profit will be made, in the long term, via maintenance and leasing. Of course construction companies must be

given the opportunity to make a profit but it would be far more sensible for these companies to be allowed to make their profit during the construction of a hospital/school etc not in some complicated, long term arrangement. In the current climate, with less industrial projects taking place, it would actually be easier for the government to achieve very good value for money in traditional contractual arrangements due to competition between contractors.

5. Both Mr Osborne and Mr Cable made very clear statements about the use of PFI during the election including comments such as a “discredited” mode (Osborne) and “a dishonest system of accounting, designed to hide taxpayers’ liabilities” (Cable). Given those comments I think it would be entirely acceptable for the public to imagine that the use of PFI would have been substantially changed and/or discontinued particularly given Mr Osborne and Mr Cable’s role in Government. To find that the Government has now approved 61 PFI projects in less than 12 months is truly a disgrace and again demonstrates why the general public have so little confidence or respect for politicians.

I would be grateful if my comments could be taken into consideration.

April 2011

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### **Written evidence submitted by John Sullivan**

I am responding to the letter from Jesse Norman in the *Guardian* today 26 April 2011, regarding PFI & public debt.

Can I ask whether or not the committee will take into consideration the status of the NHS when PFI was introduced, and the extremely long waiting lists for treatment. Plus the excessive cost of so many treatments, due to the ancient hospital buildings modern medicine was being attempted within.

It should be remembered that the millions of extra operations realised because of PFI relieved pain and suffering, for the very taxpayers that were suffering on the up to two year waiting lists. Furthermore whilst the waiting lists were waiting lists for so many, they were also death lists for far to many. Too many people died unnecessarily on the NHS waiting lists prior to the introduction of PFI & the investment in the NHS by the last government.

PFI is not simply a case of balancing the books, PFI was a means to an end, an end to the suffering of millions waiting in pain and many dying whilst waiting it was the only way to improve the quality of life for millions in a short space of time.

I therefore sincerely hope that the accountant mentality being put forward by some, can be balanced with all of the facts and not a selective set of figures that give no credit whatsoever to the benefits millions of in pain taxpayers have gained from PFI. Or to the huge interest we would still be paying on loans rather than PFI.

Literally millions of tax payers have had their taxes spent on having their lives made pain free or had their lives saved by the introduction of PFI, so what price do the anti PFI accountants put on pain or life ???

Compared to the ongoing cost of war over this period of time, it seems to me PFI has benefitted British taxpayers far more than all the bombs and the bullets. but I suppose it is a matter of your priority.

Jesse Norman suggests taxpayers are concerned about the cost, but as one tax payer who is alive today thanks to PFI along with further investment in the NHS up until this year. I suggest none of the people alive today or pain free today thanks to the provision of new hospitals via PFI, are among the concerned.

April 2011

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### **Written evidence submitted by Canmore Partnership Ltd**

#### **INTRODUCTION**

1.1 Canmore Partnership Limited (“Canmore”) is a specialist promoter of public use infrastructure projects across the UK. A brief background summary of Canmore’s activities is attached. Our submission builds upon our earlier contributions to the debate on the future role of the private sector in providing public use infrastructure. More than ever, the UK needs a settled, non-partisan view on how public services are procured and funded. In the final section of this memorandum we include an executive summary and we propose an evolution towards a revised form of Strategic Infrastructure Partnership provision.

#### **THE HISTORICAL PERSPECTIVE**

2.1 In 1995 the Conservative Chancellor of the Exchequer said: “We are changing the role of government... to being a provider of private investment opportunities and a purchaser of services, not always a direct investor and service provider.” His Labour Shadow said: “We aim to be an enabler...doing rather more steering than rowing.” We argue that this fundamental policy shift was correct and has on balance been beneficial to the public. The challenge is to identify and correct any mistakes made along the way, and to identify and spread

best practice and so reinvigorate the process of public infrastructure provision by the private sector. We should not be afraid to innovate whilst building upon progress to date.

2.2 The UK now has a mixed economy of public use infrastructure provision. Broadly this falls into three categories:

- (a) services paid for by users, either directly through user charges or indirectly through taxation, and provided by the public sector (eg water and sewerage in Scotland and Northern Ireland);
- (b) services generally paid for by the public sector on behalf of users and provided by the private sector (eg PFI/PPP accommodation and elements of health provision such as GPs); and
- (c) services provided by the private sector to users who pay for them directly within a public sector regulatory framework (eg electricity, gas and telecommunications).

Our main focus, and so the focus of our contribution to the Committee's inquiry, is on providing public use infrastructure in which the public sector continues to provide the core service (eg NHS facilities, colleges and universities). As such our model falls short of the full privatisation historically implicit in category (c) and is more akin to the support role played by the private sector in category (b).

2.3 Many of the UK's current infrastructure problems are the direct result of insufficient investment, inadequate regulation and poor project preparation. Debate on the role of the private sector is often derailed by dogmatic and selective historical references and inaccurate anecdotes. We start from the proposition that there is nothing inherently good or bad about the provision of public use infrastructure or wider public services by either the private or public sectors. We suggest that the optimum delivery model is that which works best, whether it be public, private or a mixture of both. What works best should be judged primarily in terms of overall Value for Money ("VfM"), but crucially this embraces not just cost but also quality. Efficiency and excellence should be encouraged and profits should be shared between the private and public sector partners, which neither the PFI nor the Scottish Non-Profit Distributing ("NPD") models currently achieve as well as they could and should do.

#### ACCOUNTING FOR PFI PROJECTS; VALUE FOR MONEY ("VfM")

3.1 We shall probably never know the real motivations of the Conservative Government when PFI was launched in 1994. Was it really an accounting device intended to remove much needed investment from the public accounts? Or was it, at least to some significant degree, a logical successor to privatisation which mirrored the contracting out of support functions (similar to the out-sourcing procurement strategies employed by many companies in support of their businesses)? What is certain is that private provision offers much needed additional funding which is available now without further legislation or constitutional change. It is primarily for the Government to decide on how it accounts for PFI projects; we merely seek an even playing field on which to compete against traditional direct procurement.

3.2 A number of criticisms have been made about PFI/PPP, including:

- excessive borrowing costs;
- unnecessary and/or excessive private profit;
- poor design;
- low service levels, reduced facilities and poorer quality; and
- inflexibility.

These criticisms reflect a widespread public discomfort and lack of understanding about the private sector's role. Whether the criticisms are valid or not, we must acknowledge that such discomfort and misunderstanding exist. We must answer the underlying criticisms and concerns—all of which have been, or can be, overcome.

3.3 Comparison of the relative VfM of PFI/PPP procurement is made more difficult by the continuing lack of data relating to direct public procurement. It is presumably true that procurements such as Portcullis House, the Holyrood parliament building and Edinburgh trams are exceptional, but the public sector should establish consistent reporting on the outturn costs and completion timing of all public procurements which would inform a better valuation of risk transfer. Private sector providers of public use infrastructure should also embrace openness and transparency. We successfully argued recently against the inclusion of PFI project companies within FoI provisions because this is unnecessary (because their public sector partners are generally already obliged to comply with FoI disclosure) and it is also an unwelcome and duplicated expense for the private sector. However, we maintain that all contracts to which the public sector is a signatory should be routinely released with exceptions made only in respect of exceptional security concerns or genuine commercial confidentiality (eg protection of proprietary software and sensitive input cost data but not of the resulting prices to the public sector).

#### FUNDING

4.1 PFI has built up an appetite and ability to provide long-term funding for public use infrastructure on terms and over maturities which were unthinkable prior to PFI. Undoubtedly, these funding terms reflect the fundamental covenant of the public sector counter-parties, but that covenant usually falls far short of an explicit

“state guarantee”. It is a mistake to concentrate debate solely or even primarily upon funding mechanisms; private provision of public use infrastructure should embrace much wider issues. However, when risk adjustment is included in the equation, private finance is actually much less expensive than is often stated when compared to “Treasury” funding. PPP funders take a real, not theoretical, risk on project failure on top of the simple state or semi-state borrower covenant risk. Recent projects have had historically high funding costs although refinancing should reduce these considerably in due course. Earlier projects will benefit in perpetuity from funding terms which now seem unrealistically low.

4.2 The experience of the last three years has shown that it is very difficult for a new organisation like the Scottish Futures Trust (“SFT”) to raise funds. Although we applaud much of the work of the SFT to date, it has not yet provided a major new funding stream for public use infrastructure projects in sectors such as health, education and similar local authority services.

4.3 It is also important to recognise that projects can and do go wrong sometimes; that is what risk transfer to private providers means. In those circumstances it is investors and lenders who are usually required to provide expertise and additional funding to rescue them. Critics of PPP/PFI tend to focus on projects where investors are thought to have made excessive profit, often without consideration of whether, despite that profit, those projects still were judged to have been better value for money than conventional direct procurement. This judgement is also usually made without consideration of losses sustained on other projects. A recent study suggested that 17% of PFI contracts are unprofitable and 38% are less profitable than expected (ie 55% of PFI projects generate returns lower than expectations). This is a very different picture from that normally painted by critics.

4.4 It is now widely agreed that windfall profits resulting from refinancing are unacceptable; recent Treasury guidance requires refinancing and provides for sharing the resulting gains. A reasonable balance has been struck which incentivises refinancing and shares the resulting benefits. However, we query whether calls to share investors’ gains on disposing of their equity interests in PPP projects is reasonable or practical; these procurements are presumably already deemed to represent better VfM than alternative procurement models (ie Full Business Case approvals will have had to show this to be the case) and so profits on disposals are surely part of investors’ reasonable “upside”.

#### *Not for Profit?*

5.1 The Non Profit Distributing (“NPD”) model was developed by Partnerships UK under a previous Scottish Government to avoid the accusation of permitting “excessive profits”. It has been increasingly relied upon by the current Scottish Government. However, critics of the NPD model observe that, compared to “traditional” PFI:

- it leaves the public sector more at risk if projects go wrong;
- in projects signed to date, it fails to require refinancings when they are most likely to be appropriate (ie soon after projects are operationally secure) and does not fairly compensate subordinated debt providers—so it has met the reasonable aspirations of neither public nor private sectors in this regard;
- it discourages pricing transparency by encouraging the private sector to extract additional profit at the sub-contract level to compensate for capped returns;
- it gives limited incentive to the private sector to seek truly outstanding performance but instead encourages operators merely to manage risk so as to achieve their capped returns; and
- as a consequence, it does not deliver enhanced VfM (ie it appears to cap “headline” investors’ returns but does not actually cost less).

Why then is NPD better? We suggest that it simply meets a political imperative by fudging issues. A candid review of the relative VfM of signed NPD projects would be helpful in taking this debate forward based on facts and not merely assertions.

#### **BUILDING UPON WHAT WORKS**

6.1 Whatever the faults and shortcomings, much good has come from the delivery of public use infrastructure and services by the private sector. Although there is undoubtedly a high degree of public concern about the PFI/PPP model, we query whether much of this may derive from misconceptions about what this model has actually delivered. Impartial studies generally report that the overwhelming majority of operational PFI projects deliver “good” or “very good” performance. We contend that the public are much less concerned about who provides services than who pays for them, their quality and their cost. Any rational and pragmatic review of public infrastructure provision must acknowledge that reality. We need to identify what has gone well and do more of it, identifying and spreading best practice. Moreover, any debate must acknowledge what often goes wrong with traditional, direct procurement (eg insufficient briefing and preparation, poor risk management and inadequate controls) and the resulting overruns.

6.2 Whether or not “soft” services (eg cleaning, catering etc) should be included in projects is even now sometimes justified, usually incorrectly, by reference to balance sheet treatment. It is now clear, and has been for some time, that auditors should disregard any such services which can be separately terminated when

considering balance sheet treatment. We argue that the presumption should be that additional “soft” services should be provided as part of a package by the private sector facilities provider only if that is consistent with the procuring authority’s overall procurement policy (ie how these soft services are procured in similar facilities by that authority) and, of course, only if private provision represents VfM. Canmore has led the way in combining private sector provided “hard” services (ie the buildings and their maintenance) with “soft” services provided by or for our public sector clients—our one-stop integrated helpdesks at the New Victoria and Stobhill Hospitals in Glasgow is a practical example of this approach.

#### WHOLE LIFE COSTING

7.1 Maintenance and life cycle replacement costs cannot be ignored when judging relative value for money. One of the main benefits of the PPP-type provision of public use infrastructure has been the whole-life integration of design, building, maintenance and life cycle costs. This correctly incentivises developers to invest in quality facilities at the outset, thus also increasing the availability of those facilities. At the end of a typical PPP concession the public sector will inherit assets which have been properly maintained. Any move to disaggregate the procurement of these elements would be a major error. Procurement of all these elements should, in our view, be at the core of any PPP-type procurement.

#### IDENTIFYING AND ADDRESSING FAILURES

8.1 Any failures must be addressed, but first alleged failures must be identified and analysed correctly. There is an often repeated assertion that PPP projects result in reduced facilities, lower service levels and poorer quality; that is not our experience in those projects where we have been involved. Moreover, although not all PPP design has been as good as it might have been—and measures are in hand to address this—there is no evidence to suggest that PPP design generally compares unfavourably with the designs used in direct, traditional procurement. Our New Stobhill Hospital in Glasgow has won multiple design awards, including the 2009 PPP Awards “Best Designed Project” and the 2009 Roses Design Awards “Best Public Building” and Grand Prix. None of our projects have resulted in facilities smaller or less flexible than their public sector comparators (and Stobhill and St George’s Hospital in London actually have more beds). All our projects have levels of service and quality at least as high as the equivalent direct public provision and the relevant project companies are each held accountable for performance and are financially penalised for sub-standard provision.

8.2 As always the public sector needs to provide the right brief if it is to receive the right facilities. PPP-type procurement explicitly acknowledges the ongoing costs of initial building decisions and so makes the initial briefing of facilities (which is crucial if the right facilities are to be procured) far more transparent. Critics of PPP often appear to ignore the historic costs of incorrect direct investment decisions. If public bodies realise that they will remain responsible for those decisions, as is the case in PPP procurement, then that increases the incentive for proper planning at the outset.

#### ECONOMIC AND ENVIRONMENTAL SUSTAINABILITY

9.1 Projects should be both environmentally and economically sustainable: we target and achieve BREEAM “Excellent” projects; we are also committed to fostering economic benefits (eg through directing a minimum spend through local SMEs, giving 100% interview guarantee to potential employees from the locality and requiring a Living Wage for all staff).

#### EXECUTIVE SUMMARY AND RECOMMENDATIONS

10.1 At the heart of successful PPP procurements are long-term partnerships between public sector customers and private sector providers, both of whom have real stake in the long-term success of the relationship. The Transport Secretary is reported recently to have said:” The most corrosive [element of being] a public procurer is that you can’t build relationships with people. Every time you procure something you have to start from scratch.” That is often the public sector’s choice, conscious or unconscious; our suggested Strategic Infrastructure Partnerships summarised below offer an alternative.

10.2 In summary, responding to the Committee’s specific lines of enquiry:

- strengths and weaknesses of different procurement methods (ie when is PFI suitable?)—there is no “one size fits all” model for optimum procurement, rather we should procure through a range of models;
- accounting for PFI projects—HM Treasury appears to have reached a compromise which ensures transparent reporting and achieves a level playing field;
- risk transfer to the private sector—risk transfer is real; risk should be transferred to the party which can best manage it, subject always to achieving VfM (eg volume/demand risk, if it is outwith the private sector partner’s control, is rarely appropriate for transfer); and
- PFI/PPP projects rely upon the fundamental covenant of their public sector customers; to that extent it can be argued there is at least an implicit state guarantee for PFI deals. However, the assertion that the public sector must rescue failed PFI projects is generally incorrect; most, probably all, PFI documentation provides for termination upon private sector default.

10.3 The public sector should establish consistent reporting of all public procurements identifying outturn costs against budget and completion against timetable so as to enable an informed assessment of VfM relating to risk transfer.

10.4 A new form of Strategic Infrastructure Partnerships could be achieved through simple changes to the well-proven PFI model, reflecting both the Scottish “hub” initiative and private sector partnering models, addressing concerns about excessive profits, encouraging improvement and the pursuit of excellence whilst sharing resulting gains. We suggest:

- a 30% public sector shareholding in special purpose project companies to reinforce partnership and common purpose—thus the private sector remains incentivised to achieve excellence and the public sector shares in any resulting profits (including refinancing subordinated debt);
- requiring senior debt refinancing and sharing the resulting gains in line with current Treasury guidance;
- providing for the sharing of long-term savings on insurance, maintenance and life cycle (all of which we have done on existing PFI projects), thus incentivising the identification and achievement of those savings;
- encouraging enduring partnerships with expansion potential by making provision at the outset for possible substantial future variations and phases and further linked projects; and
- requiring sustainable projects (ie mandatory environmental performance standards and commitments to local economic benefit).

April 2011

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### Written evidence submitted by KPMG LLP, John Laing PLC and Lloyds Banking Group PLC

#### FOREWORD

1. We are pleased to submit this response to the House of Commons Treasury Committee on the Private Finance Initiative (“PFI”), and welcome the opportunity for further healthy scrutiny of this particular approach to procurement.

2. Our organisations share a belief that the interests of public value for money, transparency and accountability are best served by comparing and evaluating across the full portfolio of procurement approaches available to the public sector. PFI is one such approach, but only one. *A wider scope for this inquiry, covering all public sector procurement, would allow for true comparisons to be made, and highlight the relative strengths and weaknesses of each approach.*

3. The Inquiry will no doubt elicit many submissions outlining the positives and negatives associated with the PFI approach. With the spotlight on one approach only, the danger is that supporters of PFI emphasise examples of its success and detractors emphasise examples of its failure and the true and fair view is obscured.

4. This joint submission has been prepared with a view to placing PFI in the wider context of public procurement. The intention here is not to “defend” PFI by attacking alternatives. Indeed, each of our organisations are conscious, and to some extent living the financial consequences, of examples of both poorly procured PFI deals, and deals which should never have been PFI in the first place.

- (a) As adviser to public and private sector clients KPMG has frequently advised clients not to pursue PFI within particular project contexts.
- (b) As investors in a wide range of government contracts, not just PFI, John Laing withdrew from the London Underground PPP bid process after concluding that the procurement approach was inappropriate in the context of an unclear specification that would be likely to favour contractors.
- (c) One of the largest investors in and lenders to PFI projects, Lloyds has real insight and practical experience of a small number of PFI projects that have run into difficulties: where risks that are conventionally borne by the public sector have vested with the private sector, and the private sector has borne the consequences. To put this into perspective, Lloyds is involved in around 200+ PFI projects, of which only a few have run into difficulties.

5. Despite the examples of projects which have failed under PFI, we believe that PFI has brought tangible benefits to the UK taxpayer, and that it should continue to be adapted, amended, and to be considered alongside other procurement approaches. Best value for the taxpayer will be achieved through continually evaluating projects and reconsidering procurement approaches. *Indeed, we suggest that the rigour that the National Audit Office has applied to value-for-money reviews of PFI deals should be rolled out across all conventional procurement too.* There is much to learn from the failures of conventional public finance procurements such as Eurofighter, Wembley Stadium, the British Library, the Cambridgeshire Guided Busway, and currently the Edinburgh Tram.

*What are the strengths and weaknesses of different public procurement methods?*

6. A fundamental challenge for the debate over public procurement is the lack of good quality data on the historic costs of the public sector procuring and operating its assets and services. This affects the ability of Government to properly compare the value for money of different procurement approaches and the ability of Parliamentary inquiries such as this to properly review those decisions.

7. We believe government should invest in systematically collecting and analysing evidence on the comparative performance of all procurement approaches. This is not straightforward, as “brick-by-brick” pricing fails to reflect the different commercial terms and long-term maintenance costs. To date the highest quality analysis has been undertaken by the National Audit Office<sup>25</sup>, <sup>26</sup>, <sup>27</sup>, Partnerships UK<sup>28</sup>, <sup>29</sup>, and University College London<sup>30</sup> and we recommend the Committee to consider those reports.

8. The single biggest step in this regard would be the institution of a set of national infrastructure accounts, which would show both asset investment and asset depreciation. Such accounts would provide a starting point for inquiries such as this to get under the skin of the infrastructure challenge and to compare like with like, and would force the public sector and its partners to think long-term.

9. Annex One to HM Treasury’s National Infrastructure Plan<sup>31</sup> contains helpful distinctions between approaches to public procurement. It is clear here that different approaches are expected in different arenas, reflecting the respective merits of each. What may in one circumstance be considered a weakness—eg having to take considerable time to negotiate contractual terms on how costs to government for a PFI deal are expected to increase over time (indexation)—may in other circumstances be considered a strength—eg confirming the government’s own exposure to various indices.

10. We consider that there are a series of axes against which procurement approaches should be evaluated: transparency; urgency; accountability; risk transfer; budgetary flexibility; specification flexibility; project complexity; depth of market competition; and cost optimisation. The question of “value-for-money” is much wider than just getting the lowest bid price, or even transferring the most risk, but it is about optimally meeting requirements in the broadest sense. The failure of Jarvis evidences the danger of judging the quality of bids primarily by reference to lowest bid price.

11. PFI itself has become something of a UK export success story. UK firms and UK professionals have been instrumental in establishing burgeoning PPP markets in the USA, France, Germany, Australia, Canada, and throughout the Middle East. These states have been attracted to the transparency and accountability which comes with the introduction of private finance. Indeed, it is worth reflecting on the point that even oil-and cash-rich nations with large sovereign wealth funds are using PFI, even though they evidently do not need the finance.

12. We believe the PFI programme will continue to bring much needed innovation to public procurement and that the case for PFI’s continued role can be made. PFI today is quite different to the PFI of 15 years ago.

13. The future role of private finance is subject of a legitimate debate around such questions as: the appropriate discount rate for government to use in evaluating whole-life costing; how decisions are made between procurement approaches; how public sector stop/go decisions are made; how “value for money” can be proven; how barriers to entry can be reduced to encourage further competition; how procurement processes can be streamlined; how the cost of private finance can be reduced through milestone payments or other upfront contributions; when to tender key subcontracts; and how performance data is best displayed. But the scope for continual improvement is no reason to abandon the PFI approach altogether.

*In what circumstances are PFI deals suitable for delivery of services?*

14. The challenge for public sector procurement is in determining which approach is the most suitable within a specific project context, and this challenge applies whether the proposed project is infrastructure or services or both.

- (a) PFI deals generally take a long time to procure, down in part to commercial complexity and in part to the need for clear specification at the outset. We would suggest that PFI is not suitable for urgent “quick-fixes”.
- (b) PFI deals offer cost and project transparency which is substantially ahead of other procurement approaches. PFI enables the public sector to enter into commitments with its eyes wide open. Building a new school is a financial commitment, and a commitment to a community, and whereas under PFI the costs of the school are defined, conventionally the long term costs of the commitment

<sup>25</sup> *Improving the PFI tendering process*, National Audit Office, 2007.

<sup>26</sup> *Construction performance*, National Audit Office, 2003.

<sup>27</sup> *Managing the relationship to secure a successful partnership in PFI projects*, National Audit Office, 2001.

<sup>28</sup> *Report on Operational PFI Projects*, Partnerships UK, 2006.

<sup>29</sup> *Investigating the performance of operational PFI contracts*, Partnerships UK, 2008.

<sup>30</sup> *PFI in school building—does it influence educational outcomes?* KPMG, 2009. This report draws on research conducted under the supervision of Graham Ive of the Bartlett School of Graduate Studies.

<sup>31</sup> *National Infrastructure Plan*, HM Treasury, 2010.

to the community are unknown. Such transparency also enhances accountability: across much of the world PFI is promoted as a route to tackling corruption.

- (c) PFI relies on clear upfront specification in order to optimise a series of asset management and investment tradeoffs. This means that PFI tends not to be suitable where substantial flexibility is required, such as, for example, in IT procurement.
- (d) One common criticism of the PFI concept is that it is rigid, and prevents governments substantially changing budgets on a regular basis. In some cases such flexibility may be helpful, but in many cases it is perverse to suggest that deviations should be made from an optimally planned maintenance regime. The rationale behind whole life costing is that lower investment on an ongoing basis saves substantial costs down the line. To argue for short term budget flexibility is to saddle future taxpayers with a disproportionately higher backlog of maintenance work.
- (e) Straightforward and commoditised procurements do not necessarily benefit from the rigours of the private finance approach, but where projects get too complex and specifications grow and grow the constraints of private finance can undermine delivery quality. For PFI it is important that both the specification and project risks are clear. The London Underground PPPs failed, in part, because the condition of inherited assets was not well understood.
- (f) The depth of market competition does not necessarily correlate with project complexity, and is always something that should be considered before a procurement approach is adopted. There is no point running a competitive process in which only one bid is received: different procurement approaches offer different solutions to non-competitive situations. PFI isn't best able to manage this kind of situation, and the competitive pressure between bidders is essential to keeping costs low.
- (g) The importance of the discipline that comes with whole life costing, and asking contractors and their lenders to put their money behind their forecasts to the PFI concept cannot be understated. In the right deals the higher cost of capital required on PFI deals<sup>32</sup> compared with public finance can be more than justified on the basis of risk transfer, and enhanced planning, accountability and risk management.

15. Whilst we do believe that there is potentially a role for private finance in the delivery of frontline services, this would likely require a step away from PFI in its traditional form. Projects risks and opportunities are likely to be different, especially under payment-by-results style regimen.

*How far can risk really be transferred from the public to the private sector?*

16. Successful risk transfer is based on understanding not just the project risks, but also which counterparty is best suited to managing those risks. Successful risk transfer is about finding a balanced risk transfer in which risk is optimally located with the party best placed to manage it, and who has the best incentives to do so.

17. In order to ensure contractual clarity and to properly scope the project, PFI investors undertake rigorous through-life risk analysis, and this forms a substantial part of the PFI procurement process. The intensity of such analysis makes PFI deals stand apart from conventional deals: under conventional procurements the incentive both for the public sector and the delivery partner to undertake risk analysis is diminished.

18. From the public sector perspective it is about incentivising best delivery. Risk analysis feeds into contractual incentive mechanisms, making the risks less likely to occur. Where risks are transferred to the private sector, and risks do in fact occur, the private sector bears the impact.

19. Lloyds has practical experience of projects (eg Dudley Hospital and Whittington Hospital) where costs which, were it not for PFI, would sit with the public sector, such as the cost of delayed completion, have been borne by the private sector (contractor, equity provider, investor, banks).

20. In the early years of PFI when John Laing fulfilled the combined role of investor and contractor, it experienced losses in excess of £130 million across a number of PFI projects on which technical problems gave rise to cost overruns. The most notable being the National Physics Laboratory which has been the subject of an NAO review and Public Accounts Committee review.

21. True comparison across procurement approaches requires us to understand the parallel risks under conventional procurement. How many conventionally procured projects have faced delayed completion, and what has the cost of this been to the taxpayer (and future taxpayers) when the public sector has had to foot the bill?

22. In aggregate, across a portfolio of deals, the question has to be whether the premium that the public sector pays for risk transfer is too high. Good public sector procurement should ensure that comparator modelling is undertaken to explore what the cost to government of retaining such risks is. Indeed, the understanding of whole life project risks and their potential impacts is one of the key disciplines which the PFI approach imposes.

<sup>32</sup> Again, there is helpful analysis of this in Annex 1 of the *National Infrastructure Plan*.

*Are there particular kinds of risks which are particularly appropriate for transfer through PFI deals or particular projects which are suited for PFI?*

23. Projects must be treated on a case-by-case basis, but as our analysis above suggests, PFI is likely to prove most attractive where transparency, accountability and cost optimisation are required, where a detailed specification can be achieved and extensive flexibility is not required, where there is no immediate urgency, where risks can be evaluated and risk transfer optimised, and where there is a competitive delivery market.

*What state guarantees are explicit or implicit in PFI deals?*

24. Under PFI government guarantees to pay if the project requirement is met, and in this regard is no different to any other contract. If the provider fails to deliver the requirement, the government's liability is reduced or eliminated.

25. If the public sector opts to terminate a deal it is equally costly under PFI or conventional procurement. Whilst under PFI the full return to equity providers and lenders has to be paid out at the time of termination, under conventional procurement the equivalent investment will have already been made through gilt issuance and would be a sunk cost.

26. Any further guarantees in PFI deals are explicitly written into contracts (such as the SOPC4 standard). As commercial arrangements entered into following rigorous analysis both the private sector and the public sector are expected to face the consequences of the deal—and in some cases this has meant that the private sector has lost money.

27. From the public sector perspective a key difference between PFI and conventional procurement is that whilst under PFI, state guarantees are transparent and can be managed; under conventional procurement such risks tend to be implicit only.

*If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much? How should PFI deals be accounted for?*

28. The decision as to whether to proceed with a PFI deal should be based on rigorous qualitative and quantitative value for money evaluation of all the procurement options available. Balance sheet treatment should not be a part of this evaluation, and neither should the availability of "credits".

29. There may have been some cases in the past where too much risk was transferred out of government in an attempt to secure "off-balance sheet" treatment.

#### CONCLUSION

30. We firmly believe there is a continuing role for PFI, but as one of a range of possible means of procurement. In the past, PFI has been the default method and its very existence may have resulted in projects being shaped to fit the PFI model. Any decision to proceed with a capital intensive project should be driven by need and affordability, regardless of balance sheet treatment. The selection of procurement method is a secondary consideration but for the reasons set out above we believe PFI will continue to present the most appropriate method in many instances and will present the best value for money on a risk adjusted basis.

April 2011

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#### **Written evidence submitted by Professor Lewis Lesley, Technical Director, Trampower**

Before diving into the effectiveness or otherwise of PFI, I would like the Committee to consider the definition of a public service. This term is used very loosely. Does it mean a service provided by tax payers funding, or does it mean a service provided for the benefit of the public?

The danger of the former definition, is that it becomes an end in itself, used by Government to "mop up" "unemployment" or to demonstrate virility by the volume of spending.

If it is the latter definition, then many if not most public services in the UK are not funded by taxes, eg. fresh food distribution, electricity, gas, telephones, etc. In this definition the role of (central) government is to set the rules of engagement, and provide a regulatory framework.

Having worked in a Communist Country, the Government as the provider of services and the protector of the environment/population are often in conflict. Similarly in the UK the Government as the provider of services and regulator are intrinsically in conflict, even before the question of political control/micro-management. Predecessor Select Committees have noted that Ministers are supposed to provide strategic guidance, and leave the daily management to professional managers. In practice often there is little or no strategic guidance and a lot of day to day interference.

Two recent public service developments, namely cable TV & Broadband and mobile phones, have been undertaken with a regulatory frame but private funding and management in competitive environments. A very effective way of making the provider accountable.

The basic flaw with PFI is that it is an expensive way for the public sector to invest. Firstly the risks involved may on paper be passed to the private sector, which then factors these into high costs, paid for by Government (and taxpayers) over a large number of years, with inflexible contracts.

The biggest risk faced in PFI or any other public contract is the public agency procuring the investment. Both the National Audit Office and District Audit Offices have numbers of Reports underlining this.

The most cost effective way of buy investments for the Public Sector, is one where the public procurer takes the risks, and agrees contracts where the contractor warrants workmanship and materials to an agreed cost and time frame, with penalties for lateness, and rewards for early completion. If the public sector procurer then wants to change the project or specification, then it has to be paid for and it is clear why the extra costs occurred and how should pay.

PFI's have enabled Government's to boast that so many new hospitals, schools etc have been built, many of which cannot really be afforded from current taxes but obviously can be funded by the private sector. These will have to be paid for over the next 20 or 30 years, significantly reducing the ability of future governments from making new capital expenditures.

As the cable TV and mobile phone developments show, the private sector can deliver cost effective investments, and make a just profit AND contribute tax revenues. The Government only has to redefine what constitutes public services and many more could be delivered by the private sector to meet real consumer needs, paid for by users with fair prices, and corporate profits taxed for the benefit of those services which cannot be commercial, like defence, security, education, universal health care.

*April 2011*

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### Written evidence submitted by the CBI

1. The CBI is the UK's leading business organisation, speaking for some 240,000 businesses that together employ around a third of the private sector workforce. With offices across the UK as well as representation in Brussels, Washington, Beijing and Delhi the CBI communicates the British business voice around the world.

2. The CBI welcomes the opportunity to respond to the Treasury Select Committee's inquiry into the Private Finance Initiative (PFI). Infrastructure UK estimates that £200 billion of investment is required over the next five years<sup>33</sup> and, with public finances under pressure, it is of paramount importance that private finance can be leveraged to fund new projects. Failure to secure this investment will lead to degraded infrastructure and ultimately, reduced growth. Government must ensure that a range of different models are available to contracting authorities to enable this. PFI has allowed hundreds of schools, hospitals and housing projects to be delivered in recent years, attracting billions of pounds of private investment in infrastructure. PFI has adapted to meet different requirements; it is important that elements that have worked well in the past are retained in the model as it continues to evolve.

*What are the strengths and weaknesses of different public procurement methods?*

3. The overarching objective for public procurement must be to secure value for money from spending, with quality services delivered at low cost. The success of public projects therefore depends on how effective procurement is.<sup>34</sup> Various procurement routes are available to public bodies, relevant for different purposes—no one model will be appropriate for every project. In some cases, conventionally procured projects directly funded by the public sector are appropriate while for other projects, initial funding is provided by the private sector, which takes on this risk and aims to recoup cost on delivery of contractual terms. Rather than following a set procedure from previous procurements, officials must consider which model will deliver the best outcome. Of the various models used to leverage private finance, PFI has been the most common and has been used successfully to deliver a variety of economic and social infrastructure projects.

4. PFI has enabled a great number of infrastructure projects to be delivered that otherwise would not have been. Between 2000 and 2010 over 500 PFI projects reached financial close and over 120 hospitals were built.<sup>35</sup> The UK's Victorian hospitals and dilapidated school buildings needed investment, and PFI has succeeded in directing funding to projects in a way that conventional procurement has often failed to do. When procured conventionally, political and economic cycles have tended to restrict the availability of funding, delaying or cancelling investment. PFI has allowed local contracting authorities to take control of their budgets and the delivery of assets and enabled them to deliver the improvements valued by local citizens.

5. Transferring construction risk from the public to the private sector in PFI projects has improved efficiency, with more projects delivered on time and within budget compared with those that have been conventionally procured. An NAO study found that 76% of PFI projects were ready to use by the contractual deadline,<sup>36</sup>

<sup>33</sup> *National Infrastructure Plan 2010*, HM Treasury, 25 October 2010.

<sup>34</sup> *Procurement in the Construction Industry*, The Chartered Institute of Building, December 2010.

<sup>35</sup> *PPP Data and Statistics*, HM Treasury, February 2010.

<sup>36</sup> *PFI: Construction Performance*, NAO, February 2003.

whereas traditionally procured projects were delivered late 70% of the time.<sup>37</sup> Projects that are funded directly by government are often subject to an optimism bias, meaning that costs and duration are underestimated. Another study of 39 traditionally procured infrastructure projects found that they overran by an average of 17% and cost 47% more than anticipated.<sup>38</sup> Using PFI, the public sector can transfer risk management functions that are not within its core capabilities and concentrate on strategic policy-making and performance management of its contractors.

6. Under PFI, the design and delivery elements of the contract are integrated, with the private sector provider responsible for the construction, maintenance and associated service delivery. This creates a strong incentive for rigorous planning at an early stage and ongoing innovation over the course of the project. From the outset, the infrastructure is designed with users in mind and potential problems are identified and overcome. Collaborative planning and knowledge-sharing between the public authority and the private sector partner provides opportunities to agree on specifications that are technically optimal and deliver the services that are needed in the most cost-effective way. The PFI approach obliges contracting authorities to quantify costs over a project's entire lifetime, prioritising maintenance and equipment replacement, which can be neglected under traditional procurement. At the end of the contract, the asset is handed back to the contracting authority in good condition as set by pre-agreed standards. The longer-term approach adopted in PFI projects has made it easier to marry sustainability objectives with those associated with service delivery.

*Pembury Hospital—innovative design to meet patients' needs*

A new hospital will open in July this year and become fully operational in 2012, consolidating Pembury Hospital and Kent and Sussex Hospital into an improved modern facility on the Pembury site. The 512-bed hospital will be the first in the UK to be constructed with 100% single bedrooms with en-suite facilities.

The layout has been designed to enable patients to look out on surrounding woodland, which has been proven to aid recovery. The National Patient Safety Agency (NPSA) was involved in the design of wards so that patients' comfort and safety needs were taken into account at an early stage.

The hospital's development director Graham Goddard said, "*Every room is designed to provide the best patient experience and to be safe.*"

7. PFI is often criticised for being too expensive, with the private sector companies involved gaining substantial returns on their investments. In reality, very few projects generate above average returns and there are a number of examples where companies have lost money on projects, even entering into administration as a consequence. PFI contracts are let after a competitive process during which providers have to offer the best price possible if they are to be chosen as the preferred bidder. This choice is made on the basis of the lowest net present value, which ensures that bidders price the optimal mix of capital and operating costs. Any gains that are achieved through refinancing projects following the construction phase are now shared between both partners.

8. Many PFI projects have proved to be adaptable to changing requirements, showing that with good contract design the model is flexible. PFI designs often include spaces that can be used for a variety of purposes, which means that service resources can be allocated effectively to meet changing demand. When the change is significant enough to warrant amendment to contracts, PFI projects can support these variations—an NAO report finding that 90% of contract managers were either satisfied or very satisfied with changes in these circumstances.<sup>39</sup> The long-term nature of contracts, while delivering the benefits mentioned above, requires commissioners to be aware of the need for future flexibility and build change mechanisms into contracts.

*Waste management in Southwark—Flexible PFI benefiting residents and charities*

Southwark Council's waste management contract shows how the model can be applied flexibly, and used to help charities provide services for the community.

Since January 2010, Veolia has offered the British Heart Foundation access to all the unwanted furniture and electrical items in the borough that currently goes to the Recycling and Reuse Centre it runs in partnership with Southwark Council. Under the scheme, the British Heart Foundation cherry picks items in good condition or that can be reconditioned and sold on to residents.

All funds made from sales of the furniture and electrical items go towards helping the British Heart Foundation fund research, patient care and life saving equipment.

9. Elements of the procurement process could be modified to produce better results from major projects including PFIs. For example, competitive dialogue has been the preferred procurement route when contracting for PFI, but it is not always the most appropriate. For less complex projects, or those that are similar to previous ones, more simplified procedures could be followed. In circumstances where the contracting authority is unable to determine the technical means by which to achieve the desired outcome it should engage with potential suppliers to negotiate a solution. However, this is not a substitute for conducting sufficient pre-procurement research. The European Commission's review of the procurement directives is an opportunity for UK Government and business to push for simplified rules that reduce bid costs. For complex procurements to be successful it is essential that project teams have the appropriate skills and experience and are adequately supported by central bodies with strategic oversight.

<sup>37</sup> *Modernising Construction*, NAO, January 2001.

<sup>38</sup> *Review of large public procurement in the UK*, Mott MacDonald, commissioned by HM Treasury, July 2002.

<sup>39</sup> *Making changes in operational PFI contracts*, NAO, January 2010.

10. PFI will not be suitable in every situation and not all PFI contracts are perfectly designed or produce optimal outcomes. The Government can borrow money more cheaply than the private sector so the cost of financing conventionally procured projects can be lower if the process runs smoothly. However, publicly-funded projects have been poor at quantifying risk and specifying required outcomes at an early stage. Conventional capital spending with a limited tender process and simple “lowest price wins” award criteria can be brought to the contract award point quickly. However, without rigorous planning numerous variations are often made during the build period. This can add cost to the project and delay it significantly.

11. Many methods other than PFI are used in the UK and internationally to leverage private finance to fund infrastructure authorities. Tax Increment Financing (TIF) has been used in North America for more than 50 years, and when used properly it results in net gains for local authorities without any need for additional taxation. The Regulatory Asset Base (RAB) model has been used widely in the regulated utilities sectors and has successfully funded projects in airports, energy and social housing. User-pays models have been used extensively in countries such as Australia to fund economic infrastructure projects. Local Asset-Backed Vehicles (LABVs) allow local authorities to use their assets to attract long-term investment from the private sector to deliver socio-economic development and regeneration. These models provide alternatives to PFI, offering commissioners greater flexibility and driving down the cost of finance. For taxpayers to obtain maximum value for money from infrastructure projects, contracting authorities need to develop a good understanding of these models; when they are appropriate and how to apply them.

*If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much? How should PFI deals be accounted for?*

12. The CBI supports measures to improve transparency and accountability in public sector contracts which will allow contracting authorities to make better-informed judgements on the value for money of services. Bringing all PFI projects on-balance sheet was a positive measure that will help to support the long-term viability PPPs. PFIs should be on-balance sheet and the value delivered by a scheme in terms of certainty and risk reduction should not be skewed by its accounting treatment. For simplicity, one set of accounting standards should be applied to PFI projects to standardize reporting requirements and improve business confidence.

13. Choosing the right procurement route is dependent on having access to reliable data on the relative costs of each option. Contracting authorities should have access to comprehensive databases that allows the PFI model to be compared with conventional approaches on a project-by-project basis. Final decisions must be made on a value-for-money basis, taking into account the public policy goals that are to be achieved.

*How far can risk really be transferred from the public to private sector? What kinds of risk are appropriate for transfer?*

14. As noted above, transferring financial risk to the private sector partner has contributed to improved performance during the construction phase, with a larger proportion of projects being delivered on time and within budget. Risk transfer is real. Numerous examples of private sector losses illustrate this. Where such losses were sustained it is clear that without that risk transfer these would have been incurred by the public sector.<sup>40</sup> Risk transfer is equally valuable on successful projects. When it is transferred appropriately risk will be allocated to the party best able to manage it with incentives to ensure that it is less likely to materialise. Transferring risk when it is more appropriate for it to be retained can lead to higher costs and reduced value for money. For example, transferring those that involve a high level of uncertainty or that are low probability but high-impact can reduce value for money.

15. It is right for contracting authorities to seek optimal value from contracts and that commercial officials explore opportunities to make operational savings. The CBI therefore supports the Treasury’s review of operational PFI projects to identify how savings could be achieved through reallocating certain elements of risk. For example, there could be benefit in the public sector taking on insurance risk in some instances. It may be possible to obtain economies of scale by increasing the range of services that are bundled into PFI contracts. In many recent accommodation projects, “soft” facilities management services have been retained in-house which can limit the efficiency of services by creating additional interfaces. It is important that the drive to find efficiencies in operational contracts is approached in a way that does not damage business confidence and future investment in infrastructure.

*Are there particular projects which are suited for PFI?*

16. PFI works well when the risks of a project can be identified, quantified and transferred appropriately. Build and service contracts that have been used to provide schools, simple healthcare facilities and housing have been successful. So too have economic infrastructure projects, which have seen roads, railways and airports built and maintained over the long-term. Schemes which introduce complex technology risk, or in which future outcomes cannot be readily forecast may be less appropriate as they will carry a higher risk premium, which will have an impact on overall value-for-money. Schemes with extended construction periods

<sup>40</sup> Examples of private sector losses include the National Physical Laboratory, which was terminated in 2004 for non-performance, costing the private sector in excess of £100 million; Dudley Hospital cost sponsors over £100 million; Croydon Tramlink, whose private sector operators made financial losses between 2000 and 2003 of £18.3 million.

do incur significant costs around the pricing of contingent events and should be considered in detail as to their suitability.

17. PFI is suitable for large projects, which justify the comprehensive commissioning process that is typical of this model. It is less likely to be appropriate for projects with a capital value under £30 million. However, if a number of similar projects are being commissioned at the same time it may be possible to take a “batching” approach, to ensure there is sufficient scale to warrant the transaction costs of PFI. This will require leadership from central departments, who can identify the opportunities for implementing this approach and coordinate commissioning.

*What state guarantees are explicit or implicit in PFI deals?*

18. As PFI projects are principally financed through debt, they must be an attractive investment opportunity to potential lenders. For this to be achieved, it is important that, whatever the position of the agency involved in the transaction, the Treasury will pay the revenue streams required to service the debt. This gives financiers confidence in the covenant of contracting authorities, which is crucial when entering into long-term projects.

19. Properly transferring risk to the private sector requires that there is no implicit or explicit guarantee that it will be “bailed out” if the project encounters difficulties. This allows the contracting authority to shield itself from the majority of costs incurred when projects are delayed. Examples of businesses shouldering this burden are plentiful and companies have even failed as a result of entering into poor PFI deals. Conversely, there are relatively few examples of PFI companies being bailed out by the Treasury and when it has happened it has been because of contractual guarantees, which have limited the extent to which risk has been transferred.

*In what circumstances are PFI deals suitable for the delivery of services?*

20. PFI contracts are suitable when efficient and effective services are conditional on good design and maintenance of the asset. For example incorporating highways maintenance and management services with road building contracts has increased innovation in design, reducing costs throughout the operational period. As the Treasury has noted, PFI refreshes services by “breaking the grip of historic or standard public sector design approaches”.<sup>41</sup> If the private sector partner is responsible for service delivery, they are incentivised to ensure that the final design will lead to more efficient services over the long term. For example in PFI hospitals, design changes which reduced the distance between wards raised staff productivity. PFI prisons have adopted the use of long, wide corridors, which has enabled CCTV to be used more effectively, improving safety levels for prison staff and inmates.

*Birmingham Highways—successful maintenance and management to support the local economy*

In 2010, Birmingham City Council (BCC) signed a PFI deal with integrated public service provider Amey to provide maintenance and management services across the city’s road network over a 25-year period. This has enabled BCC to move from a routine and reactive maintenance model to a fully mapped programme of planned asset management.

The deal includes significant improvements to the structural and surface condition of around 45% of the 2,500km road network, strengthening 29 bridges and replacing over 40,000 street light columns with state of the art LED technology.

Amey is working with BCC’s Highways Service to reduce congestion, minimise disruption and improve safety by feeding into their traffic management strategy whilst liaising with residents to highlight maintenance priorities in their communities.

21. PFI has helped to open up public services to a more diverse range of providers including those from the private and voluntary sectors. Competition for service delivery places downward pressure on costs and helps to ensure that resources are distributed most efficiently to improve quality. For prison services it has been estimated that competitions for new-build prisons based on design, construction, management and operation have delivered total savings of 38%.<sup>42</sup>

22. There is also good evidence to show that services delivered during the operational phase of PFI projects are high standard. In the Treasury’s 2006 review of over 500 operational PFI projects, 79% of projects reported that service standards are delivered always or almost always, 89% reported that services were being provided in line with the contract or better, 83% reported that their contracts always or almost always accurately specified the services required, and 72% report good or very good service.<sup>43</sup> A recent study found that PFI hospitals had better patient environment ratings and higher cleanliness scores than conventionally procured hospitals of comparable age in which the facilities management services are provided in-house or by a third party.<sup>44</sup>

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<sup>41</sup> *Technote 7: How to achieve design quality in PFI projects*, HM Treasury, 2000.

<sup>42</sup> *Market Testing*, Ethos Journal, published by Serco, Autumn 2010.

<sup>43</sup> *PFI: Strengthening long-term partnerships*, HM Treasury, June 2006.

<sup>44</sup> *Operating healthcare infrastructure: analysing the evidence*, UCL & KPMG, May 2010.

## Written evidence submitted by Hogan Lovells

### 1. INTRODUCTION AND EXECUTIVE SUMMARY

1.1 Hogan Lovells has one of the largest global legal practices covering public infrastructure and services (including PPP and PFI). We regularly represent financial institutions, project sponsors, investors, contractors, private equity funds, export credit agencies, governments and government bodies on some of the world's largest and most challenging projects in Asia, Africa, Europe, Latin America, the Middle East, and the United States. We are active in all sectors such as energy, transport, social infrastructure and defence and aerospace.

1.2 In addition to the Private Finance Initiative and other forms of Public Private Partnership, we advise clients on transactions involving the full range of public procurement delivery models, including conventional procurements (such as design and build/service agreements, DBO, service outsourcing and partnering).

1.3 We advise on a "for profit basis" but are also one of the most active firms working on a "not for profit"/pro bono basis. Our pro bono work extends to very substantial infrastructure and PPP advice on both a project and Government policy basis (including projects such as the Haitian reconstruction), working with world leading organisations. We care about best practice in the procurement of global infrastructure and public services for all.

1.4 We have no institutional preference for one procurement route over another: PFI/PPP models are just one of a number of structures available in the procurement "toolkit".

1.5 It is clear that much of the public debate around PFI in the UK has, to date, been largely political rather than based around economics or best procurement practice. Although this is inevitable, it is largely unhelpful and represents a lost opportunity.

1.6 In our view the Private Finance Initiative is not a panacea, nor is any other procurement model. Our comments here are focused on PFI due to the questions raised and we have not set out a comprehensive comparison with the other procurement models. PFI needs to be used on the "right" deals and by sophisticated procurement teams. When used properly, in our view, it has generally delivered favourable results compared to the alternative procurement models.

1.7 Clearly PFI has some weaknesses. The cost on some deals of minor variations is the most often cited example. Whilst this reveals an issue that needs to be addressed, these kinds of issues are largely irrelevant/marginal to an accurate cost/benefit analysis of PFI. Indeed there are almost certainly as many or more similar examples of the excessive cost of variations on conventionally procured projects in the public sector. Another key issue previously identified is lack of flexibility (largely in that PFI has created some large projects which have then turned out to be unwanted (or not needed as much as first thought)). Where that is the issue, the issue is one of project selection rather than procurement approach—there is no difference in the position on this as between PFI than conventionally funded projects.

1.8 It is worth noting that in evaluating issues, one needs to pay careful attention to differentiating between substance and politics/what makes a good story. One also needs to evaluate carefully whether issues which may have arisen on PFI projects have anything whatsoever to do with their being PFI (as opposed to being building projects/services in a particular industry sector).

### 2. What are the strengths and weaknesses of different public procurement methods?

2.1 The different public procurement methods have substantial differences. Some key differences and brief comments, focused on PFI, are below:

- (a) *Level of risk transfer.* This is traditionally much higher on PFI than conventional projects. This has generally resulted in PFI achieving better performance for projects completing on time, to budget and defect free. Risk transfer could be increased on conventional projects. However, the primary instrument of risk transfer on PFI is placing the overarching risk with debt and equity over the whole life of the project and this cannot be achieved if the project is paid for up front. This feature of PFI not only underpins the risk financially but also has a dramatic effect on the quality of risk/project planning that flows from capital being at risk. This cannot be replicated simply by process (eg commitment to better planning of projects by the public sector) for a variety of reasons tried and tested over time.

Sometimes risks have been transferred which have probably not been good value for money (eg insurance cost), but that is simply Government's choice and could apply under any procurement approach and is not inherent in PFI.

- (b) *Level of public sector expertise required.* PFI requires a sophisticated client at the procurement stage and there have been some poor procurements. The necessary skills are now largely available through the supporting organisations (eg PUK/IUK etc and the relevant industry sector equivalents). Post contract award a lower degree of expertise is required compared to self providing or managing a contract with a high degree of retained risk.
- (c) *The extent to which whole life costing is incentivised.* This is a fundamental feature of PFI and, we believe, has fundamentally improved the quality of procurement and planning/building—we

doubt anyone would disagree. Inclusion of the concept has been attempted around the periphery of other procurement approaches but without long term debt and equity at risk we believe those attempts are largely meaningless.

- (d) *Duration and amortisation of payment.* PFI is the only method which integrates long term amortisation. The cost in terms of debt and equity return is a matter of financial evaluation.
- (e) *Use of Output Specification.* PFI has been key to the introduction of output specification approaches within procurement although they can be applied (and are applied) under a variety of other procurement approaches. This has been a positive development in the market. The downside has been occasional temptation by procurers to leave it to the private sector to specify what the public sector needs rather than how the private sector can best deliver the output that the public sector specifies it needs.
- (f) *Performance incentives and the “no service no fee” principle.* In our view PFI is strong in this area. Whether the public sector is strong in operating the contracts so as to enforce its rights, time will tell. However, in general we believe performance will be good because debt and equity will have a clear understanding of what is expected and cannot afford the consequences of failure.
- (g) *Procurement duration and cost.* PFI is slow and costly during the procurement phase. We believe it could be substantially improved and there are clear comparisons which show the UK in an unfavourable light compared to other jurisdictions. Again much of the issue probably comes down to UK practice, politics and the structure of procuring bodies. The important point though, is that generally “a stitch in time saves nine”; it is far better to spend time at the planning/procurement phase than to press ahead without proper planning and to pay the time and cost consequences later. Getting this wrong has been a traditional widespread problem of procurement outside of PFI for many years (in both the private and public sectors), usually driven by short term political or commercial expediency.

3. *If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much? How should PFI deals be accounted for?*

We believe this issue is better answered by others although we note that for many years, post the earliest days of PFI, the rationale has been value for money rather than off-balance sheet debt. We do not recall projects which proceeded which were evaluated as more expensive than a conventional approach simply because they were off-balance sheet.

4. *How far can risk really be transferred from the public to the private sector?*

4.1 In short the answer is pretty much completely. The only real limitation on risk transfer has been the public sector’s view on the value for money of transferring any particular risk. This is no different to the view that any purchaser on any procurement model takes in deciding which risks it wishes to transfer and the associated cost.

4.2 Where there have been time and/or cost overruns on PFI transactions, the associated costs have generally been absorbed by the private sector. As the procuring public sector entity does not bear the risk of such overruns, it is not privy to information as to the sums of money involved and therefore such matters receive very little coverage in government reports, inquiries or the media.

4.3 If the question is concerned with the political risk of public services failing then the protections against this are almost certainly much stronger than where they are retained by the state. Further, Government retains rights to “step-in” or take back contracts where there are problems so it is no worse off even in the worst case scenario. In contrast to conventional procurements, Government is much better protected in the case of serious risks occurring and (in the worst case) of contractor insolvency. In conventional procurement that risk is ultimately borne by the public sector. On PFI it is born by equity and debt. The contracts provide that the cost of the risk is deducted from any money due to debt/equity, on a default termination, for the value of the asset Government retains. This would not generally be the case on a conventional procurement.

4.4 The exceptions to the principle of full risk transfer are the very, very few deals where Government has given some kind of “debt underpin” (which are a matter of public record). In relation to these transactions, the use of a debt underpin was a decision made by the procuring authority: the authority made a value for money judgement on the level of risk it wished to transfer. On these very unusual deals Government chose to guarantee a certain level of debt repayment (and thereby underwrite risk) for value for money reasons. Whilst interesting in themselves these deals have nothing to tell us about the procurement technique and the ability or success of risk transfer under PFI, although they may have lessons for Government in terms of its procurement choices.

4.5 The nature of the question displays a lack of understanding of the basis on which most PFI deals have been done, and reflects the disproportionate press coverage. The better question is the transfer of which risks represent value for money for Government. This question is no different on PFI to any other procurement model. High or low degree of risk transfer is not inherent to PFI, although Government opted for comparatively high degrees of risk transfer. That could easily be changed although our personal view is that would be a mistake (save for a small number of risks which are probably not vfm). See below.

5. *Are there particular kinds of risk which are particularly appropriate for transfer through PFI deals, or particular projects which are suited for PFI?*

5.1 Projects which are suited for PFI

- (a) Subject to the exceptions stated below, any project which involves substantial asset provision in which Government or the public sector/public will have an interest over the “whole life” of the asset is suited to PFI.
- (b) PFI projects need to be of a certain size in order to be value for money, given the higher procurement costs. This is reflected in the government’s position that PFI is not suitable for projects with a capital value of less than £20 million. However, the degree of market commoditisation for a particular type of transaction is also a relevant factor in determining whether the procurement costs will be disproportionate.
- (c) Even where the above two conditions are satisfied, PFI is rarely suitable for procurement involving complex software development or novel technology risk which is unlikely to be financeable in the market.<sup>45</sup>
- (d) Finally, we would observe that what may be viewed as an “excessive price” for transfer of a particular risk on a PFI deal is obviously the price of that risk, as assessed by the market. It is therefore the “real” price of such risk, which is effectively borne by the public sector on a conventional procurement of a project involving that same risk. In some cases Government may get better value by retaining the risk because of its wider portfolio and risk spreading, but there are obvious downsides.

5.2 Risks which are appropriate for transfer through PFI

- (a) This topic has been explored in enormous detail in the Government standard forms and the endless negotiation on deals which has resulted in the current settled market view of appropriate risk allocation. We refer to the comprehensive discussion of the subject, which is broadly accurate, contained in the SoPC 4 guidance on contract terms for PFI.
- (b) There is some history of Government being very aggressive in transferring risk, where the market has pointed out that it would not be value for money to do so. An example is the approach taken in relation to increases in insurance premia, political risk, public sector credit risk and capital expenditure arising from general changes in law; similarly, the approach taken in respect of indexation on conventionally procured deals. Transfer of some of those risks in some circumstances may not be best value/sensible.

6. *What state guarantees are explicit or implicit in PFI deals?*

6.1 As noted above, there have been a small number of exceptional deals which have involved explicit state guarantees by way of debt underpin.

6.2 There are no implicit guarantees inherent in PFI transactions. The question is presumably driving at whether it is implicit that Government will rescue these deals because they involve national infrastructure. Government can, but is not obliged to, take back the contract and re-let it. Where it does in almost all deals any losses/additional cost is for the private sector’s account.

7. *In what circumstances are PFI deals suitable for delivery of services?*

7.1 Service delivery is inherent in all PFI deals—there is no payment other than for service. We assume the question is about scope of service—this is a political issue and has much to do with the political status of the welfare state in the UK. PFI deals in themselves are suitable for the delivery of a wide range of services connected with the various assets/sectors for which the technique is used.

7.2 The private sector provides a broader range of services in many other jurisdictions’ versions of PFI, when compared with the UK. In broad terms, PFI/PPP as an approach is growing as a global trend leading to an increased diversity of services being included. We are not aware of particular problems being identified (other than political issues) other than the issues identified above eg around software development services.

7.3 In summary our view is that it is for Government is to take a view on what services it wants, as a political matter, to be provided by the state and which services it wants the private sector to provide. We believe the general trend has been that private sector involvement and the efficiency and innovation that it brings is generally perceived to have positive benefits and beyond that, it is simply a question of whether the market price is acceptable to Government.

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<sup>45</sup> Note that it is well known in the market that there was a series of catastrophic conventional procurements of IT before PFI was attempted.

## Written evidence submitted by Donald Roy

### THE PRIVATE FINANCE INITIATIVE

This submission deals with the Private Finance Initiative. It considers the background, context and experience and makes some suggestions for improvements. It reflects my knowledge as an economist and my experience (both as a member of the Government Economic Service from 1995 to 1998 and as an active citizen participating in the health service since then). The views expressed do not necessarily reflect those of any institution with which I have been involved.

### THE BACKGROUND—THE LATE 1980S

In the late 1980s, the Private Finance Initiative did not exist. Indeed at the time HM Treasury discouraged the use of private finance in public services. The so-called “Ryrie rules” implied that if a scheme made sense with private finance it would make even more sense with public. The one exception was the Channel Tunnel, which the Government facilitated but did not finance (or even act as guarantor). More typical was the sustained effort to prevent local authorities from various devices (including sale and leaseback of assets such as street lights) intended to evade restrictions on their spending.

### PFI MARK ONE—LAMONT TO ROBINSON

As a policy the Private Finance Initiative developed under the 1990 to 1997 Conservative Government led by John Major. Among precipitating factors were the large cost overruns on the (conventionally-financed) Jubilee Line and the contrasting experience of the Channel Tunnel (where the tab was picked up by the private sector first as investors and later as lenders). In the light of the difficulties with local government mentioned in the previous paragraph, it was confined to central government and bodies subject to it such as the National Health Service and (at the time) London Transport. PFI was encouraged by the requirement that any procurement be tested for private finance (the loose wording of initial guidance and the absence of any lower limit meant that in principle any decision to buy departmental stationery supplies should have been preceded by formal examination of the scope for using private finance—leasing paper from an obliging bank, perhaps!). Rather less attention appears to have been paid to timescales and value for money. Nor, crucially, was much thought given as to the willingness of the private sector to accept transfer of risk in practice. This last led to a hiatus with regard to schemes in the NHS which was resolved at the end of the Major Government by legislation agreed between both front benches which had the effect of rendering the Secretary of State for Health the ultimate guarantor of all PFI schemes undertaken by NHS Trusts. This last marked the entrance onto the scene of a Minister who was interested in getting PFI to work, Geoffrey Robinson.

### PFI MARK TWO—THE CLASSIC PERIOD—1997 TO 2008

The Government formed in May 1997 had taken the decision to rescue PFI rather than abandon it. The next few years were marked by efforts to make it work. First, size thresholds were introduced (avoiding the absurdity highlighted above of the departmental stationery order having to be tested for private finance). More force was given to the idea that PFI schemes should be tested as against a public sector comparator (although this seems to have had less impact than might have been expected). Some experiments involving public sector equity or protection of employees’ rights were undertaken. Enough was done to render a reformed PFI defensible.

### PFI—THE STANDARD CRITIQUE

This emerged at roughly the same time as the Robinson reforms. It suggested that schemes were not value for money as against a public sector comparator. Almost certainly this was true for some of the earlier schemes. However this could not be established by the techniques used by the most prominent and vocal critics. These employed a high degree of double counting and, remarkably, refused to contemplate capital charges on state-owned assets (a stance rejected by most socialist economic thinkers as early as the 1930s!). The double counting arose because in many PFI schemes facilities management was included in the PFI scheme but excluded from the interest payments used in the comparator used by the critics (a true comparator would have included them). One of the principal critics told the Health Select Committee in its 2001–02 session that capital charges should not be used in the NHS. Unfortunately, this narrow ideological focus led to neglect of three out of four other objections to PFI. The one that the main critics recognised was that estimation and valuation of risk transfer was questionable yet increasingly required to prove value for money against a public sector comparator. They missed the consequences of delay, the effects of diverting management time and, last but not least, the effects of payment obligations on departmental budgets (they spotted this for NHS Trusts but not elsewhere). One consequence of delay (due to an elaborate and lengthy process of negotiation) was that where a scheme was required urgently, resort was had to conventional finance from the Treasury (the Elective Orthopaedic Centre at Epsom is a case in point). Management diversion has, in my view, affected the performance of NHS Trusts in some cases (lengthy negotiations over PFI led them to take the eye of the ball). Last the accumulation of PFI payments, which are contractual in nature, can affect control of departmental expenditure. This last would be a problem even when such expenditure could be expected to grow; in current circumstances (where budgets may be reducing significantly over the next few years) it is rather more serious.

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## THE CREDIT CRUNCH AND AFTER

The events of 2008 have weakened the case for PFI both practically and theoretically. Funds for new schemes have dried up to the point where HM Treasury has had on occasion to lend public money to support groups offering “private finance” (surely a situation beyond satire!). The theoretical implications are more serious and likely to be longer lasting. As critics have found, value for money depends on the valuation of risk transferred to the private sector (without it the vast majority of PFI schemes would fail the test against a public sector comparator). Yet the financial crisis has cast doubt on the ability of institutions to value risk in a reasonable way. At best they may have been over-ambitious rather than consciously dishonest in their approach to measuring and valuing risk. If, as seems likely, there may be no acceptable way of valuing risks transferred currently available can these be included in a value for money comparison? Yet without this how many PFI schemes would pass the test?

## SUGGESTIONS

Complete abandonment of PFI might have been possible, if difficult, in 1997. It is impossible now. All that can be done now is to scale down new commitments and deal with existing ones. First, reliance on PFI for new public sector investment needs to be curtailed drastically. A small number of public bodies with a demonstrably good record on PFI should be allowed to continue with new schemes. All others should be expected to use public capital. Second existing commitments need to be managed sensibly. Departmental ceilings should be set on the proportion of outgoings that can go on PFI payments—similar arrangements should apply to NHS bodies. No body near its ceiling should be allowed to take on further commitments even if it was qualified otherwise to continue with PFI. Bonds in PFI consortia could be included in purchases by the Bank of England under quantitative easing, thus transferring them to the public sector.

*April 2011*

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## Written evidence submitted by Skanska

### EXECUTIVE SUMMARY

1. Skanska welcomes the opportunity to submit written evidence to the Treasury Committee and to contribute to the ongoing debate regarding private investment in public infrastructure.
2. The UK Government recognises that significant infrastructure investment is required to underpin the UK’s growth and that a high proportion of this investment must come from the private sector.<sup>1</sup> The key is to find a model of investment that works for both parties.
3. Skanska has been involved in the UK PFI/PPP market since its inception and has accumulated a wealth of experience across sectors including health, education and transport infrastructure. Our experience suggests that, whilst PFI is a significant improvement over traditional procurement methods in many respects, such as long-term cost certainty, it also has weaknesses, such as limited flexibility and high procurement costs.
4. However, we strongly believe that PFI remains an effective procurement route for certain types of projects and that a number of the concerns about the PFI model can be eliminated or mitigated by some relatively simple changes. These include re-assessing risk transfer, re-examining specifications for both construction and operations and streamlining the procurement process. PFI is a tried and tested model that has evolved over time and both public and private sectors now have considerable experience which can be used to improve the process and its application.
5. Skanska supports the further development and evolution of PFI to provide a procurement model which facilitates much-needed private sector investment into infrastructure in a manner which meets the current and future needs of the public sector.

### *What are the strengths and weaknesses of different public procurement methods?*

6. There is a proven need for infrastructure in the UK that is currently unfulfilled. The Government’s National Infrastructure Plan 2010<sup>ii</sup> sets out ambitious targets for development of public infrastructure, particularly economic infrastructure, to facilitate growth and development across the country. In the current economic climate, however, there are insufficient public funds to provide all of the investment required and the Government therefore acknowledges that continuing private investment is vital.
7. Various funding models have been proposed to facilitate investment from non-public sector sources. We consider some of these alternative models further below (see paragraph 11) but think it is helpful to consider first the strengths and weaknesses of PFI.
8. PFI is a significant improvement over traditional procurement (ie procurement funded entirely by the public sector) and has brought a number of benefits including:

- *Fixed price, time certain construction*—historically, traditional procurement had resulted in construction projects that experienced significant delays and cost overruns. The NAO paper to the Lords EAC<sup>iii</sup> identified that 69% of PFI projects were delivered within a month of the due date and the vast majority of price increases resulted from public sector-requested changes during construction. In contrast, a previous NAO report had found that only 30% of major non-PFI construction projects were delivered on time and 27% on budget;<sup>iv</sup>
- *Whole-life costing*—maintenance of public sector assets tended to be inconsistent and, in difficult economic times, sometimes non-existent, leaving a legacy of dilapidated assets. PFI provides cost-certain long-term maintenance, ensuring that the asset is returned to the public sector at the end of the project in the same condition as it has been maintained throughout the project term;
- *Improved service delivery*—the performance regime that is built into PFI contracts provides incentives for high quality service delivery, a major benefit in areas that had not previously been subject to such regimes;
- *Improved public sector procurement*—as recognised in the Lords EAC report<sup>v</sup> and explored by PwC in its 2008 review,<sup>vi</sup> the increased discipline in risk analysis and allocation that is required in PFI has spilled over into traditional procurement which has consequently benefited from the lessons learned.

9. We recognise, however, that PFI is not a perfect procurement solution and is not suitable for all projects. In addressing some of the problems of traditional procurement, it has brought with it some new weaknesses, the main criticisms being that it is inflexible and expensive, tying up public resources that could be used elsewhere.

10. We acknowledge that there are good reasons for these criticisms, but believe that whilst some of the concerns result from the model itself, others arise from the way in which the model has been used or interpreted. More importantly, the model has been improved significantly over the last 10 years and we believe this development can continue. Areas that we would suggest for improvement include:

- *Risk transfer*—it is crucial that risks are transferred appropriately in order to maximise value for money for the public sector (see further paragraph 22 onwards);
- *Projects selected*—PFI is more suitable for projects where the public sector requirement over the long term is relatively straightforward and predictable (see further paragraph 32 onwards);
- *Funding*—shorter term funding should be considered to reduce costs and increase flexibility;
- *Procurement process*—as recognised by the recent HMT review,<sup>vii</sup> the introduction of competitive dialogue has not been entirely successful. We welcome the recognition that it can be burdensome and expensive and look forward to further Government progress on this issue;
- *Public sector skill base*—as recognised in both HMT's review of competitive dialogue<sup>viii</sup> and their draft guidance on operational PFI savings,<sup>ix</sup> the lack of public sector skills can have a significant detrimental effect, not just on procurement efficiency but also on management of existing contracts. There needs to be focus on development of public sector in-house skills, encouraging the public sector to take ownership of projects rather than relying on external advisers;
- *Specifications*—the public sector need to consider more carefully the specification of the project they are procuring in order to ensure that it represents the best value for money (see further paragraph 25 onwards).

11. We also recognise that PFI will not be suitable for all procurements and that there are alternatives that have been proposed to channel private investment into public infrastructure. These include:

- *Local asset backed vehicles or LABVs*—these are dependent upon the public sector having appropriate land or other assets to transfer into the joint venture vehicle and upon the market value of the land/asset that is available;
- *Tax incremental finance or TIF*—used appropriately, this model should result in income generation for the public sector but the model does not of itself provide any infrastructure investment;
- *Regulated asset backed or RAB model*—this approach has worked well in the utilities sector but, by passing costs onto consumers, it raises issues around affordability and impact on consumers. Equally, it may be more difficult to apply to social infrastructure where users do not generally pay for the services delivered;
- *User funding*—this model requires users to pay directly for the relevant infrastructure so is best suited to areas where there is a clear demand from users eg transport. However, it is not yet clear whether there is sufficient public or political appetite for such schemes to be used more widely.

12. A detailed analysis of these alternatives is beyond the scope of this evidence, but the committee should note that few have a significant track record in the UK and there is little clarity around their potential strengths

or weaknesses. Strategic partnering does not of itself introduce private finance and not all funding models result in development of infrastructure.

13. In contrast, PFI delivers both funding and infrastructure, bundling together a range of activities that the public sector would otherwise have to manage separately, and also ensures that the public sector retains ownership of infrastructure assets. To date, PFI has played a significant role in the expansion and renewal of UK infrastructure,<sup>x</sup> ensuring that key Government priorities have been met.<sup>xi</sup> Equally, PFI is now well understood, with a wealth of expertise and experience across the market and what the IMF described as the best developed PPP programme in the world,<sup>xii</sup> all of which will facilitate the further refinement of the model to ensure it remains an effective tool for the public sector.

14. The UK has also successfully exported the concept and there are lessons to be learned in return, eg from Canada (which now has a thriving P3 programme) and from other European countries eg France, Spain which appear to have a more efficient implementation of European procurement rules. Equally, other countries have implemented variants of PFI that could offer insights into potential areas for development eg the co-lending arrangement being used on our New Karolinska Hospital project in Sweden and the Non-Profit Distributing model used in Scotland.

15. In summary, Skanska believes that PFI offers a solid foundation for future infrastructure investment and that, with the right refinements and used for the right projects, it can remain a useful part of the public sector procurement toolbox alongside other funding and procurement models.

*If PFI debt had been on-balance sheet rather than off-balance sheet would pfi projects have been used as much? how should PFI deals be accounted for?*

16. Skanska believes that this is primarily a question for the public sector. From our perspective, the balance sheet treatment of a PFI project should be a by-product of the process rather than a key driver of it. The public sector should select a procurement model on the basis of whether it genuinely represents value for money and should not be influenced by matters such as accounting treatment.

*How far can risk really be transferred from the public to the private sector?*

17. Skanska supports the NAO's view<sup>xiii</sup> that PFI can, when properly implemented, deliver genuine risk transfer. There is a tendency for PFI's detractors to focus on the consequences to the public sector of project failure but risk transfer is a much more complex issue.

18. We recognise that, ultimately, the public sector are responsible for ensuring that services are delivered—if a project fails, they will need to re-procure those services elsewhere. They are also responsible for ensuring that they have selected the right procurement method for the project and for assessing the absolute need for the asset and services over time (see further paragraph 32 onwards), although it is worth noting that this is no different for PFI than for any other type of procurement—all capital spending decisions pre-suppose that the public sector has made a clear assessment of the evolution of demand over the lifetime of the asset.

19. However, when projects get into difficulties, the private sector often suffers significant losses. On project failure, investors will usually lose their entire investment (as was the case on the National Physical Laboratory project), often after also spending significant sums trying to rescue the project. For example, when Jarvis and Ballast got into difficulties, investors in some of their projects provided their own cash to ensure that the projects remained viable.<sup>xiv</sup> It is also worth remembering that, on termination for contractor failure, the public sector will usually receive the project assets at nil cost, which further mitigates any losses they may suffer.

20. More importantly, project failures are rare and PFI has a very strong delivery record, ensuring long term risk transfer. Delivery is incentivised by the model's structure—construction is for a fixed price and there are significant financial penalties for the private sector for both late construction delivery and service performance failures. Equally, investors have a long-term exposure to the success of the project and tend to be proactive in managing performance and developing good working relationships with the public sector client.<sup>xv</sup> Skanska, for example, has an asset management team, provided at its own cost, to monitor and manage the projects in which it invests.

21. The considerable time and financial input from contractors and investors alike tends to ensure that projects continue to run smoothly and is often vital to the project's success, shielding the public sector from risks and costs that they would otherwise have borne.

*Are there particular kinds of risk which are particularly appropriate for transfer through PFI deals, or particular projects which are suited for PFI?*

22. Risk allocation should follow the fundamental principles that risks should be allocated to the party best able to manage them. Over time, standardisation of contracts and the impact of the competitive process have led to an increasing level of risk being passed to the private sector<sup>xvi</sup> and a tendency for the public sector to take the view that greater risk transfer is better.

23. However, as with any business, a PFI company will need to price and allocate resources to manage the risks that it takes. Where there is a risk that cannot be managed or is difficult to predict, the company may

price that risk at a premium. In these circumstances, the public sector needs to consider whether the benefits of this risk transfer outweigh the cost and therefore represent value for money. Standard form contracts have created a generic approach to risk allocation which does not always represent optimum value for money.<sup>xvii</sup>

24. We would support the approach of the recent HMT guidance on savings<sup>xviii</sup> which has identified that there are some risks that unnecessarily add cost to a project. Potential areas to reconsider on existing projects include risk sharing around insurance premiums and capital expenditure resulting from changes in law. In future projects, the scope for varying risk transfer is significantly greater and we would suggest that matters such as title due diligence, title risk and responsibility for project insurance could also offer potential cost reductions.

25. We also believe that there is scope for better value for money from reconsidering the specification and performance regimes that are being procured. Our experience has been that PFI projects often have premium levels of design (providing landmark, as opposed to purely functional, buildings) and service delivery requirements far in excess of those provided elsewhere in the public sector.

26. Whilst this step-change in quality of infrastructure and services has been valuable, in a time of austerity, it is necessary to consider whether this approach genuinely represents value for money. In our experience, there has been a tendency for the public sector to seek ever-higher standards without considering whether this is the best use of their funds. For example, rapid responses times for minor issues may seem appealing but the private sector will require additional staff to ensure capacity is always available and this will increase costs.

27. Equally, PFI currently requires all assets to be handed back to the public sector at the end of the project term, usually a minimum of twenty five years after construction, in the same condition as they are required to be at the outset and throughout the contract. This can be close to the end of the useful life of the asset, thereby creating a significant lifecycle cost. A review of the handback requirements could offer potential savings to the public sector.

28. We believe that considerations around value for money and appropriate risk transfer also affect the type of projects that are suitable for PFI (see further paragraph 32 onwards).

*What state guarantees are explicit or implicit in PFI deals?*

29. At the heart of every PFI deal is the implicit guarantee that the public sector will always pay what it owes. This public sector covenant strength is the cornerstone of the lower lending rates offered by banks and the capital markets enjoyed by PFI projects.

30. Skanska believe that covenant strength is a key element of any contract with the public sector, but is particularly crucial where it underpins repayment of significant long-term borrowing, as in PFI. We also believe that whilst this guarantee can remain implicit for central and local government (since no local authority has yet gone insolvent), it needs to be explicit for entities such as NHS Trusts, particularly Foundation Trusts, where there is a real risk of insolvency.

31. Historically, this explicit guarantee has been provided in the form of deeds of safeguard from the Department of Health and, in our experience, has been fundamental to the cost-efficient private sector funding of our acute hospital projects. We therefore believe that removing such deeds from the process has no economic benefit for the public sector.

*In what circumstances are PFI deals suitable for the delivery of services?*

32. We believe that PFI is most suitable for the delivery of services that contribute to whole-life costing benefits and which are stable and predictable over the long term. PFI is less suitable for services that need to flex significantly over time to reflect changes in public service delivery, demographics or technology.

33. The concerns around flexibility logically lead to the conclusion that PFI should be used where the public sector can predict, with a reasonable degree of certainty, that there will be sufficient demand for the services procured, in the same configuration, for the duration of the project term or, alternatively, where it is possible to build flexibility into the design of the asset and/or the services specification from the outset within appropriate value for money parameters.

34. In contrast, we do not believe that PFI is generally suitable for services that are technology-based such as IT or equipment, because of the pace of change of those areas and the resulting obsolescence risk. For example, our experience of ICT in the Building Schools for the Future programme has been that it over-complicated the process, introducing risks that were unnecessarily complex and which it was therefore difficult to incorporate into the model whilst retaining value for money for the authorities. A number of local authorities, including Bristol Council, Skanska's partner in the Bristol BSF scheme, have now taken the decision to remove ICT from their BSF procurement and procure it separately.

35. Equally, we believe thought should be given to whether "soft" facilities management services, such as cleaning and catering, should be included. These interface much more closely with frontline services and are proportionately more affected by changes in public sector service delivery. They are also much more exposed to changing employment costs and commodity prices.

36. This issue has been recognised by HM Treasury in the use of value testing arrangements for these types of services, which allow services to be re-priced periodically. However, whilst our experience has shown that this is a useful tool, its primary benefit is to ensure that the initial costing of services represents the best value for money for the public sector. It is more difficult to use these mechanisms to flex the services themselves, which returns to our point that PFI is best suited for services that can continue in their original form for the duration of the project term.

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- <sup>iii</sup> *A Paper for the Lords Economic Affairs Committee*, National Audit Office, October 2009.
- <sup>iv</sup> *PFI: Construction Performance*, National Audit Office, 2003.
- <sup>v</sup> *Private Finance Projects and off-balance sheet debt*, House of Lords Select Committee on Economic Affairs, 17 March 2010.
- <sup>vi</sup> *The value of PFI—hanging in the balance (sheet)*, PwC, March 2008.
- <sup>vii</sup> *HM Treasury Review of Competitive Dialogue*, HM Treasury, November 2010.
- <sup>viii</sup> *HM Treasury Review of Competitive Dialogue*, HM Treasury, November 2010.
- <sup>ix</sup> *Making Savings in operational PFI contracts—DRAFT*, HM Treasury, January 2011.
- <sup>x</sup> *Private Finance Projects and off-balance sheet debt*, House of Lords Select Committee on Economic Affairs, 17 March 2010.
- <sup>xi</sup> Government Response to the First Report of the House of Lords *Economic Affairs Committee, Session 2009–10*, April 2010.
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- <sup>xiii</sup> *A Paper for the Lords Economic Affairs Committee*, National Audit Office, October 2009.
- <sup>xiv</sup> *The value of PFI—hanging in the balance (sheet)*, PwC, March 2008.
- <sup>xv</sup> *The value of PFI—hanging in the balance (sheet)*, PwC, March 2008.
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- <sup>xvii</sup> *Public private partnership financiers' perception of risks*, Demirag, Khadaroo, Stapleton and Stevenson, 2010.
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- April 2011

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#### **Written evidence submitted by Greg Dropkin and Sam Semoff on behalf of Keep Our NHS Public (Merseyside)**

##### EXECUTIVE SUMMARY

The Value for Money assessment of PFI schemes and the democratic accountability of the process are criticised with reference to the recently approved Outline Business Case for redevelopment of the Royal Liverpool and Broadgreen University Hospitals. The role of PFI debt in forcing NHS "Efficiency Savings" is highlighted. The claim that Care in the Community will reduce the required bed capacity in the current economic climate is questioned.

1. Difficulties in meeting PFI payments have plagued NHS Trusts. Some current examples are cited in a press release (1 April 2011) from the campaign group "Health Emergency" [1], media reports from the BBC [2, 3, 4], *Telegraph* [5], and *Liverpool Daily Post* [6].

2. We would like to highlight four other issues regarding the impact of PFI on the NHS.

- (A) Value for Money.
- (B) Democratic accountability.
- (C) PFI debt and "Efficiency Savings".
- (D) Care in the community.

3. (A) The use of PFI is routinely justified on the grounds of “Value for Money”. Yet the evidence from studies of actual PFI schemes is at best equivocal as to any overall advantage of PFI, see Hellowell [7], Pollock [8].

4. Treasury Guidance on Value for Money includes a Quantitative Assessment procedure which includes at least one questionable assumption: “Optimism Bias” is applied to conventional procurement but not to PFI, giving an inbuilt advantage to PFI in the comparison. Yet the Treasury has acknowledged that on-time and on-budget performance can be secured through conventional procurement, so long as the design and build services are procured through a fixed-price, “turn-key” contract.[7]

5. In practice, the actual application of the Quantitative Assessment is open to abuse. In the recently approved Outline Business Case for the PFI scheme to redevelop the Royal Liverpool Hospital, there was strong evidence that the scheme would not provide Value for Money, and internal documents from the Dept of Health acknowledged this in December 2009.[7, 9] The scheme was subsequently revised but was subject to legal challenge, after final approval, as it still involved several questionable assumptions and violations of Treasury policy. The withdrawal of Legal Aid prevented the evidence from being tested in the High Court. During public debate in the local media, political proponents of the scheme acknowledged that Value for Money had not been proven. For example, Liverpool City Council leader Joe Anderson told BBC Radio Merseyside on 17 Nov 2010 “I know it doesn’t provide Value for Money now or in the future, but it’s the only game in town”.

6. Critical errors in the Value for Money assessment of the scheme as approved included:

- (1) Justification of chosen parameter values for the Liverpool scheme by reference to just one other recent scheme (North Bristol) when Treasury guidance required taking account of experience in all relevant PFI schemes. Several directly relevant recent schemes were omitted from consideration when selecting parameters for Liverpool.
- (2) A very low value for the Internal Rate of Return was said to apply at North Bristol, but a higher IRR value for North Bristol was quoted by senior officials in two internal Dept of Health documents, one of which was the final submission to the NHS Director of Finance, David Flory, dated 4 March 2010, after the North Bristol scheme had closed.
- (3) A value for the credit spread adopted from North Bristol contradicted the value supplied under a Freedom of Information request to North Bristol.
- (4) An exceptionally high value of “optimism bias” implied an exceptionally high transfer of risk to the PFI, contradicting the exceptionally low value of IRR assumed for the Liverpool scheme.

7. Had any of the errors been corrected, the scheme would have failed the Treasury’s VfM assessment. Even with these errors, the scheme’s VfM assessment found only an 0.03% advantage for PFI over conventional procurement. In any case, uncertainty in the parameter values—which are only predictions—meant there was no significant advantage in PFI over conventional procurement.

8. Proposed PFI schemes invariably show positive VfM in order to obtain approval. Whilst the VfM assessment includes a Qualitative questionnaire, in fact there has never been a case where an OBC for a PFI scheme has been approved where the Quantitative analysis shows a negative VfM. [9]

9. (B) The Liverpool story also illustrates the lack of democratic accountability in the process of approval for PFI schemes. During the initial consultation in 2008, the public was not told that PFI would be used to finance the scheme. The High Court then forced a second “engagement exercise” with the public now informed of PFI. However, the Outline Business Case was not disclosed and there was no means to question any of its assumptions. The scheme’s approval was announced in the press by the then Sec of State for Health in late March 2010, though in fact the scheme was only given final approval in mid April. The Outline Business Case was eventually published after the General Election.

10. Thus throughout the entire period of two public consultations, and even after final approval from the then Sec of State, the public did not know exactly what the scheme entailed, whether it would provide Value for Money or be Affordable. Instead, the scheme was reviewed internally by the Dept of Health and the Treasury. Without a legal challenge, the failings identified by senior officials at the Dept of Health would have remained hidden from the public.

11. There is a further lack of public accountability during the period following approval of the OBC. Changes in the wider economic context, eg interest rate rises, may adversely affect the VfM and/or Affordability of a PFI scheme after the OBC has been approved, without any mechanism for the public to re-open the decision.

12. In any case, the contractual negotiations leading to the Full Business Case are commercially confidential, as is the FBC.

13. A further lack of accountability can occur at Local Authority level. Council committees, including Oversight & Scrutiny, may fail to undertake or commission any independent analysis of the Outline Business Case and instead rely on Trust officers to brief them on the PFI scheme.[10]

14. The lack of public accountability is very serious given the scale of public funds involved in PFI hospital building schemes, with debt repayments typically running over 30 years. The public must be able to weigh up

whether, in view of the long-term debt burden imposed by PFI and repaid from local NHS budgets, the costs of obtaining a new hospital by this route outweigh any advantages.

15. (C) In August 2009, the *Daily Telegraph* [11] reported that the massive “Efficiency Savings” which had been announced that summer by the NHS Chief Executive Sir David Nicholson were themselves the consequence of mounting PFI debt. At the time the savings were to be £15 billion, they turned out to be £20 billion.

“Repayments during the next spending review period—from 2011 to 2014—will reach £4.18 billion, almost £1 billion more than current levels, according to the documents, sent from the Department of Health to the Treasury.

“The steep increases come as the NHS prepares for its annual budget to be frozen, meaning cuts in real terms as PFI and other costs rise.

“As a result, hospitals have been ordered by Sir David Nicholson, the NHS chief executive, to make ‘efficiency savings’ of at least £15 billion over the same period.”

In other words, NHS cuts in real terms are being caused by PFI.

16. (D) PFI schemes to redevelop or build new NHS hospitals routinely involve a reduction in bed capacity in order to achieve Affordability, though the slimmer design is often explained by reference to “new medical techniques” and an “Out of Hospital strategy”, ie Care in the Community. However, bed shortages have been a problem at PFI hospitals. [12, 13, 14]

17. In the current circumstances, it must be open to question whether Care in the Community will actually reduce the demand for hospital care sufficiently to justify reduction in bed numbers. The current circumstances include recession, unemployment, inflation, cuts in Welfare, all of which will increase poverty and therefore increase demand for healthcare both in and out of hospital. Furthermore Care in the Community depends on cooperation between the NHS and local authorities, whose budgets are also being cut. Care in the Community budgets are not ringfenced, and so it is questionable whether such Care will be delivered as planned. Should the Health & Social Care Bill become law, the PCTs currently responsible for developing Community Care will be abolished and the GPs will have new responsibilities arising from the reorganisation.

18. Thus, separate from any concern over Value for Money, there should now be questions as to whether the smaller hospitals provided under PFI will be adequate to meet demand in the coming period.

19. If the Select Committee wishes to safeguard the NHS, it should recommend the complete replacement of PFI funding for hospital building and redevelopment by Public Finance, a cheaper, saner alternative.

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PRESS RELEASE FROM HEALTH EMERGENCY

<http://www.healthemergency.org.uk/breakingnews.php>

NHS HOSPITAL TRUSTS AXE STAFF AND BEDS UNDER MILLSTONE OF PFI SCHEMES

Friday 1 April 2011

More and more NHS hospitals built at high cost with private finance in the last decade (under the controversial Private Finance Initiative) are already closing beds and axing clinical and other staff in a desperate bid to balance the books as NHS budgets face the biggest-ever squeeze.

And now cuts and closures of services are being combined with asset-stripping sales of land and property to bail out floundering Trust finances.

The financially-strapped South London Healthcare Trust, which includes two financially-disastrous PFI hospital schemes (Bromley's Princess Royal University Hospital and the Queen Elizabeth Hospital in Woolwich) has announced plans to flog off "spare" land assets on several sites. This will virtually dismember what remains of the Queen Mary's hospital in Sidcup, where A&E and maternity services have already been axed, despite pre-election promises that they would be kept open—killing any last faint hopes of restoring the lost services.

In West London, the struggling West Middlesex Hospital Trust is planning to axe hundreds of nursing and admin jobs, and close more of the beds in the PFI-funded hospital, seeking to cut spending by 12% in two years.

In North East London, the £239 million Queen's Hospital in Romford, part of Barking Havering & Redbridge Hospitals Trust, is running with a whole floor unused, while the Trust is still seeking ways to close most of the 18-year old King George's Hospital in Ilford in order to stem its continued yearly deficits.

Upwards of 100 beds in the most costly PFI development in the country, the £1 billion Bart's & London Hospital (where each bed is costing £1 million to build, and £5 million over the lifetime of the contract) are also to be closed—before they are even built, leaving the Trust saddled with the escalating bill for building capacity it cannot afford to run.

In Portsmouth, too, a brand new £256 million 1,200 bed Queen Alexandra Hospital has announced 700 job losses and the closure of 100 costly beds in a battle to balance the books. The "unitary charge" PFI bill, which rises each year, is £43 million this year, making the total cost of the hospital and support services under PFI a staggering £1.6 billion.

Many other PFI hospitals are facing financial problems but have yet to announce cuts. But perhaps the financial nonsense of PFI is clearly underlined by the plight of the West Middlesex Hospital, which has already paid out £89 million to the consortium which built the £60 million hospital, but faces another 20 years or more of payments totalling more than £420 million before the £515 million contract is complete.

Commenting on the latest revelations, Health Emergency's Information Director Dr John Lister said:

"PFI means that hospitals face rising bills each year—regardless of their income: and it also means that private sector profits are protected by legally binding contracts taking an increased share of declining Trust budgets, while clinical services, patient care and the jobs of NHS staff are sacrificed—in an impossible battle to balance the books as the NHS faces real-terms cuts for the first time in a decade.

"Isn't it significant that Andrew Lansley's massive and controversial Health and Social Care Bill is seeking to break up almost every structure in our NHS, claiming to make the system more efficient, but leaving PFI intact, and instead opening even more ways for the private sector to rip off the taxpayer and undermine public services?"

"The Tories appeared opportunistically critical of their own PFI policy when Labour was implementing it, but are now happy to see this growing haemorrhage of cash from the NHS.

"If ministers really wanted value for money in the NHS, they would scrap Lansley's crazy Bill which hardly anyone—even GPs—supports, and which will cost £3 billion or more to implement, and focus instead on nationalising the PFI hospitals, many of which will be paying through the nose for a generation to come to banks that the taxpayer already effectively owns."

## Written evidence submitted by Healthcare Audit Consultants Ltd

### 1. THE UK PROBLEM WITH CAPITAL SPENDING AND PUBLIC SPENDING IN GENERAL

Despite all the evidence that the state has performed an essential and providential role in providing the infrastructure of public goods and services that provide the basis of our quality of life and security in the UK their remains a reticence for the state to accept that role and to manage that role positively. All political parties have been reluctant to invest in capital goods for long term benefits (for fear of the short term costs in terms of taxation or the impact on totems of sound economic management—value of the pound, PSBR , money supply, inflation etc).

The advice of civil servants has been tainted by Treasury orthodoxy which has viewed public expenditure as a necessary evil and essentially a cash issue—there has been no balance sheet mentality or a view of public assets being developed and nurtured.

The controversies over the years led to severe constraints on capital spending, underinvestment in essential utilities and publicly owned industries, and, eventually to the privatisation of large sections of the economy at bargain prices. The subsequent flourishing of some of these industries (although not all) has reinforced a common sense that public sector management is bad and the private sector good.

Controversy remains even in the firmly established public spheres of health and education which has recently funded large investment programmes through the PFI route. PFI was chosen both to introduce private sector expertise in the management of large capital projects but more importantly as an off balance sheet solution to the capital funding requirement rather than the state funding projects directly and acknowledging the investment on its own balance sheet even though this may have been cheaper in terms of the cost of capital.

In my view reluctance by the state to accept that there can be comparative benefits from retaining certain key industries and services within the public realm and managing them responsibly is a problem that could weigh on the nation in the future.

Everyone accepts that private monopolies can be a bad thing and that private control of health services in particular, as in the USA, can lead to profiteering and a sub-optimal service at excessive costs. This is why regulation of key industries such as armaments, telecommunications, utilities, transport and banking remain controversial as the benefits of light touch regulation have been offset by the loss of control over location of factories, payment of taxes , excessive risk taking and sustainability and security of long term services.

#### Recommendation 1

The UK should be more even handed and strategic in managing key industries and services and accept that certain goods and services can be supplied by the public sector; and, if this is accepted, that Investment funds should be available at market costs- without artificial funding barriers erected on essentially ideological grounds.

### 2. WHAT ARE THE PROBLEMS WITH PFI PROJECTS?

There are several problems that have been identified:

- It has created more public debt at a time when public debt is excessive.
- It is more expensive than Government debt.
- Transaction costs are very high.
- It has caused knock on funding crises in local hospitals and education authorities as the new facilities failed to deliver savings and are more costly to sustain.
- The schemes consolidate old ways of working and do not represent good investments in themselves.
- The schemes are inflexible with the costs of change prohibitive.
- The inflation escalation clauses mean that the burden of PFI schemes will increase over the years.
- There is uncertainty at the end of the contract period as to what will happen with the large risk that the NHS will be forced to pay twice for a public asset.

MY COMMENTS AND RECOMMENDATIONS ARE:

#### 2.1 *On the Public Debt*

The distinction between public debt and private debt can be arbitrary with hospitals providing similar services being classified as either public or private in an inconsistent way from country to country.

There is no right or wrong way. There is no reason to suppose that the UK has overinvested in hospitals in the last few years. Indeed all the evidence suggests there is still a backlog of old out-dated facilities requiring modernisation and improvement.

Up until the recent banking crisis UK public debt was low by international standards. The current government are taking stringent measures to reduce public spending to reduce public debt.

#### Recommendation 2

Valid international comparisons of debt should classify the debt associated with hospital funding programmes on a consistent basis. But we know of no evidence to suppose that investment in UK PFI hospitals is excessive or represents poor value for money in comparison to the extent of hospitals in other countries (most have many more beds and hospitals) or in the method of funding (most are funded through private routes involving premiums to sovereign debt rates).

##### *2.2 The Cost of PFI capital in relation to Sovereign Debt*

PFI schemes raise money from banks at a small premium to the LIBOR rates and UK sovereign debt. This is to compensate the private provider for taking on the construction risk and the risk of overspending for the project. There is some debate on whether this is excessive or not but in any case there is a risk and the extra cost is not large in relation to the costs and benefits overall at c2–3%.

#### Recommendation 3

The excess cost of capital for PFI schemes should be kept under constant central review to ensure that the risk premium is proportionate to the actual risks and not to notional risks.

##### *2.3 Transaction costs are high*

Transaction costs were much lower in earlier years when the NHS managed the process but arguably this led to overspend and extra costs through underspending on project management and risk management.

#### Recommendation 4

The transaction costs of PFI schemes should be kept under constant review by the DH and steps taken to ensure these are proportionate to the risks involved. The Treasury should be alert for PFI industry capture of the advisory process leading to excessive costs in comparison with other countries procurement processes.

##### *2.4 The knock on operational and revenue costs of PFI has prompted funding crises in their wake impacting on the quality of services*

This is where the major controversy has been generated but we would question whether these problems can be attributed to PFI or whether they should be more accurately attributed to the NHS tariff system. The recent Kings Fund booklet “Reconfiguring Hospital Services” by Keith Palmer attributes the financial problems accompanying hospitals with recent PFI schemes to the NHS tariff system which, as it based on funding average historic capital costs provides windfalls to some hospitals who may have modernised before the tariff was introduced and penalises hospitals with more recent PFI schemes. His calculations accounts for the bulk of the financial problems of hospitals with PFI schemes. A minor tweak to the market Forces Factor used to supplement the tariff would cost nothing and relieve much of the so called revenue problems of PFI schemes. It is perplexing why this has not been done already.

The explanations that come to mind are:

- Treasury orthodoxy is still to deter new capital investment (as I encountered first hand when sent to discuss funding redevelopment of an old London Teaching hospital site) or at best to delay schemes (they can do this for years).
- Extra pressure to reduce revenue costs is seen as no bad thing.

In any case it has been a struggle to manage the inevitably higher costs associated with modern hospital facilities in comparison with older, makeshift, ill-equipped facilities not suited to modern intensive healthcare. The pressure to reduce costs results in more contracting out of support services, back office services and pressure (so far resisted) to contract out clinical support services. As these services are highly unionised there has been a well-orchestrated campaign by the staff unions to oppose this and which has tarred PFI with the accusation that it is at the root of the problems in local services caught up in PFI projects.

In reality all the NHS is under pressure to achieve year on year cost improvements- particularly over the next four years where cost savings of 4% per annum are planned. It is likely therefore that savings from contracting out support services; back office services and clinical support services will be pursued aggressively across the board, irrespective of a PFI site in situ. It is predicted therefore that opposition to PFI will metamorphose into opposition to contracting out and to government policy generally.

This is not to deny that pressure to make cost savings has been heightened in recent years in organisations with PFI schemes but to clarify that this situation arose because of the double penalty of the tariff system (double in the sense that costs increased with PFI schemes but income failed to match this leaving Trusts with increased cost savings targets).

#### Recommendation 5

Hospitals with PFI schemes should have their tariff adjusted to reflect their actual cost of capital. This could be funded by adjusting the tariff of the rest who may enjoy fortuitous benefits at present.

#### Recommendation 6

Staff opposition to contracting out can be reduced by harmonising pay and conditions, including pension rights across the public and private sectors.

#### *2.5 PFI consolidated outdated working practices rather than lead to modernised practices*

It is not argued that this happened—but that the opportunity to fund a new hospital development appears in a narrow time window. Achieving clinical change in the NHS takes too long to negotiate and so there has been the consolidation of old working practices.

#### Recommendation 7

There should be more central identification and driving of change as part of the PFI approvals process. For example modernisation of pathology services should be mandated prior to approval.

#### *2.6 PFI schemes are inflexible and the costs of change prohibitive*

There has been considerable adverse publicity to the charges levied for items of extraordinary maintenance or for making small changes to premises.

#### Recommendation 8

The problem of PFI contract inflexibility can be resolved by the insertion of a standard clause requiring arbitration to ensure reasonable costs only can be charged as a result to changes in premises. This should be imposed nationally.

#### *2.7 PFI inflation escalation clauses will escalate funding problems over the years as the prices of services will rise with inflation despite most costs having been sunk*

The maintenance and support services costs would rise with inflation but the historic investment will not.

#### Recommendation 9

The fairness of the PFI price escalation clauses needs to be reviewed to ensure that they do not guarantee excessive profits over time. Again a centrally imposed change may be required to ensure fairness.

#### *2.8 The situation at the end of the PFI period is unclear in many contracts with the high risk of the asset having to be paid for twice*

In order to preserve the fiction that the asset is not a public asset the premises at the end of the contract period will revert to the private sector at the end of the contract. The issue will be on what terms the contract will be renewed. There is every chance the NHS will be asked to pay twice for the right for continuing use.

#### Recommendation 10

It is recommended that each PFI contract be reviewed to ensure there is no ambiguity and risk of the public sector being seriously disadvantaged in any renewal negotiation. A central team should be designated to achieve a fair settlement.

### 3. FAILING PFI'S AND KILLING THE CUCKOO

If the recommendations above are followed there is no reason why a lot of the problems associated with PFI's shouldn't be overcome but there will be instances where past PFI's are too expensive for the larger NHS community to bear without inappropriate distortion to the resources available for healthcare and the accessible delivery of healthcare. This can arise when an oversized development, inappropriate to modern needs is in situ requiring escalating funding—effectively cannibalizing adjacent providers—and which can only be sustained by the recurring pre-emption of an ever increasing proportion of the commissioners funds.

The system must be able to recognise failure and write off assets and liabilities that cannot be sustained.

#### Recommendation 11

If PFI assets become surplus to commissioners requirements that could be better invested in alternative ways commissioners and providers should be able to nominate PFI assets for disposal. In the event of no ready market for partly used NHS premises or in the event of losses on disposal against redemption of loans outstanding for

these assets then the NHS nationally should meet these costs. The DH would negotiate with the PFI provider and bankers for an appropriately discounted early redemption charge. This is in recognition that it is better to recognise losses early, that there is a case for creative destruction of assets and such a move will be beyond the resources of a local community and should be recognised as an extraordinary event requiring national recognition and funding.

#### 4. SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS ON PFI FUNDING

- (a) PFI has been pursued as a response to the view that the public sector could not be trusted with large scale capital projects. It was thought that inevitably costs would escalate and benefits fail to be realised. But in addition by moving capital projects off balance sheet it took away many short term costs from decision makers and imposed them on future generations. PFI therefore achieved two policy objectives seen to be self-evidently good: It transferred risk and responsibility for large scale projects to the private sector and it brought forward the replacement of public assets sooner than under traditional funding methods ie bidding for tightly controlled centrally allocated funds.
- (b) A more even handed and strategic view needs to be taken of public investment, the creation of public assets, and the provision of public goods and services. The experience of the US healthcare industry shows the risks of private ownership and control of a public service can lead to over treatment and poor use of investment capital, lack of access to service by the underprivileged, profiteering and corruption. The recent experience within the banking industry reemphasises the risks associated with light touch regulation and the opportunities for public provision of banking services eg by the creation of an Infrastructure Bank funded by the public sector. Just as the European Investment Bank helped finance the new Barts' and the London Hospital so a UK infrastructure bank could make funding easier for needed capital expenditure within the public sector without recourse to the dead hand of the Treasury or to private banks, who inevitably will exploit opportunities for large profits at the states expense.
- (c) Valid international comparisons of debt should classify the debt associated with hospital funding programmes on a consistent basis. But we know of no evidence to suppose that investment in UK PFI hospitals is excessive or represents poor value for money in comparison to the extent of hospitals in other countries (most have many more beds and hospitals) or in the method of funding ( most are funded through private routes involving premiums to sovereign debt rates).
- (d) The excess cost of capital for PFI schemes should be kept under constant central review to ensure that the risk premium is proportionate to the actual risks and not to notional risks.
- (e) The transaction costs of PFI schemes should be kept under constant review by the DH and steps taken to ensure these are proportionate to the risks involved. The Treasury should be alert for PFI industry capture of the advisory process leading to excessive costs in comparison with other countries procurement processes.
- (f) Hospitals with PFI schemes should have their tariff adjusted to reflect their actual cost of capital. This could be funded by adjusting the tariff of the rest who may enjoy fortuitous benefits at present.
- (g) Staff opposition to contracting out can be reduced by harmonising pay and conditions, including pension rights across the public and private sectors.
- (h) The problem of PFI contract inflexibility can be resolved by the insertion of a standard clause requiring arbitration to ensure reasonable costs only can be charged as a result to changes in premises. This should be imposed nationally.
- (i) There should be more central identification and driving of change as part of the PFI approvals process. For example modernisation of pathology services should be mandated prior to approval.
- (j) The fairness of the PFI price escalation clauses needs to be reviewed to ensure that they do not guarantee excessive profits over time. Again a centrally imposed contractual change may be required to ensure fairness.
- (k) It is recommended that each PFI contract be reviewed to ensure there is no ambiguity and risk of the public sector being seriously disadvantaged in any renewal negotiation. A central team should be designated to achieve a fair settlement.
- (l) If PFI assets become surplus to commissioners' requirements commissioners and providers should be able to nominate PFI assets for disposal. In the event of no ready market for partly used NHS premises or in the event of losses on disposal against redemption of loans outstanding for these assets then the NHS nationally should meet these costs. The DH would negotiate with the PFI provider and bankers for an appropriately discounted redemption charge. This is in recognition that it is better to recognise losses early, that there is a case for creative destruction of assets and such a move will be beyond the resources of a local community and should be recognised as an extraordinary event requiring national recognition and funding.

#### NOTE TO COMMITTEE:

*My background:* I have academic qualifications in Public Finance and am a member of the Chartered Institute of public finance and accountancy (CIPFA). My professional life has been devoted to the NHS as a Director

of Finance and outside the NHS as a consultant—including working on large PFI projects in Swindon and North East London—including Barts’ and the London PFI, as acting performance manager for the NE London SHA capital programme of over £2 billion. Healthcare Audit Consultants have advised Local authorities on some of the most controversial putative NHS reconfigurations—many with PFI’s at their core eg SW London, Hertfordshire, West Sussex, Gloucestershire and West London. I have also worked on business cases for the private sector including private hospital projects. This background and experience puts me in a good position to comment on PFI.

April 2011

### Written evidence submitted by J P Heewood

#### ABOUT MYSELF

I am a resident of York who was alarmed by early reports of PFI, doubly so when it came to the local primary school which our children had attended. With others I formed York PFI Watch (now defunct) to inform teachers, parents and others, by a website, leaflets, press letters and attendance at meetings, about the operation of PFI and its implications. My reading since then suggests that the fundamentals of PFI are unchanged, and I wish to make a criticism of it which I think is not sufficiently recognised.

#### EXECUTIVE SUMMARY OF SUBMISSION

- (1) PFI as operated is dishonest, because it forces bodies applying for PFI funding—to which there is usually no alternative—to present private finance as cheaper than public funding, whether it is or not.
- (2) In practice, as has happened in York, an initial case showing public funding as cheaper than private is tilted the other way by a figure for transferred risk.
- (3) In fact no risk is transferred unless specified in the contract, and there are reasons to think that in reality much risk remains with public bodies.
- (4) Secrecy makes PFI undemocratic; its operation is dishonest, corrupting and coercive, perpetuating in every submission the myth that “private” funding is always cheaper than public, despite contrary evidence, and thereby wasting resources.
- (5) The inquiry should make public the detailed operation of PFI, and make genuine comparisons of private and public funding; it should recommend the abolition of all public spending disguised as private, and of all funding tests requiring “evidence” that is a foregone conclusion; and it should recommend elimination by all means of excessive costs in existing PFI contracts.

#### 1. INTRODUCTION

PFI has many faults, but I will limit myself to a crucial criticism which is seldom aired. This concerns the dishonesty of PFI, and the expensive falsehood that maintains it. PFI was brought in to disguise certain public spending as private finance. To justify this, it was deemed necessary to present “private” funding as cheaper than undisguised public spending—most improbably, as governments borrow at preferential rates and do not have to create a profit. Councils and other authorities have been forced by this into a culture of dishonesty, for which their “reward” is decades of serious over-expenditure.

#### 2. THE YORK SCHOOLS EXAMPLE

A local and typical example is the fairly recent rebuilding of three primary schools in York: Hob Moor, Westfield; St Barnabas’, Beckfield; and St Oswald’s, Fulford. To get new schools, the City of York Council had to apply for private finance, “the only show in town”. To secure this, York’s business case had to show the PFI cost as being lower than undisguised public funding—whether it was or not.

In the York Schools PFI Project, the executive summary of the Outline Business Case (OBC) gave the PFI cost as £11.1 million, with the projected Public Sector Comparator (PSC) better value at £10.3 million. But of course a bid with those figures wouldn’t get public funding—it would get no funding!

So, as was customary, an “estimated risk” figure of £1.4 million was added to the PSC, which made PFI look better value; York’s bid was then accepted, in March 2002, and the schools were built. This estimated risk figure, which made York’s PFI bid viable, was held to represent risk that would be transferred to the “private provider”, Sewell Group, if it built the schools. It was impossible to test this figure, as the OBC was not made public.

#### 3. THE CLAIM OF RISK TRANSFERRED

The council’s claim, as conveyed to the public by York Schools Project Manager Damon Copperthwaite in a newspaper interview (*Yorkshire Evening Press* 24 March 2004) was that “by entering into a PFI agreement

the provider takes on all the risk". This was quite untrue, for several reasons (taken from an indispensable pamphlet, Rowland & Pollock "Understanding the Private Finance Initiative", Unison, 2002):

- (1) No risks are transferred to the provider unless specified in the contract, with enforceable financial sanctions.
- (2) Nor do risks always stay transferred. Companies failing to deliver have regularly used this as a reason to renegotiate their PFI contract—upwards!
- (3) If Sewell go bankrupt or withdraw, York carries the can, since PFI contracts are technically speaking not with the PFI company but with a "Special Purpose Vehicle" for which that company is not financially responsible.
- (4) PFI creates new risks: under a PFI contract, the PFI repayments are "protected", with priority in school budgets over all other spending—even teachers' pay.
- (5) If for any reason PFI costs rise during the following 25 years, the government will not increase its contribution: any increase will fall in full on the council.

I made points (1)–(3), worded as shown, in a reply to Mr Copperthwaite which the paper printed, inviting him to correct me if my information was wrong or outdated. He did not do so. This destroyed all faith in the council's claim about £1.4 mILLION of transferred risk—which remained the only "evidence" that PFI was cheaper than public spending!

#### 4. SUMMARY OF CRITICISM

- (1) *PFI is undemocratic*: the break-down of York's expenditure is a commercial secret from York's taxpayers, who will pay for it over 25 years, but can't hold their councillors accountable for the costs, because they don't know in detail what the costs are.
- (2) *PFI is dishonest*: the alleged comparison between "private" and public funding is not obtained honestly; since the PFI "option" is the only one, the council's task is not to find out whether, but to ensure that, the PFI figure appears as better value.
- (3) *PFI corrupts*: there is pressure on officers to make the figures come out right, ie in favour of PFI; they may well feel their professional integrity threatened or tarnished.
- (4) *PFI coerces*: councillors are coerced into voting for policies they may completely disagree with; in York in 2001, 24 Liberal Democrat councillors, whose party's policy was opposed to PFI, had to vote for it for fear of losing three new schools for York.
- (5) *PFI perpetuates falsehood*: every PFI scheme submitted (many more are submitted than succeed) adds perforce to the accumulated mass of improbable "evidence" that PFI is cheaper than public spending.
- (6) *PFI wastes resources*: as the "proof" that PFI is cheaper is a charade, it is no surprise that true figures show councils loaded for decades with grossly excessive repayments, corresponding to enormous profits made by some (not all) PFI providers.

#### 5. RECOMMENDATIONS

I suggest that this Inquiry should:

- (1) make public the detailed operation of PFI, so that its fundamental dishonesty, and the culture of corruption and falsehood it has created, are evident to everyone;
- (2) make unbiased comparisons, for a representative sample of PFI projects, between the overall costs of PFI and the corresponding costs of straightforward public spending;
- (3) invite evidence regarding (1) and (2) above, first and foremost from Prof Alyson Pollock, academic, and also from Ms Polly Toynbee, journalist, both of whom have produced full and convincing evidence for the criticism of PFI presented here;
- (4) recommend the abolition, if necessary by statute, of attempts to represent public spending as private financing;
- (5) recommend the abolition, if necessary by statute, of government funding tests that require submission as "evidence" of what is in fact a foregone conclusion; and
- (6) recommend urgently the reduction of expenditure on existing PFI contracts, whether by renegotiation, taxation or legislation, so that profits from these schemes no longer impose an excessive and unreasonable burden on local or national taxpayers.

## Written evidence submitted by BDO LLP

### 1. EXECUTIVE SUMMARY

1.1 BDO LLP is the award-winning UK member firm of the BDO international network, the world's fifth largest accountancy organisation, with more than 1,000 offices in over 100 countries. We have a dedicated Government & Infrastructure team—our team members have worked on over 200 public sector infrastructure projects undertaken through a mixture of procurement routes. We are committed to developing our business in this sector and are committed to the delivery of infrastructure in the UK.

1.2 We are pleased to have the opportunity to submit written evidence to the Committee's inquiry into the future of the Private Finance Initiative (PFI). Our submission focuses on the areas of our direct experience. We would welcome an opportunity to give oral evidence to the Committee and are happy to provide additional information.

1.3 There have been many successful PFI projects that have been delivered to time and budget, providing well designed and well maintained buildings. There are also examples of schemes that have suffered difficulties, particularly on earlier projects. The model has been refined, and continues to be subject to further improvements.

1.4 As set out in the National Infrastructure Plan 2010, there remains a need to continue to improve the UK's infrastructure and, to do this, there is a need for private finance. PFI is a valid option for many projects, but it should not be the only option, as it has been in some cases in the past. It should be used only where it is genuinely the best method to fund and deliver the specific project.

1.5 In some sectors, a new model may be required that adopts the successful aspects of PFI, but provides more flexibility to change the usage of the assets during the concession or renegotiate/terminate where appropriate.

### 2. *What are the strengths and weaknesses of different public procurement methods?*

2.1 There is not sufficient room in this submission to consider all procurement routes—we have outlined some methods but, as the inquiry is into PFI, have focussed on that method.

2.2 The procurement methods covered in this submission are:

- 2.2.1 PFI—the public sector pays a Unitary Charge to a private sector provider that designs, builds, finances and operates the facilities, usually for a concession of at least 25 years.
- 2.2.2 Design and Build—the public sector enters into a contract to design and build the facility, with the design sometimes provided by the public sector. Operation of the facility is undertaken separately.
- 2.2.3 Leases—a private sector developer builds the facility and leases it to the public sector. The private sector owns the asset, with the public sector body responsible for maintenance and insurance during the lease term.

2.3 It should be noted that many of the perceived weaknesses of PFI are actually weaknesses in procurement or project management that would have arisen under any procurement method. For example:

- 2.3.1 Client specification—there are examples of projects delivering facilities that do not meet the requirements. This has often been down to the public sector getting its specifications wrong and would have been an issue under any procurement route.
- 2.3.2 Demand—there are instances of facilities no longer being needed. These are not caused by PFI, but by poor planning. The issue would arise whatever the procurement route, but has been compounded by the long-term nature of PFI. The capital value would have been paid under traditional procurement, but operational costs could be terminated.

2.4 Similarly, a number of the “issues” highlighted are due to inconsistent comparisons. Critics point to “expensive” PFI projects by comparing total unitary charge to the initial capital value, but do not consider the fact that this is a total whole-life cost, as opposed to a simple repayment of capital. The public sector has not historically kept detailed records of the whole-life costs of its buildings, including lifecycle, facilities management and internal resource in managing separate contracts. Therefore, cost comparisons can be flawed. PFI appears more expensive as it is the only route that accurately includes all costs.

### 2.5 PFI—Background

- 2.5.1 PFI was introduced in the early 1990s to access private finance to allow a step change in the level of investment in Government infrastructure.
- 2.5.2 Over time, the PFI model has been, and continues to be, refined, with particular reference to lessons learned from earlier projects. This has led to a more appropriate share of risk on later projects—areas where risk transfer has changed significantly include refinancing and insurance. In addition, funding costs for both debt (subject to the lack of liquidity following the banking crisis) and equity have reduced as the risks have become better understood by all parties.

## 2.6 PFI—Principles

- 2.6.1 A Unitary Charge usually covers design, build, finance and operations. This allows an accurate assessment of the total cost of building and operating a facility.
- 2.6.2 The concept of “no service, no fee” ensures that the public sector only pays for infrastructure that has been delivered and is functioning correctly. Any instances of unavailability, or poor performance, lead to deductions from the Unitary Charge. This encourages quality design and build, as the private sector is responsible for the ongoing standard of the facility over the full length of the concession.
- 2.6.3 One of the major principles of PFI is the transfer of risk to the party best suited to manage it. In most cases, the private sector is better able to manage the delivery of infrastructure and, therefore, it is a benefit to pass this risk to the private sector. If the infrastructure is poorly designed and built, or poorly maintained over the life of the concession, the public sector will not have to fund any remedial works—indeed, the public sector can make deductions from the PFI payments if the infrastructure does not meet the required standards.
- 2.6.4 Risk of delivery to time and budget is passed to the private sector on contract signature. The majority of PFI projects have, therefore, been delivered on time. The public sector does not pay for the service until it is delivered, which is a powerful incentive to the contractor. In addition, any cost overruns in construction are at the private sector’s risk.

## 2.7 PFI—Lessons Learned

- 2.7.1 PFI has introduced private finance to government infrastructure, allowing a greater level of capital investment. This need for private finance is highlighted in the National Infrastructure Plan 2010. However, PFI should be one of a number of options to access this funding, and should be used only on suitable projects and where the long-term payments are affordable.
- 2.7.2 PFI has led to a robust and rigorous procurement process. The involvement of private sector funders, and the due diligence required by these funders, has been one of the factors in this. However, due to its complexity, the procurement process can be lengthy and costly—early projects typically took over 24 months to procure. Standard documentation and commonly used principles have shortened procurement timescales to, typically, 12–18 months, with scope for further reductions.
- 2.7.3 The Unitary Charge allows simpler budgeting for public sector bodies and ring-fencing of budgets to cover lifecycle in future years and ensure that the assets are properly maintained. This has brought benefits but also added to the perception that PFI is expensive as this maintenance (and associated cost) is mandatory and accurately recorded. Historically, the public sector has not always properly maintained its estate—this is cheaper in the short-term but can lead to poorly maintained facilities and expensive remedial works when the need arises.
- 2.7.4 One of the fundamental principles of PFI is risk transfer. However, it must be appropriate risk transfer. On early projects, there was a push to transfer as much risk as possible, but this came at a cost. This has been, and continues to be, refined so that the principle is based on the risks being managed by the party best placed to do so. Experience of operational projects also provides a more accurate quantification of the value of risks, which leads to better pricing and negotiation of contracts. However, it is still difficult to accurately compare against other procurement routes as the data is not as accurately recorded. PFI may appear expensive but, in reality, it includes costs that are not included in headline figures for other routes.
- 2.7.5 It is generally accepted that the private sector can apply a contingency to cover risks transferred. However, in some early cases this contingency was disproportionate to the risk. There is currently no mechanism for the public sector to share in any savings on unused excessive historic contingencies. This is being refined on some new projects, and is also being revisited on some operational projects.
- 2.7.6 There have been examples of expensive projects due to excessive performance standards being specified by the public sector client. This can be the case on non-PFI projects, but is exacerbated by the long-term nature of PFI. Currently, many public sector bodies are considering renegotiating contracts based on relaxing these standards to more realistic levels, for example wider temperature ranges. In addition, the public sector has recognised this issue and it is not as prevalent on newer projects.
- 2.7.7 There can be a lack of flexibility during the operations stages. This can range from difficulties in changing the usage of the asset, to disproportional legal and funding costs in providing small-value works to remodel the facility. This remains an important issue and one which is being further refined in newer projects. This should be considered in any new mechanisms.
- 2.7.8 The complexity of the PFI contractual documentation, coupled with a lack of resource and/or experience in public sector bodies, has often led to contracts being poorly managed. Many public sector bodies do not enforce the contract due to a lack of understanding, or a lack of time or appropriately qualified resources to check the deductions. There needs to be better monitoring by the public sector.

2.8 PFI is a sound model, and one that has been adopted successfully in a number of countries. There have been project failures, but these are rare. Lessons from these failures have been used to continually refine the process to provide a robust model of procurement that also provides access to private sector funding.

2.9 However, it must be applied correctly—it could be one of a number of procurement options available for infrastructure projects, and used only where it is genuinely the best method to fund and deliver the project.

## 2.10 Design and Build

### 2.10.1 Strengths include:

- (a) simpler and quicker procurement route than PFI. In addition, there is a lower cost of procurement and less need for external advisers. However, external advice should still be used as appropriate, for example on technical issues;
- (b) contractual documentation is simpler than PFI;
- (c) flexibility during the construction stage—designs can be updated and the design & build contract renegotiated;
- (d) different contracts can be let for different services, eg build and operations, or they can be delivered in-house, to ensure that each is provided by the most suitable organisation rather than a “one-stop shop”; and
- (e) flexibility to change usage of the asset and/or remodel at a later stage.

### 2.10.2 Weaknesses include:

- (a) risk of projects being delivered late and over budget (the public sector’s track record was one reason cited for the introduction of PFI). The public sector maintains the risk of these overruns but is not always well placed to control them. There can be less discipline in design which leads to costly changes during the build phase;
- (b) flexibility during construction is costly; and
- (c) assets have not been maintained properly, leading to an outdated estate that, in many cases, does not meet legal requirements for Health & Safety or DDA. When maintenance is undertaken, it is often reactive and more costly than if it had been undertaken before the problems had arisen.

## 2.11 Leasing and developer projects

### 2.11.1 Strengths include:

- (a) procurements can be faster than PFI;
- (b) no need for upfront capital funding—the asset will be leased on an annual basis; and
- (c) greater flexibility to change usage, or end the agreement. However, there are still limits and any remodelling will need to be agreed by the developer.

### 2.11.2 Weaknesses include:

- (a) public sector will never own the building. At the end of the lease, it must either negotiate an extension or find alternative premises;
- (b) potential penalties for the public sector if the asset is not maintained or insured;
- (c) as the developer owns the asset at the end of the lease, it will factor the cost of converting the building for alternative use into the lease cost. This can be excessive if the asset is a specialised building; and
- (d) borrowing costs are more expensive than the rates at which the public sector can borrow itself, or can be accessed for PFI projects (due to their long-term nature).

2.11.3 This route is best suited to facilities that are easily convertible to alternative uses, for example offices or non-specialised courts.

*3. If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much? How should PFI deals be accounted for?*

3.1 The balance sheet treatment of PFI debt was undoubtedly an influencing factor in the use of PFI. As the granting of PFI funding was dependent on debt being off-balance sheet, there were examples of structuring projects to ensure the correct balance-sheet treatment, rather than to provide the best value for money. However, in recent years accounting standards have changed, leading to most PFI debt being accounted for as on-balance sheet for individual Government Bodies, and the use of PFI has continued with structures best suited to the projects, rather than the accounting treatment.

3.2 In future, PFI deals should be accounted for in line with International Accounting Standards. The accounting treatment should not be a deciding factor in the use of PFI—the procurement route should be assessed based on the best delivery vehicle for each project.

4. *How far can risk really be transferred from the public to the private sector?*

4.1 PFI has seen a genuine transfer of risk from public sector. Essential to the success of a project is not “how far is risk transferred?”, but “have the most appropriate risks been transferred?”—any risk transferred is done so at a cost and, if the private sector is not able to control the risk, it will increase the price to include a contingency. Some early contracts attempted to transfer unsuitable risks, leading to long negotiations and high prices.

4.2 As in other areas of PFI, risk transfer has improved in later contracts. For example, an equitable share in insurance risk is reflected in lower contingencies being applied by the private sector. Also, there has been a reduction in the size of lifecycle funds as experience of operational projects and the actual level of lifecycle required has grown.

4.3 Standard contracts have also been helpful in maintaining a consistent level of risk transfer, and in reducing the time spent negotiating this transfer.

4.4 It is important that there is sufficient risk transfer to incentivise the private sector. The underlying principle of all PFI contracts must be that there is no payment if there is no service—the risk of non-delivery must entirely lie with the private sector.

5. *Are there particular kinds of risk which are particularly appropriate for transfer through PFI deals, or particular projects which are suited for PFI?*

5.1 It is important to ensure that the risks transferred are those that can be managed by the private sector more successfully than the public sector. One of the fundamental principles of PFI was that the private sector is better at designing and building infrastructure to time and budget—therefore, the transfer of the risk of doing this is central to the model.

5.2 A risk that generally remains with the public sector is demand risk, unless the private sector can genuinely control demand (eg by providing a “better” road or promoting waste recycling). However, this has led to some facilities that are no longer needed still being paid for through a PFI arrangement. This demonstrates that projects that require flexibility of usage are not best suited to the current PFI structure.

6. *What state guarantees are explicit or implicit in PFI deals?*

6.1 It is recognised that the state stands behind all PFI transactions, which provides a stronger covenant than the private sector. This covenant has led to lower debt and equity borrowing costs than could be accessed for a similar project in the private sector, if such long-term funding is available at all to the private sector.

6.2 It should be noted that funder margins have reduced since the introduction of PFI as funders became more comfortable with the risks involved. Margins did increase post-credit crunch, but this was a reflection of the reduced liquidity in the market, rather than profiteering.

6.3 However, irrespective of covenants, the PFI payments are only made if the contractor performs to required standards.

7. *In what circumstances are PFI deals suitable for delivery of services?*

7.1 As outlined in Section 2 above, PFI has a number of strengths, and it should be used to deliver services where these strengths can be applied.

7.2 The circumstances that lead to PFI being suitable for delivery include:

- 7.2.1 defined usage for the length of the concession—both type and demand for usage. Some refinements would be needed to the current model if significant changes were required during the concession period;
- 7.2.2 access is needed to private sector financing;
- 7.2.3 complex design and build that is better managed by the private sector; and
- 7.2.4 a market for the project that will lead to genuine competition and value for money.

## Written evidence submitted by Kent Police

### 1. EXECUTIVE SUMMARY

1.1 PFI projects, when compared to traditional “design and build” procurement methodology for estate provision, are cost effective and deliver Value for Money. Providing the costings and comparisons are done on a “Like for Like” basis including furniture, fixtures, fittings, outsourced services, and all associated Lifecycle and maintenance costs (where included in a PFI proposal/contract) there is very little, if any, cost variation if projected over a PFI contract period.

1.2 Authorities need to be clear as to the specification of their Requirements in terms of building/facility/service needs. The original methodology of leaving this to the private sector did not work and, without a doubt, was the cause of many of the PFI issues. The contract must be supported by a strong but fair Payment Mechanism to deal with delivery failures. Furthermore, Authorities need to have in place strong Contract Management provision with staff who understand the contract and are prepared to “challenge” providers over poor performance/non compliance and ensure relevant financial deductions to charge payments are realised having due regard to potential costs of such a “challenge” and the benefits of a “commercial settlement” where appropriate. This ensures facilities are delivered and maintained to the required standard along with the specified service delivery. This way good quality buildings and services are provided and maintained.

1.3 However, early PFI projects suffer from poor national/central guidance and there is probably very little that can be done about these. Over more recent times the guidance has improved with experience and knowledge gained but the current SOPC4 guidance still appears biased towards the private sector. Should PFI continue this requires a radical overhaul making better use of the knowledge and experience gained through delivering PFI projects currently available across the public sector.

1.4 To assist authorities in the delivery of PFI projects central government needs to move away from a position of “protecting the image of PFI” experienced over recent years, to one of supporting authorities to challenge the private sector provision where such provision is below the required standard. Government also need to respond and challenge misleading media coverage of the PFI.

1.5 Those PFI contractors that have a reputation for providing quality should be able to capitalise on this whilst those that have gained a poor reputation should not. To this end consideration should be given to the establishment of a national database identifying good providers (may be sector specific), including the individual companies that make up an SPV. If these companies/organisations were then the “preferred suppliers” this would act as an incentive on all PFI providers that wish to remain in the sector to deliver good service for inclusion on the database.

### 2. INTRODUCTION ABOUT SUBMITTER

2.1 Kent Police/Kent Police Authority has two PFI projects for new police stations at Gillingham (Medway Police Station) and Northfleet (North Kent Police Station) the contracts being signed in July 2004 and 2006 respectively with different “Providers”. The experiences are completely different with one having had numerous disputes and construction completed nine months late whilst the other went exceptionally well, construction being completed on time and no significant subsequent service delivery issues.

2.2 Overall contract management is provided centrally with localised day-to-day management/supervision including of contractors performance. This means expert advice and guidance is always available to support local staff and delivers corporacy. This model ensures strong management with an “independent overview” whereby non-compliance matters are identified with appropriate timely action being implemented.

2.3 The submitter is the central PFI Manager/Advisor for both projects with a number of years PFI experience. As such, the submitter now has extensive PFI experience including contract management, dispute and legal procedures.

2.4 This submission covers the PFI perspective rather than the wider procurement domain.

### 3. FACTUAL INFORMATION

#### 3.1 Main Strengths:

- 3.1.1 Capital sums do not have to be identified along with financing arrangements.
- 3.1.2 As contracts include maintenance of buildings, fixtures and fittings with all being “lifecycled” budget expenditure can be projected over the lifetime of the project avoiding “peaks and troughs”.
- 3.1.3 Good quality buildings are provided and generally the facilities are well managed and maintained owing to contractual financial implications if not. This is in distinct contrast to the quality of public sector buildings procured pre or outside of the PFI.
- 3.1.4 PFI projects are no more expensive to local authorities than a traditional “Design and Build” contract if costed on a “like for like” basis. In general Design and Build does not include building maintenance, furniture, fixtures and fittings with “lifecycle” costs and “outsourcing “of certain functions. Further cost savings are achieved by the public sector through not having to employ people for estate management. PFIs deliver Value for Money.

- 3.1.5 Strong contract management by Authorities ensures delivery of contracted services with financial deductions from the monthly Unitary Charge where the service provision is not up to standard increasing the VfM of PFI projects.
  - 3.1.6 Risk Transfer of costs in relation to facility/services provision over the lifetime of the project avoiding unforeseen and significant expenditure for local authorities.
  - 3.1.7 During the service delivery stage managers see the long-term financial implications of estate provision/management proposals (traditionally the “hidden costs” which are now available) making managers better informed and more accountable for their decisions avoiding them being made on a “spur of the moment” basis and incurring unnecessary expenditure. From an operational managers perspective this is not necessarily liked but from a business and VfM perspective should be regarded as “good practice”.
  - 3.1.8 The Government grant to local authorities makes PFI, from a local perspective, the most cost effective method of procurement to use.
  - 3.1.9 During the early stages of service delivery of a PFI contract the cost of carrying out Variations (works, etc) always appears very high at first view. However, if one takes in to account the Lifecycle charges and “market tests” often the PFI route is cheaper than traditional procurement over the remaining contract lifespan owing to the buying power of some PFI providers. However, most PFI providers are smaller than “Police UK” or, indeed, the public sector, begging the question why the public sector is not maximising its buying potential across the board?
- 3.2 Main Weaknesses:
- 3.2.1 Too much reliance placed on private sector to identify public sector needs and solutions in early PFI projects leading to poor design and contracts. Undoubtedly this has led to subsequent horror stories regarding the PFI.
  - 3.2.2 The requirement to follow national guidance, which was not good in relation to early PFI projects, once again lead to poor design and contracts. Even now the latest SOPC4 guidance, although better, still appears to be biased towards the private sector and does not appear to take in to account the wealth of knowledge and experience that now exists within the public sector. This guidance, if PFI is to continue, needs updating reflecting more of the needs and requirements of the customer rather than the provider.
  - 3.2.3 The process for securing PFI Credits is bureaucratic making it too long and rather expensive for local authorities (and probably providers). This has to be streamlined.
  - 3.2.4 Historically some Government departments have been more interested in protecting the image of PFI rather than supporting Authorities to challenge poor provision.
  - 3.2.5 The “Adjudication Process” for disputes defies the traditional rules of justice and either needs a radical overhaul or omission from the PFI dispute processes.
  - 3.2.6 Information on good and bad providers is not available nationally yet the information is out there. This leads to bad providers still being awarded contracts. The provision of a national database on how providers perform would not only avoid further contracts being given to such bad performing organisations (and a repeat of the same problems) but it would also put pressure on providers to ensure they deliver a good product and services.
  - 3.2.7 Lack of Government support to counteract misleading media articles regarding the PFI.
  - 3.2.8 Lack of flexibility in budgets. Traditionally, at times of economic stress, such items as estates maintenance are usually amongst the first matters to suffer financially. Under a PFI project, this cannot be achieved. Of course, this is also a significant strength as it ensures the public investment is protected improving VfM, leading to public buildings always being maintained to a high standard, protecting the public investment.

#### 4. PFI DEBT “ON” BALANCE SHEET

4.1 This question is somewhat academic now as PFIs are required to be shown “on” balance sheet. However, from an Authority perspective whether the debt is “on” or “off” balance sheet makes very little difference as to whether the PFI route for procurement would be followed or not. It is acknowledged the procedures for showing “on” balance sheet are somewhat complex but have always been available.

4.2 It is further acknowledged that from a Government perspective there may be some small advantages to PFI projects not being shown “on” the balance sheet.

#### 5. RISK TRANSFER

5.1 Providing the Authority Requirements are clear, whether construction/facility needs or service delivery, and supported by a robust and fair Payment Mechanism then the transfer of risk for compliance with those Requirements is sound and achievable if good quality contract management is employed by Authorities.

5.2 The PFI providers to Kent Police Authority are constantly reminded that compliance with the Authority Requirements remains the risk of the Contractor.

5.3 The “risk transfer” includes the delivery of policing services where those services have been transferred to the PFI provider for delivery (Public Counter/Enquiries; Lost/Found/Seized Property Management; Logistical services; etc).

5.4 All non-core policing activity (Custody management; office functions; Crime Scene/Forensic Investigation; etc) delivered from a PFI building could be suitable to be outsourced to a PFI provider. The only functions that need to remain “in house” are those where a “Warrant” is required to deliver them. With the transfer of the functions would go the “risk” with tight performance criteria against which to perform. However, if there were a desire to outsource such functions across a police force area then the PFI route is probably not the preferred option for a number of reasons including complications caused to police financing v Government PFI grant. The “PFI “Good Practice” of having tight performance requirements to be delivered and the financial consequences if not met is a robust model to take forward in to “outsourcing” in general outside of the PFI domain along with the lesson some authorities have had to learn—such contracts require good contract management.

## 6. STATE GUARANTEES

6.1 PFI providers generally see the investment in the public sector as “safe” although “long term” with returns on the investment as being acceptable rather than outstanding. This has become more apparent during the current financial situation.

6.2 From an authority perspective, it assures good quality public buildings maintained to a high standard, thus protecting the public investment which, in view of the Government PFI grant, is affordable, notwithstanding, in real terms, this reduces over the contract period, but by a known amount, making budgets manageable. It is implied this Grant is guaranteed for the contract lifetime. If it were taken away then it would create severe financial issues for many authorities.

## 7. SUITABILITY FOR DELIVERY OF SERVICES

7.1 Only having experience of delivering PFI projects within the police environment and building related, this element is based upon those experiences;

7.2 In essence any services required to be delivered within such an environment can be incorporated under a PFI (other than those where a Warrant is required, namely police officers). However, as PFIs operate under a performance culture, to ensure delivery of services and incentivise performance, the roles must be able to demonstrate measurable outputs/outcomes in order to ensure VfM. The potential is, therefore, very wide with the determining factor being VfM and affordability.

April 2011

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### Written evidence submitted by Dr Yseult Marique, University of Essex

#### EXECUTIVE SUMMARY

In recent years, “public private partnerships” (PPPs) and “private finance initiatives” (PFIs) have been used as long-term projects based on cooperation between public and private entities to deliver public infrastructures and services. Value for money (*VfM*) and risk allocation are commonly associated with PPPs/PFIs and their articulation of public and private interests. As highly tailored solutions to complex problems, PPPs/PFIs work as a global framework of agreement to integrate within one project a range of fragmented issues. Flexible articulation of the public-private relationships would result in a governance structure fitting the particularised circumstances of the PPP/PFI, supported by a relevant procurement and risk allocation. Public procurement requires the bringing together from the outset of the various parties involved in the delivery of the project over its whole duration. Risk management demands a fair degree of legal certainty. Therefore, a good understanding of the project specificities and of the various parties’ interests is key to the success of their joint endeavour. It calls for distinguishing between different PPP/PFI structures to map the specific difficulties each structure involves. Such an approach would equip public bodies with a toolkit of strategies to define the circumstances in which a specific PPP/PFI structure may be used. Further steps are then needed: developing such a typology of PPPs/PFIs with legal or practical relevance, gathering the data needed to model the dynamics specific to each category, and ensuring that the gathered data are worked in the modelled typology.

#### 1. SOURCES OF THE FINDINGS

1.1 The information and opinions expressed here result from a doctoral dissertation in law carried out at the University of Cambridge between 2006 and 2010 under Prof. Bell’s supervision. The thesis ascertains the role of the law in public private partnerships (PPPs) on the basis of a comparison between England and Belgium. It draws on semi-structured interviews with PPP experts and on case studies. The London Underground PPPs, waste PFIs, *BsF* and accommodation PFIs illustrate English practice. The Oosterweelverbinding (a major failure involving a tunnel in Antwerp), Flemish and Walloon school PPPs and Aquiris (a water treatment plant in Brussels) illustrate Belgian PPPs. Belgian PPP players are major construction contractors such as BAM, Veolia or Suez. Finally, the thesis builds on information gathered during a research project carried out on behalf

of a Belgian university (Université libre de Bruxelles) in 2009. This project was commissioned by the Belgian professional organisation for the construction industry and involved panel discussions with construction industry members.

1.2 As a lecturer in law at the University of Essex, I am developing my research in the area of public contracting. I am also a member of an advisory board to a PPP Chair at the Vrije Universiteit Brussel. Located within the Business School, the Chair is sponsored by Deloitte, Grontmij and Laga, which are involved in PPP consulting.

## 2. PPPs/PFIs: FRAMEWORK FOR BUNDLING CONTRACTS

### 2.1 *Complex projects*

2.1.1 PPPs/PFIs are long-term projects based on cooperation between public and private entities to deliver public infrastructures and services. Value for money (*VfM*) and risk allocation are commonly associated with PPPs/PFIs. PPPs/PFIs integrate in one major project a range of contractual, financial or economic relationships. PFIs have two main features. The first feature is “*the bundling of construction, maintenance and sometimes other services into long-term ‘whole life’ contracts under which private sector contractors are responsible for the construction and functioning of public buildings over many years, in return for annual payment by public authorities*”.<sup>46</sup> The second feature is the use of private debt finance. Depending upon the PPP/PFI considered, the public-private cooperation integrating these contracts in one project takes various forms.

2.1.2 Mainly used for infrastructure, PFIs involve design-build-finance-maintain-(operate) (DBFM(O)) contracts. Different purposes, such as urban regeneration projects, require, as well, the integration of similar contracts to PFIs. They beg interlinked legal questions in terms of procurement, risks or governance structures.

### 2.2 *Management and control*

2.2.1 Bundling a range of contracts into one project requires balancing management and control of the various relationships integrated into the project. PFIs “*brought about perhaps the greater change to the construction procurement*”.<sup>47</sup> Indeed, since WWII, the construction industry has struggled with poor records regarding deadlines, budgets and endless disputes. This still applies today. PFIs/PPPs here bring two contributions to *VfM*: coordinating the supply-chain and challenging accountability for public spending. These contributions have their own drawbacks however.

2.2.2 First, PFIs help overcome issues linked to the organisation of the supply-chain for two reasons. The first reason is that the public client is free from coordinating the supply-chain: it may focus on its core tasks and the private contractor, the SPV (special purpose vehicle), bears the risks associated with organising the supply-chain in the construction phase of the project and the risks of construction delays. The SPV has to start servicing the debt at a specified deadline, while the public authority starts paying the periodic payments only when the project is delivered. The second reason is that PFIs integrate the construction and the operational phases of the project. Early integration in the project of all variables influencing the operational costs should save money in the long term. It also results in solutions in which risk management is improved.

2.2.3 Secondly, PFIs/PPPs develop a single point of contact, the SPV, for the public body. On paper, PFI/PPP contracts would formalise the breakdown of costs, performance monitoring and control of money flows by the public party. The accountability for public spending in PFIs/PPPs is subjected to various controls (from political bodies, the OGC, the NAO, taxpayers, external audit, financial institutions, competitors, etc). This blurs how *VfM* is assessed: the concrete contribution of these techniques to understanding PFI costs is unclear. However, as PPPs/PFIs are tailored to specific projects, they may provide a strategic overview of accountability lines. It may enable to map them realistically so as to streamline control. This would prevent accountability issues from jeopardising projects (cf. the Bicester Accommodation Centre).

2.2.4 In organising and controlling these complex relationships, problems also arise. Firstly, constructors and maintenance firms are not one single entity, so more parties need to be brought into the discussions, which takes time and money. Secondly, PFIs are rigid: any changes to match ever-changing public interests lead to over-expensive processes. Thirdly, ensuring proper accountability for public spending requires monitoring mechanisms, which are costly or difficult to fine-tune to the specificity of the projects. One way to lessen these drawbacks is to develop stronger cooperation—“partnering”—between the parties to PPPs/PFIs. Against this background, procurement, risks and governance structures are examined.

## 3. PROCUREMENT FOR COMPLEX PROJECTS

### 3.1 *Introduction: planning*

3.1.1 As procurement is a planning process, public authorities exercise discretion and make a series of choices. They may use this discretion in a creative way to reach *VfM*. Yet, they may also harm market players’ and taxpayers’ interests. Procurement regulations take a prophylactic approach and limit possible abuses of discretion. However, this approach reduces the ways in which discretion can be used to the benefit of all

<sup>46</sup> SCEA, *Private Finance Projects and Off-balance Sheet Debt* (63–1 HL 2009–10) para 3.

<sup>47</sup> P Hibberd “New Procurement Routes of Little Benefit” (2010) 21 8 Cons Law 23.

interests involved. When it comes to complex procurement, the question is how public authorities may be encouraged to use their much-needed discretion positively without being unduly constrained by technical complexity.

3.1.2 During the procurement, public authorities have to make decisions related to the future performance of the PPPs/PFIs. Many issues in contractual performance find their roots in bad planning. Yet, there are few indications about how the performance should be legally framed. European regulations are silent. Most English contractual arrangements rely on construction contracts models (eg NEC3), whose respective advantages are not definitively settled. However, the anticipated contractual governance influences the planning process, and the planning process affects the resulting contractual governance.

3.1.3 This mutual influence between planning and contractual outcomes is part of the many uncertainties public authorities face during procurement. Public authorities have to deal with information asymmetry with the bidders, limited numbers of market players, and ensuring competition, transparency, non-discrimination and the regularity of the overall process. Finally, they also need to work with the chosen contractor towards flexible solutions for supervening risks for the whole duration of the contract.

3.1.4 Public authorities have to make their choices between different procurement processes available, with each their own advantages and drawbacks to ensuring cooperation in PPPs/PFIs.

### 3.2 *Competitive dialogue*

3.2.1 Competitive dialogue offers a procurement route for “particularly complex contracts”, for technical, legal or financial reasons.<sup>48</sup> A dialogue is open once publicity has been released and expressions of interest received. The dialogue follows the process the public authority defined in its publicity and once the dialogue has been formally closed no further discussion may be held.

3.2.2 It requires the public authority to plan an informed strategy as it has to set out beforehand the various stages of the competitive dialogue. It gives bidders a fairly clear overview of the preparations needed for the whole process. The dialogue is open to any issues related to the project, which leaves space for innovation from bidders. Finally, this process enables the maintenance of equality between bidders.

3.2.3 This has proved to be difficult to implement. As it is a novel route, it may require more time for fine-tuning. However, some structural issues have been pinpointed. First, negotiations cannot be held with only one preferred bidder, which increases costs. Competition may drive prices down or improve the contractual terms. Yet, in the long-term, bidders whose bids have been kept instrumentally may withdraw. They also want to recoup the high costs of their bidding. If public authorities accept this claim, the overall costs of the project increase. If they don't, they may face legal challenges for violation of the procurement process. Procurement regulations are complicated enough to provide such grounds. The contracts may then be postponed. Secondly, bidders fear violation of confidentiality. Thirdly, once the dialogue is closed, no discussions may be held. This may cause trouble if the financial institutions involved require changes in the contracts for financing the project or granting more favourable terms.

### 3.3 *Two stages—design and build under a restricted procedure*

3.3.1 The restricted procedure enables the public authority to choose which private contractors it invites to submit tenders, once publicity has been released and expression of interest received. The basis for choice may not be discriminatory grounds and needs to have been published in the contract notice.

3.3.2 According to construction literature, this procedure is especially efficient in overcoming supply-chain problems as it favours partnering and collaborative working.

3.3.3 Public authorities may not discuss the contract with the bidders, but amendments to the contracts, albeit non-negotiable, may be included in the bids if the public authority has mentioned this faculty. The lack of discussion is problematic for complex projects, which require tailoring negotiated solutions. Furthermore, this procedure has to comply with EU procurement. First, the first stage may be used as negotiation towards the final contract, while such negotiation is not allowed under the restricted procedure.<sup>49</sup> Secondly, the second stage needs to respect competition. Therefore the first stage does not ensure that successful bidders get the contract at the end of the second stage, which may discourage bidders. France has tailored its own two-stage process to supplement European procedures. However, the ECJ ruled that the European procedures were limitative,<sup>50</sup> ending creativity.

### 3.4 *Negotiated procedure*

3.4.1 The negotiated procedure is open for utilities and under specific conditions in the classic directive 2004/18.<sup>51</sup> These conditions restrict its use to exceptional circumstances.

<sup>48</sup> *Public Contracts Regulations* 2006 reg 18.

<sup>49</sup> J Barber and S Jackson, “Pre-construction Services Agreement—Early Lessons from Experience” (2010) ConsLJ 182.

<sup>50</sup> ECJ, *Commission v France* (C-299/08), 10 December 2009.

<sup>51</sup> *Public Contract Regulations* 2006 reg 13 and 14.

3.4.2 Negotiations are possible quickly with only one bidder. The public authority is in a weaker bargaining position however, which weakens *VfM*. It also requires due justification from public authorities. Competitors may successfully challenge the use of the procedure, the awarded contract may lose its effects, or financial penalties may be awarded against public authorities. Both sanctions result in wasted money.

### 3.5 Concessions

3.5.1 In concessions, public authorities grant private contractors the right to build an infrastructure or provide a service for which the users pay. Because the remuneration comes from the public, the contractor bears the commercial risks, and not the public authorities. However, financially free-standing PFIs awarded through concessions in the 1990s have been bought back by public authorities (eg Skye Bridge) or involved in public subsidization, challenging the choice of “concession” as a procurement route.

3.5.2 Service concessions in theory do not involve public money and therefore are not subject to the formalities of European procurement but only to Treaty principles such as transparency and non-discrimination on grounds of nationality. However, the ways in which these principles have to be respected are unclear.

3.5.3 Labelling a contract as a concession is tricky. First, choosing the lighter tendering process of concession is problematic when it results in an arrangement falling within the public procurement regulation: the procedure is invalid. The competitive dialogue was introduced to avoid this. Secondly, public authorities often partly subvent these projects to lessen contractors’ risks. Yet, this may change the legal qualification. Thirdly, it is tricky to assess the risk transfer linked to the remuneration beforehand. The ECJ recently judged that what matters is that “*the supplier assumes all, or at least a significant share, of all the operating risk faced by the contracting authority, even if that risk is, from the outset, very limited on account of the detailed rules of public law governing that service.*”<sup>52</sup> This may not solve all issues of categorisation. Further evolution may follow a 2010 consultation by the European Commission.

### 3.6 Conclusion

3.6.1 The suitable procurement route depends upon the project features, which may or may not enable cooperation. Skill and familiarity with the process also bear on the success of the chosen route.<sup>53</sup> Unprecedented procurement litigation has recently appeared,<sup>54</sup> making it even more important to choose an appropriate route. It implies that any procurement has to respect strictly procedures. The ultimate decision regarding the regularity of any creative technique to attain *VfM* lies with the courts.

## 4. MANAGING RISKS: A LEGAL PERSPECTIVE

4.1 Risk identification, allocation and management demand legal certainty: the law shapes solutions to risks (eg frustration in contracts) and takes risks into account (eg public procurement), or risks may arise from challenges/disputes against the PPP/PFI, or between the parties, or from contractual fragmentation in the networks of contracts bundled in PPPs/PFIs. Here some brief points highlight the connection between the law and risks.

4.2 Construction literature underlines joint risk management and partnering as important for success in construction projects. Yet, partnering has a legal drawback: it lacks enforceability when parties need it, ie when they cannot reach an agreement. Partnering help manage supervening risks but it becomes a risk when it no longer works.

4.3 The law plays a role in allocating risks, through contract law, joint venture arrangements or organising SPV separation from its shareholders. In case of financial failure of the PPP/PFI, the law may provide direct or indirect answers. For instance, the legislation sometimes makes it clear that the ultimate risk-holders are the public authorities. Legislation may impose minimum requirements in service delivery. If the public authorities want to discontinue the service provided by the PPPs/PFIs, PPP/PFI users may be partially protected through legal techniques such as legitimate expectations. All this result in public authorities having to bear the ultimate legal risks and costs associated with the PPP/PFI failure.

4.4 The law may impose either confidentiality or transparency in PPPs/PFIs. Both relate to information/data regarding risks in PPPs/PFIs and their costs. This contentious point<sup>55</sup> also highlights the lack of methodology for monitoring risks and *VfM* in PPPs/PFIs. In France, an “évaluation préalable” is legally mandatory at the start of the procurement process<sup>56</sup> In England, the NAO has developed a matrix but its use and practical result are both uncertain. The Gateway Process may have built its own methods, but access to their reports is currently uncertain. Legal challenges have managed to gain some information but this is by no means systematic. Because of this lack of data,<sup>57</sup> the necessary in-depth understanding of PPP/PFI dynamics required for

<sup>52</sup> ECJ, *Wasser- und Abwasserzweckverband Gotha und Landkreisgemeinden (WAZV Gotha) v Eurawasser Aufbereitungs- und Entsorgungsgesellschaft mbH* (C-206/08) 10 September 2009.

<sup>53</sup> P Hibberd “New Procurement Routes of Little Benefit” (2010) 21 8 Cons Law 23.

<sup>54</sup> D Thomas, “Contractors Challenge Tender Awards with Notable Success” 2009 (4/2) Cons LI 30.

<sup>55</sup> *Veolia ES Nottinghamshire Ltd v Nottinghamshire CC* 2010 EWCA Civ 1214; 2011 EuLR 172.

<sup>56</sup> Ordonnance n°2004-559 du 17 juin 2004 sur les contrats de partenariat s. 2 recently modified.

<sup>57</sup> SCEA, *Private Finance Projects and Off-balance Sheet Debt* (63-1 HL 2009-10) para 38 ff.

modelling public procurement and risk management is so far based on uncertain assumptions. This represents a crucial risk for developing PPPs/PFIs.

## 5. GOVERNANCE STRUCTURES

5.1 Clear-cut recipes for PPPs/PFIs clash with the need for PPPs/PFIs to be tailored to particularly complex issues and the uncertainty surrounding available data. To define in what circumstances PPPs/PFIs may be suitable for the delivery of services, a possible thinking path would be to design a couple of PPP categories on the basis of the specific risks mainly connected to a given project and their possible evolution over time. This would at least give a starting point for filling in the data gaps and a general direction/strategy for designing PPPs/PFIs and governance structures interfacing public and private interests. Different criteria may be used to develop such modelling. One approach would hinge upon the relationships between cooperation and trust within the overall governance structure.

5.2 First, PPPs/PFIs may be market-driven: they focus on services bought from private contractors with no legal connections to end-users of the public services (eg defence, accommodation PFIs). The structure may be based on commercial arrangements to ensure *VfM*. Attention would be focused on ensuring suitable practical monitoring techniques and reinforcing trust between the parties

5.3 Secondly, PPPs/PFIs provide intricate services/infrastructures where both the public and private sectors have to cooperate in the effective delivery of services/infrastructures to end-users. PPPs/PFIs offer a point from which to adjudicate between competing demands. The governance structure needs to define clearly which party is responsible for which risks in the delivery of the service itself and clarify possible conflicts of interests, to promote trust. The dispute settlement mechanisms developed in construction contracts do not apply between the public and private parties, but they do between the SPV and its supply-chain. These two levels need further articulation to strengthen cooperation.

5.4 Thirdly, PPPs/PFIs may rely on joint ventures. So far, the various institutional and legal provisions needed to ensure an environment of trust and cooperation between parties have been external to specific PPP/PFI projects as they have been developed at a scheme/programme level (eg *BsF*). The extent to which the general level may be translated directly into specific projects require further fine-tuning and experience, especially regarding the possible conflicts of interests jeopardizing trust in PPPs/PFIs.

## 6. CONCLUSIONS

6.1 Cooperation between public and private actors is needed to deliver public services and infrastructures. PPPs/PFIs provide spaces for articulating public and private commitments and for maturing/aligning them in complex cases. Project structures matching specific circumstances need to embrace a range of possibilities, with each their own tailored advantages and dynamics. The procurement environment is currently changing as the European Union is considering a range of issues impacting on PPPs/PFIs (public procurement, concession). Legal risks are uncertain due to partnering and transparency/confidentiality questions. Governance structures are evolving. Only fragmented information is available regarding all these points, mostly drawn from patent failures, limiting the relevance of lessons to be drawn. More systematic data are needed to refine our understanding of the strengths and weaknesses of PPPs/PFIs.

6.2 To model governance structures appropriate to PPPs/PFIs and their specific circumstances, further stages must be defined: fine-tuning a typology of PPPs/PFIs with legal/practical relevance, gathering the data needed to model the dynamics specific to each category, and ensuring that the gathered data are fed back into the typology. Developing such an approach to PPPs/PFIs would maintain their flexibility and allow for building on their ability to work as a platform for the public and private sectors in sharing their respective strengths, and, most of all, creativity.

April 2011

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**Written evidence submitted by Professor Ron Hodges<sup>58</sup>**

### INTRODUCTION

1. This memorandum is submitted in response to the Treasury Committee's call for evidence for its inquiry into the future of the Private Finance Initiative (PFI). The call seeks evidence on the following points:

- What are the strengths and weaknesses of different public procurement methods?
- If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much? How should PFI deals be accounted for?
- How far can risk really be transferred from the public to the private sector?
- Are there particular kinds of risk which are particularly appropriate for transfer through PFI deals, or particular projects which are suited for PFI?

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<sup>58</sup> I am Professor of Public Services Accounting at the University of Sheffield Management School. I take sole responsibility for the contents of this memorandum and the views expressed here should not be attributed to any organisation with which I am or have been connected or to any person who may have worked or co-authored papers with me.

- What state guarantees are explicit or implicit in PFI deals?
- In what circumstances are PFI deals suitable for delivery of services?

2. My comments refer specifically to PFI schemes except in cases where wider forms of co-operation between the public and private sectors are included which I will refer to under the generic title as Public Private Partnerships (PPP).

#### EXECUTIVE SUMMARY

3. The accounting treatment of PFI under UK-based accounting rules has been inconsistent, between the public and private sectors and within the public sector. The accounting treatment under international accounting regulation may not prove to be adequate in view of the limited scope of application of IFRIC12/ED43. It may be necessary to develop UK additional guidance to support the accounting for new forms of PPP.

4. There are always implicit state guarantees in PFI/PPP arrangements; these typically relate to service continuity risks which cannot be transferred from public sector responsibility. Other forms of guarantees should be limited in the extreme. Such guarantees should be assessed at Treasury level. The total value of any such guarantees should be placed in the public-domain by the Treasury.

5. It should be recognised that PFI encourages a “capital asset based” view of public service provision, which may not always be appropriate; that transfer of PFI principles to new parts of the public sector is likely to be time-consuming and expensive; and that a real choice of funding mechanisms is needed to ensure that PFI is not the “only game in town”.

#### ACCOUNTING FOR PFI/PPP

6. The accounting treatment for PFI projects has long been a matter of debate and controversy. For example, there is evidence that, in the early years of establishing the PFI from 1992 to 1997 and prior to the development of formal accounting guidance, there was little in the way of disclosure of PFI contract arrangements and development costs in the accounts of public sector entities.<sup>59</sup>

7. The development of guidance by the Accounting Standards Board, through its application note<sup>60</sup> (FRS5A) and the revised technical note 1 of the Treasury Taskforce<sup>61</sup> (TN1R) might have been expected to promote consistent accounting treatment of PFI deals in the accounts of both public and private sector entities. This does not appear to have been the outcome.<sup>62</sup> One reason was that, in the public sector, FRS5A and TN1R became de-facto alternative accounting standards, despite the technical note being promoted as an interpretation of the application note. A second reason is that the public sector purchasers and private sectors operators adopted different accounting treatments or interpreted their own risk positions differently, leading to the PFI assets and financial obligations of some schemes failing to be recorded in either set of their accounts. Finally, private sector operators moved towards treating the PFI schemes as debtors, or financial assets, as this typically benefitted them with regards to the profile of profit recognition and tax effects.<sup>63</sup>

8. There is little doubt that one attraction of PFI deals for public sector purchasers was its ability to provide an “off-balance sheet” accounting approach in which neither the PFI assets nor the related financial obligations appeared on public sector entity balance sheets. This reduced the financial transparency inherent in these deals. It seems that the accounting treatment was influenced by the particular regulations surrounding the funding mechanisms in each part of the public sector; for example local government PFI schemes were invariably off-balance sheet in order to benefit from PFI credit funding arrangements, while central government PFI schemes were more likely to be on balance sheet.<sup>64</sup>

9. In the immediate future, the accounting treatment of PFI schemes will be based upon the guidance issued by the International Accounting Standards Board in its interpretation statement<sup>65</sup> (IFRIC12) and influenced by the ‘mirror’ treatment for public sector entities proposed by the IPSASB<sup>66</sup> (ED43). This still leaves open the opportunity for inappropriate off-balance sheet accounting because of the limited scope of arrangements covered by IFRIC12/ED43. In periods of austerity off-balance accounting may be particularly attractive to governments as a means of accessing finance without having to record the underlying obligations. The existence

<sup>59</sup> Hodges, R and Mellett, H (1999), ‘Accounting for the Private Finance Initiative in the National Health Service’, *Financial Accountability & Management*, vol 15, no 3&4, pp 275–90.

<sup>60</sup> Accounting Standards Board (1998), *Amendment to FRS5 Reporting the Substance of Transactions: Private Finance Initiative and Similar Contracts*, London: ASB.

<sup>61</sup> Treasury Taskforce (1999), *Technical Note 1 (revised): How to Account for PFI Transactions*, London: H.M. Treasury.

<sup>62</sup> See for example, Financial Reporting Advisory Board (2006), “‘On-On’ and ‘Off-Off’ balance sheet PFI/PPP Capital Assets—Issues and Recommendations—Office for National Statistics”, *Agenda Item 82(04) of the FRAB meeting—31 October 2006*, London: FRAB.

<sup>63</sup> Heald, D and Georgiou, G (2011), “The Substance of Accounting for Public Private Partnerships”, *Financial Accountability & Management*, vol 27, no 2, pp 217–47.

<sup>64</sup> See the table of signed PFI deals on the Treasury web-site, which is summarised in Heald and Georgiou (2011, p 225).

<sup>65</sup> International Accounting Standards Board (2006), *IFRIC12 Service Concession Arrangements*, London: IASCF Publications.

<sup>66</sup> International Public Sector Accounting Standards Board (2010), *Exposure Draft 43: Proposed International Public Sector Accounting Standard—Service Concession Arrangements: Grantor*, Toronto: IPSASB.

of weak tests for national accounting treatment under ESA2008, also seem likely to allow an off-balance-sheet treatment for many Public Private Partnership arrangements.<sup>67</sup>

10. I believe that the scope of current PPP accounting proposals in IFRIC12/ED43 will not prove adequate to prevent off-balance sheet accounting for the increasing diversity of PPP structures. It may be necessary for further accounting guidance to be developed in the U.K. to seek to ensure that there is appropriate accounting for PPP/PFI schemes and for the inherent obligations arising from those projects in which significant financial and service continuation risks remain with the public sector.

#### RISK TRANSFER IN PFI SCHEMES

11. It is possible and usual for many risks to be transferred to the private sector under PFI schemes. Such transfers are appropriate where the risks are best able to be managed by the private sector. Such transfers may be effective where the private sector truly takes on those risks, will suffer if those risks materialise negatively and will benefit if such risks result in positive outcomes.

12. It would be expected that risks relating to the construction and maintenance of assets could be transferred in this way. However, it is not apparent that other types of risk have routinely and successfully been transferred from the public sector. For example, it is doubtful in PFI deals is that the risk of service failure can be transferred from the public sector; the taxpayer always picks up the pieces when the private sector cannot deliver and the service has to be maintained.

13. There are always implicit state guarantees in PFI/PPP arrangements. These relate to business continuity as described above; when the services must be and are maintained irrespective of the performance of the private sector. The terms of PFI deals should reflect this underlying reality. I consider the use of explicit guarantees above and beyond these business continuity risks to be inappropriate to PFI/PPP arrangements unless the terms of such arrangements are also explicit about the financial saving to the taxpayer as a result of such guarantees. For example, how can the private sector be said to have taken on significant financial risk in deals which have involved the public sector providing guarantees for the repayment of borrowing? The early promises that PFI deals would see significant risks taken away from the taxpayer ring very hollow when we find that project failure results in the taxpayer covering private sector losses such as in the Metronet scandal.<sup>68</sup>

14. The imposition of state guarantees is a particular risk in periods of reduced public spending. The danger is that private sector finance is used to procure public investment and avoid the direct scoring against public expenditure, while at the same time, building up significant obligations that may crystallise in the future. Such 'hidden' obligations should be discouraged in the extreme. This might be done by requiring that any such guarantees are subjected to specific approval after a value for money test at the Treasury level and that public domain data on signed PPP deals provided by the Treasury should also include the total value of guarantees given to the private sector.

#### IN WHAT CIRCUMSTANCES ARE PFI DEALS SUITABLE?

15. Successive governments have promoted PFI deals as being appropriate for service delivery in almost any part of the public sector. I am not aware of there being any robust assessment of the application of PFI across sectors, unencumbered by either financial or public policy interests. However a number of generalisations can be made.

16. First, the operation of PFI appears to rest upon the need for projects to be based upon significant capital assets such as roads, railways, hospitals and defence systems. It should be recognised that this pushes public policy towards a 'capital asset' solution to a particular problem and it should always be questioned as whether or not this is appropriate.

17. Second, previous governments have underestimated the difficulties of transferring PFI to new sectors. There seems to have been an assumption that PFI is always a potential, and even a likely, solution and that its principles can easily be transferred across sectors. The reality is often different. For example in the social housing sector, it appears to have been assumed that PFI was equally adaptable to renovation of existing individual properties as it had been to large new-build schemes. There was extensive delay in signing up the first wave of PFI social housing schemes<sup>69</sup> and subsequent lack of evidence of value for money.<sup>70</sup> It needs to be recognised that attempts to extend PFI into new areas will be likely to be accompanied by delay and additional costs above and beyond its application in existing areas of expertise.

18. Third, the Treasury has consistently promoted PFI on a value for money basis. However, it has often been reported that managers involved in developing PFI schemes have seen it as "the only game in town". In other words, PFI was seen as the only likely route to obtain funding to promote service improvement. Whether

<sup>67</sup> European PPP Expertise Centre (2010), *Eurostat Treatment of Public Private Partnerships: Purposes, Methodology and Recent Trends*, Luxembourg: European Investment Bank.

<sup>68</sup> National Audit Office (2009), *Department for Transport: The failure of Metronet*, HC 512, Session 2008–09, The Stationery Office, London.

<sup>69</sup> Hodges, R. and Grubnic, S. (2005), Public Policy Transfer: The case of PFI in Housing, *International Journal of Public Policy*, vol 1 no 1&2, pp 58–77.

<sup>70</sup> National Audit Office (2010), *PFI in Housing*, HC71, Session 2010–11, The Stationery Office, London.

this perception was accurate or not, its result was to promote a view that managers needed to support the PFI route if a project was to be completed. This was certainly the impression that I received from work in the health and housing sectors. If PFI is to continue, it needs to be assessed against other types of funding mechanisms on as neutral a basis as possible. This implies that Departments must be given the flexibility to draw on different funding mechanisms as appropriate to obtain best value for particular projects rather than treating PFI financing as a separate (and perhaps the only) pot of money available for a range of projects. Such flexibility should be assured without the need to provide state guarantees or other forms of subsidy which has brought PFI into disrepute in the past.

April 2011

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#### **Written evidence submitted by Edward Milner**

I am an ordinary member of the general public, a pensioner aged 69, a science graduate previously working as a BBC TV producer and then as an independent TV and video producer. My wife is an experienced Practice Nurse working in the NHS for 40 years.

As a scientist I have always been impressed by the “evidence-based” approach of the NHS towards health policy, and to some extent and in some areas by education policy. However this approach seems to have been completely abandoned when it comes to funding. I have read a good deal about PFI and projects in both health and education fields. It seems that not only is there no positive evidence on which the whole idea of PFI was started (by the Labour Government), but no serious analysis (to inform policy) of the PFI experience up to now. My impression is that if the evidence was used, the entire idea would be abandoned; clearly PFI is a bad deal for the public and a means of benefitting small numbers of influential people either with profits, or in the case of politicians, the opportunity for patronage. The test for politicians at local and Government level would seem to me to be as follows:

Would you countenance a PFI scheme if it was your own money involved?

Two factors seem to me to militate against even the best possible PFI schemes. 1. Raising loans must be cheaper for Governments than commercial companies; by turning over schemes such as building a new hospital to the private sector inevitably means that the loans involved will be more expensive, and costs of the project much higher; I believe this has already been demonstrated in several scandalous cases. 2. With shareholders and other private investors involved (and expecting profits), how can such schemes possibly be good value for money? On the other hand, if they are profitable wouldn't such profits be better accruing to the public purse?

April 2011

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#### **Written evidence submitted by UK Contractors Group**

##### **EXECUTIVE SUMMARY**

1. In this evidence UKCG argues that:

- Continued infrastructure investment is essential to maintain the UK's international competitiveness and to stimulate growth and employment.
- PFI has been one way of delivering that investment. It has significant strengths on which we should build. Even so, it could be delivered more cost effectively if government was clearer on its long term investment intentions and there was a more equitable sharing of risk between the public and private sectors.

##### **INTRODUCTION**

2. UKCG represents over 30 leading construction companies who together produce some £36 billion of construction turnover—some 30% of the construction industry's total output. UKCG members have played an active role in PFI as construction contractors, investors and asset managers. UKCG members have greatest experience on the construction of PFI assets and especially the procurement processes used. This evidence therefore largely focuses on these elements.

##### **INVESTING IN UK INFRASTRUCTURE**

3. The UK needs modern infrastructure to maintain its international competitiveness. The CBI has suggested that, to maintain the UK's existing infrastructure assets, the country needs to spend at least 2.25% of GDP on capital programmes. However, current fiscal constraints have reduced annual spending to around 1% of GDP and there is little immediate prospect of any increase. This risks our asset base deteriorating and a decline in international competitiveness. Use of private finance could help to bridge the growing shortfall in capital spending provided that it is affordable in the longer term.

4. Moreover, construction investment stimulates both growth and employment. An independent report produced for UKCG by L.E.K. consulting showed that:

- every £1 invested in construction generates £2.84 in total economic activity;
- every £1 spent yields a return of 56p to the Exchequer—net investment is therefore 44p; and
- 92p in every £1 spent is retained in the UK.

5. The report also demonstrated that investment in construction in the UK is the best way of stimulating employment. A full copy of this report is attached (Appendix 1) to this evidence.

6. With economic growth remaining fragile and youth unemployment worryingly high, more construction investment would help to stimulate the economy and employment.

7. PFI has been a means of delivering longer term investment programmes because it spans changes of government (nationally and locally) and allows investment to remain fairly constant throughout the economic cycle.

8. The UK construction industry performs at its best when it has clear information about the forward line of infrastructure investment. Given adequate information about the output required (eg numbers of new houses, hospitals and roads) it can help develop the most cost effective solutions to deliver them. Such information provides investor confidence to allow the industry, for example, to purchase material in bulk, invest in off-site pre-fabrication and to exploit economies of scale.

9. Currently information about public sector investment is patchy at best and recent political rhetoric about PFI has damaged investor confidence. This has been partially recognised by the government which has made a commitment to publish better information on forward investment from the Autumn of this year. It is required now as a matter of some urgency. In addition, the industry has yet to engage with government in a meaningful discussion about how we might produce alternative procurement models building on the strengths of PFI and overcoming its weaknesses.

#### THE STRENGTHS AND WEAKNESSES OF PFI

10. Almost without exception PFI funders and investors have required the construction to be procured via a design and build contract which provides certainty that the project will be delivered to time and to budget. That is one of its main strengths.

11. A major criticism of PFI is that it is an expensive way of borrowing money. Without doubt government can borrow money more cheaply than the private sector because it is not pricing specific “risk”. However, that means the risks are not always properly analysed leading to project costs escalating and to programme delays. Over 70% of non-PFI projects are delivered over budget and in all such instances the public sector has had to pay more. In contrast, less than 20% of PFI projects have been over budget and in most of these cases the cost has been borne by the contractor and not by the public sector.

12. Other strengths of procurement via PFI include:

- It manages “risk” much more effectively because of the extensive due diligence necessary to secure private investment—hence the majority of projects are delivered to time and budget.
- It provides greater transparency on the “whole life costings” of projects, because of the obligation to maintain the facilities to pre-agreed stringent standards and hence clearer information on value for money.
- It maintains the asset to pre-agreed standards. In contrast, buildings procured by other methods often quickly fall into disrepair due to the lack of an adequate maintenance budget.
- PFI has transformed the way in which the public and private sector work together—relationships have moved from one of adversity to partnership and trust—also increasing certainty of outcomes.
- Because the public entity is entering into a long-term commitment it has been encouraged to consider its long-term requirements, possible changes to how services are delivered and procure more flexible and adaptable buildings.
- Generally, because the buildings are owned by the private sector partner, the authority avoids having to pay capital charges.<sup>71</sup>
- Generally the asset is returned free of charge at the end of the concession (even LIFT<sup>72</sup> offers an option to acquire at below market prices).

13. As operated in the UK, there are also a number of weaknesses with the PFI model. These are:

<sup>71</sup> Capital charges are the capital costs of a project together with depreciation.

<sup>72</sup> LIFT is an NHS vehicle for improving primary and community care facilities.

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#### THE PROCUREMENT PROCESS IS OVERLY LONG, EXPENSIVE AND WASTES RESOURCES

14. There are various reasons for this:

- In the early days of PFI (especially in the health sector) it was because the public sector could not decide quickly what it wanted and what it could afford. A survey carried out by the then Major Contractors Group in 2005 on 57 PFI projects showed that the average delay in projects against published schedules was 8 months and the costs associated with these delays were £1.21 million per project (some 1.6% of project values).
- More recently, when not applied appropriately the EU Competitive Dialogue Procedure has led to delays in the procurement process and consequently increased costs. This was recognised in the findings of the HM Treasury Review of Competitive Dialogue published in November 2010.
- In the recently aborted Building Schools for the Future Programme the client required too many fully worked up bespoke designs the majority of which were wasted as contractors were eliminated from the competition. More upfront attention to design and some elements of standardisation would reduce procurement costs significantly.

15. Even now the procurement process for a new hospital project in the UK can take over two years before any construction work is undertaken. For example, Papworth Hospital Procurement—OJEU in August 2010 and due to sign a contract in late 2012. However, in contrast, where PFI has been exported the procurement process has been shorter and slicker. For example the equivalent timeline for Bermuda's first PFI project was less than 18 months.

#### THERE HAS BEEN AN EVER INCREASING TRANSFER OF RISK TO THE PRIVATE SECTOR

16. PFI seeks to transfer the risks to the party best able to manage them (including retaining certain risk within the public sector). As the risks of PFI have become better understood and better managed the costs of PFI should have consequently reduced. This has not been the case because, as PFI has evolved, the private sector has been asked to take on more and more risk—some of which is unnecessary—which has added to costs.

17. Some examples of risks transferred to the private provider which may offer better value for money if retained by the Public Authority include:

- Insurance, where under more traditional procurement government has a policy of self insurance.
- ICT.
- “Soft” services.
- Anomalies in the Payment Mechanism.
- All of the Unitary Payment at risk.
- Security of electricity supply and related switchgear design, which could be standardised in a common specification.
- Change of Law.
- Interest rates.
- Energy efficiency.
- TUPE.
- Pensions.

18. A more sensible balance of risk between the public and private sector would reduce the cost of projects significantly.

#### “GOLD PLATED” SPECIFICATION ON BOTH THE CONSTRUCTION AND OPERATION OF BUILDINGS

19. There are numerous examples of over specification by clients both for the initial building specification and the on-going operational service requirements. These include:

- Construction.
- Public art.
- BREAMM specifications.
- Services.
- In many contracts there is evidence of inappropriate response times requiring resources and procedures that are unnecessarily expensive to achieve over-specified outcomes.

20. In addition, contractors are asked to hand back buildings at the end of the concession period (normally 25 years) in pristine condition. The adoption of less stringent standards would also reduce costs significantly.

#### AFFORDABILITY OF PFI UNITARY CHARGES

21. As pressures increase on the public purse, there is growing public concern about the affordability of interest payments on the loans which, as in the case of mortgages on houses, will always be much more costly than buying the asset up front. There are opportunities to reduce these costs significantly by looking at other funding mechanisms. Two possibilities are:

- a more vigorous approach to identifying and selling surplus public land to help offset costs; and
- offsetting costs by charging users for the use of the asset (for example through toll charging on roads).

#### INFLEXIBILITY OF SOME PFI CONTRACTS

22. All PFI contracts include provisions for the client to vary his requirements, including the right to terminate voluntarily. The process to define, price, finance and implement changes can be overly cumbersome due to the need to consider the immediate capital cost and the ongoing impact on maintenance, lifecycle, soft services, insurances etc, compounded by the necessary involvement of the funders and their due diligence process. It is worth noting that should there be a significant shift on how services are delivered or stopped being delivered this may result in redundant facilities however they were procured initially.

23. Experience over the past decade has shown that it is not always sensible to lock all FM services into long term contracts spanning the life of the PFI projects. In some cases—especially recognising that the use of buildings will change over time—it would be more sensible to have much shorter time horizons which would deliver greater flexibility. This is likely to create better value for money in areas such as ICT and soft services.

24. Turning to the other specific questions posed by the Select Committee, not answered above:

*If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much? How should PFI deals be accounted for?*

25. Most PFI assets are now on the Government's books under IFRS accounting. Even under the old accounting economists factored PFI obligations (and pension obligations) into the UK's total indebtedness. Some of the early deals are believed to have been driven by the off balance sheet factor, however the success of their risk transfer meant that PFI/PPP came to be recognised as an efficient model for some procurements.

26. All new PFI contracts now appear on balance sheet. There is no doubt, however, that some of the early decisions to keep PFI off balance sheet have contributed to much of the bad press that it does not provide value for money. Increased transparency is therefore vital to maintain the long term credibility of the market. More transparent accounting also provides an evidence base to demonstrate the advantages of using PFI. Even so, to provide a clear comparison between PFI and other methods of procurement, the amount shown on the balance sheet should be confined to capital costs and not the ongoing service provision.

*Are there particular kinds of risk which are particularly appropriate for transfer through PFI deals, or particular projects, which are suited for PFI?*

27. PFI has delivered numerous successful projects in both the economic and social infrastructure category, on time and within budget.

*What state guarantees are explicit or implicit in PFI deals?*

28. Implicit in dealing with Government is the application of the highest standards of probity and governance. Explicit in the PFI contract is that if services are delivered to the contract requirements then payment is guaranteed. Failure to deliver to contract requirements will trigger deductions according to the terms of the contract, which can vary in detail considerably from one contract to another. The extent to which deductions can amount is typically capped. The willingness of the banks to lend is predicated on the basis of an implied Sovereign guarantee underwritten by the British Government. Deeds of Safeguard are issued when a public sector partner changes status, as in the NHS when Foundation status—giving a high degree of financial independence—is achieved. This protects the interests of the private sector partner.

*In what circumstances are PFI deals suitable for delivery of services?*

29. PFI requires relative certainty, therefore is not appropriate in rapidly changing technological environments (IT) or where the scope of work required is impossible to determine until after the contracts have been signed (London Underground). In all circumstances when there is a sufficiency of money. The difficulty arises when there is insufficient to pay the PFI Unitary Charge *and* provide an acceptable level of services delivered by State Departments. When the public sector purse dries up the PFI contract demands that the PFI payments are paid irrespective of consequences, for example to staffing levels.

**Written evidence submitted by Andrew Barrie, Vice President Operations and Jon Mitchell,  
Development Director, KBR International Government & Defence**

1. EXECUTIVE SUMMARY

1.1 As a large organisation which participates in major project delivery in several business sectors, KBR can give evidence of the value for money benefits of PFI where cost and risk considerations have driven key decisions in the design of the solution and adoption of new practices in the interest of reduced whole life cost. However, the authors consider that a major determinant of success or failure of any project is the quality and experience of the project leadership (both client and contractor) and that this is not currently receiving sufficient focus. We consider that PFI should have a firm place as a useful and effective procurement model in appropriate circumstances but that especially in the current period of severe fiscal constraint the government should place greater emphasis on project leadership and also actively promote the use of alternative procurement models such as financially incentivised collaborative alliance contracting.

1.2 We consider that the driver for selection of appropriate procurement routes should be to optimise risk transfer, recognising that different procurement models will impact on initial contract value as well as the risk adjusted outturn forecast—ie risk transfer may come with an initial price premium.

2. INTRODUCTION

2.1 This memorandum is submitted by Andrew Barrie and Jon Mitchell of KBR International Government & Defence. The authors both have broad experience of project and operations management spanning defence, government, transport utilities, hydrocarbons and other commercial sectors, including in particular the negotiation and execution of a number of major PFI projects.

2.2 KBR is a leading engineering, procurement and construction company with more than 35,000 employees in 45 countries on five continents and offering a range of services through ten business units: Downstream, Gas Monetization, Infrastructure & Minerals, International Government & Defence, North American Government & Defense, Oil & Gas, Power & Industrial, Services, Technology & Ventures.

2.3 KBR is currently delivering Private Finance Initiative (PFI) and Design Build Fund & Operate (DBFO) projects in many sectors such as the Heavy Equipment Transporter and (in joint ventures) Project Allenby Connaught, the 1420 km Alice Springs-Darwin railway, several road projects in the UK and the N8 in Southern Ireland. KBR has also provided technical consultancy advice for DBFO schemes.

3. *What are the strengths and weaknesses of different public procurement methods?*

3.1 Our perception is that Government contracting agencies can tend to follow a mantra that “outsourcing is more efficient and industry is better at managing risk” but then fail to give sufficient care and attention to structuring the procurement in order to optimise the transfer of risk. Contractors are of course unlikely to challenge those areas where the contracting authority has retained inappropriate risk.

3.2 In the hydrocarbons and utility sectors we observe a two way flow of senior personnel moving between client and contractor organisations and we see this as a healthy indicator of the intelligence of the sector in procuring and delivering major projects. On the other hand we see comparatively little interchange of senior project and commercial personnel between major contractors and public contracting authorities. This division into two resource pools together with the “arms length” separation between industry and public bodies that is being driven by public procurement processes is in our view having detrimental effects on project outcomes. Poachers often make the best gamekeepers and *vice versa*.

3.3 While the choice of the procurement method is important, it is our experience that the quality of project leaders and managers in the client organisation and the supply chain organisations a significant factor in determining whether a project succeeds or fails. We suggest that too little emphasis is currently being placed on the capability and experience of project leadership; (a) by the contracting authority when establishing its project team, (b) by project teams when selecting the supply chain and finally (c) in the integration of the project delivery team.

3.4 In commenting on different public procurement methods below we have obviously focussed on those which seek material transfer of risk. There is, of course, a very small class of projects where it is appropriate for contracting authorities to self perform the management and accept risk but these models have not been discussed.

3.5 PFI models

3.5.1 In the search to reduce cost and/or reduce risk in a competitively tendered PFI environment there is no doubt that designs and solutions differ from those produced through other procurement routes. We can cite many examples from KBR PFI & DBFO projects (eg bridge deck design, pavement design, buildings design, general scheme rationalisation, development of a supply chain strategy, selection of materials and the introduction of enhanced condition-based maintenance strategies) where new solutions have been used and/or current solutions have been improved or developed in the interest of lower whole life cost.

3.5.2 It is recognised that PFI has driven industry to develop much greater knowledge and understanding of operating and maintenance costs. BRE and other studies demonstrate that knowledge of lifecycle costs is greatest in sectors where PFI has been most extensively used (eg healthcare), confirming that PFI has and is adding value.

3.5.3 A common criticism of PFI is inflexibility however we can point to examples such as Heavy Equipment Transporter and Project Allenby Connaught where the contracting Authority properly foresaw the need for flexibility. Appropriate mechanisms were built in to the concession agreements in order to accommodate significant variability in utilisation levels, collaborative development of detailed elements of the solution and provide much additional transparency in pricing data which has and will continue to facilitate the effective pricing of change and deliver enhanced value for money.

3.5.4 PFI is denigrated (by the press and less well informed) for the high cost of change and any additional services. We wholly endorse the view expressed by Dr Tim Stone of KPMG in his memorandum on PFI procurement to the Economic Affairs Committee where he noted that costs of late changes are often and quite appropriately material but that under other procurement methods such costs are rather easier to bury.

3.5.5 A weakness of PFI can be the time & high cost of the procurement phase itself and this may be significantly exacerbated by poorly managed Competitive Dialogue and any lack of data or general uncertainty around the requirement. This is a factor which must be considered and managed but should not in our view rule out the method.

### 3.6 Turnkey or EPC models, potentially with two stage appointment

3.6.1 Turnkey or EPC models provide for effective transfer of cost, delay and some aspects of performance risk and but pay little heed to issues associated with through life cost and will not lead to optimised solutions. We view this as a material drawback.

3.6.2 Two stage contractor appointments are becoming the dominant route in the private sector. Initial selection is focused on the competencies and skills of the contractor's team and the price for the capital works is then developed in collaboration with the client, which in turn leads to much closer integration of the overall project team and tangible benefits in quality, cost and time.

3.6.3 Such routes are in no way ruled out by the EU Procurement Directive or SI 2006 No 5 however we observe that few public contracting authorities focus on selection of the design and delivery team and instead revert to capital cost estimates as the principle method of selection. We believe this hesitancy should be challenged very robustly.

### 3.7 Alliance models with gainshare/painshare mechanisms

3.7.1 The private and utility sectors have had considerable success in the use of incentivised alliance procurement models (eg Scottish Water, Southern Water) in which client and contractor sign up to a target cost at an early stage and thereafter adopt this as the basis for common financial incentive structure, sharing the gain or pain of the final outcome by formula. Whilst there have been a number of defence projects which have been procured through hybrids of this model ( eg CVF Carrier project, Surface Ships Alliance, MBDA Complex Weapons, D154 Devonport) our view is that the outcomes have not always been optimal.

3.7.2 Having reviewed KBR's long track record in incentivised alliances (which dates back to the North Sea offshore developments of the 1990s) we have drawn two key conclusions which may in part explain why the alliance route has not yet had the success one might expect in public works and services:

- As noted above, success is often related to the capability and effectiveness of leadership and focus on successful integration of the project team.
- The incentivised alliance model has been most powerful where the 'business as normal' cost base is well understood and the driver is major cost reductions. The dramatic fall in oil prices spawned the use of alliances in the North Sea and it is widely recognised that that savings in the capital cost of delivery of between 15% and 20% were normal and repeatable. The alliance models adopted by most clients provided a vehicle for delivering transformational change, although it may not be so well suited to "first of type" projects where there is material uncertainty in the calculation of a target cost.

3.7.3 The ability of incentivised alliance models to deliver transformational change and major cost savings resonates very loudly in current times of post CSR/SDSR austerity measures. We encourage the Committee to ensure these options are properly considered as an alternative to PFI on appropriate projects.

### 3.8 LABVs

3.8.1 While KBR has no Local Asset Backed Vehicle (LABV) projects currently in its portfolio, we have undertaken detailed investigations of various LABV models and consider them to be an attractive option for outsourcing of non core activities of government departments. It is our view that LABVs have the potential to integrate many of the best of elements of the Alliance and PFI contracting models:

- Encourage a business management perspective where contracting authority and contractor work together to a common goal rather than creating an adversarial contracting environment.
- Provide a robust and balanced governance framework based around articles of association of a joint venture and the well developed rigour of a board of directors.
- Enable capital investment from private sources—but subject to proper scrutiny.
- Avoid the lengthy procurement periods and start up costs of PFI models.
- Create a business relationship that can cope with a changing and dynamic environment.

*4. If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much? How should PFI deals be accounted for?*

4.1 We can only comment upon those projects which KBR has either bid or ultimately won and in this context we are confident that all of our PFI projects would have proceeded, regardless of the accounting methodology. We are, however, aware of projects which we consider were suitable for consideration as PFI projects but where the client subsequently reverted to a more traditional procurement route and sense in some cases a subjective reaction to the complexity of PFI procurement and concern about the on/off balance sheet issue.

4.2 It is our view that accounting rules should not unduly influence the selection of procurement routes. PFI saves money by driving more carefully considered and cost effective solutions however transferring risk to the private sector inevitably carries a price. Dependant upon the project and the contracting authority, we hold the view that the price premium for risk transfer can and does still represent good value for money.

4.3 We are not well placed to express views on the matter of controlling public sector borrowing and how debt funded PFI projects should be treated in this context, save to note the vital importance of maintaining adequate investment in infrastructure during the next decade of fiscal constraint.

*5. How far can risk really be transferred from the public to the private sector?*

5.1 We would propose a different perspective on this question and ask the Committee to reflect upon how much and how far could the private sector contribute to the management of public sector's risks, which we believe is substantially more than is achieved at present.

5.2 PFI has proven to be an effective vehicle for the transfer of delivery and operation risk to the private sector. Project audits have demonstrated much greater certainty of timely delivery, increased customer focus and success in transferring risk associated with the cost of construction and operation. The contracting authority nevertheless retains some key risks such as lack of future flexibility, changes in legislation, future sale of consortium members and increased service demand.

5.3 As discussed above, PFI is but one of a number of models which can achieve effective transfer of risk, but no public procurement method will relieve the contracting authority completely. Each method has its own distinctive 'fingerprint' of risk transfer. It is therefore up to the contracting authority to determine which procurement method and which "fingerprint" best suits the particular project and the contracting authority's strategic needs.

*6. Are there particular kinds of risk which are particularly appropriate for transfer through PFI deals, or particular projects which are suited for PFI?*

6.1 As noted above, PFI has proven extremely effective in transferring delivery risk and cost risks in circumstances where there is a robustly defined and enduring requirement, where the nature of the project is not novel, and there is a good understanding of current and future utilisation levels. PFI projects are in the largest part delivered to time and to budget.

6.2 In our view a contracting authority should not use the method for the whole of its asset portfolio unless it is extremely confident that it can manage the potential need to reduce or indeed enlarge the portfolio in the longer term.

*7. What state guarantees are explicit or implicit in PFI deals?*

7.1 Early in the negotiation of Project Allenby Connaught, the client & contractor teams reached a conclusion that given the size and scale of the project, failure was not a realistic option and which should be avoided as far as possible. The response was to design a concession agreement which, as far as possible, focussed on rectification and not remedy—anticipating those circumstances which might require either state guarantees or contractor parent company guarantees and ensuring that the agreement set out fair and effective mechanics to ensure timely mitigating action before crisis was reached.

7.2 The contracting authority deserves due credit for its maturity of approach in this regard and we would hold that the final solution offers better value as a result.

7.3 In PFI projects, the state should reasonably provide guarantees for those aspects which it is best able to (or it alone) can manage, principally its own utilisation of the asset, and also such matters as war and certain risks associated with change in legislation.

7.4 We consider that the Committee should give some thought to customary approaches to insurance of assets in PFI deals and whether this provides best value for money.

8. *In what circumstances are PFI deals suitable for delivery of services?*

7.5 Two of the projects in which KBR is participating are predominantly service contracts (Heavy Equipment Transporter and Project Allenby Connaught). We would hold that PFI can be extremely effective for the delivery of services and suggest that this view is fully supported not only by the end users but also by the NAO audits that have been carried out on these projects.

7.6 As touched on above, we would commend that the Committee gives careful thought to the use of long term business partnerships (ie GoCo &/or LABV models) as routes to delivering cost savings for non core activities, such as provision and operation of training facilities and logistics infrastructure as is used by the armed forces, police and other emergency services.

9. CONCLUSIONS

9.1 It is the view of the authors that the PFI model has earned itself a firm place in the public procurement toolkit based on the evidence of successful delivery. It should not be ruled out because of known issues, which we see as largely associated with lack of flexibility.

9.2 Notwithstanding, the use of PFI needs to be considered on a case by case—or project by project basis. Indeed it would be sound strategy to maintain several solutions in the toolkit, including turnkey, incentivised alliance and LABV models and then ensure that each deal is carefully shaped and structured and the final decision on procurement methodology made by an experienced commercially competent core team.

*April 2011*

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**Written evidence submitted by Dr Richard Thorne**

I worked as a General Practitioner in Abingdon from 1968 to 2007.

Projects in the NHS financed under the PFI have resulted in massive debt repayments which are causing severe financial difficulties for the responsible Trusts. There can be no justification for continuing to award further contracts under the PFI. It is particularly perverse to continue to do so at a time when the government is preaching the necessity to live within our means; not to overspend now and leave unmanageable debt for future generations; in fact, to reduce our debt commitments.

I am gloomy about the future of the Nuffield Orthopaedic Centre in Oxford, landed with an unrealistic PFI development.

PFI was always a bad concept, born in a time of unrealistic private indebtedness and part of the boom in private financial schemes which led to the financial collapse affecting us all now.

I hope the Treasury Select Committee will examine the evidence and advise accordingly.

*April 2011*

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**Written evidence submitted by Meridiam Infrastructure**

EXECUTIVE SUMMARY

Meridiam is a leading long term PPP or PFI infrastructure investment fund in Europe and North America with a highly experienced team focusing on greenfield PPP projects in the transportation, social and environmental sectors. Meridiam firmly believes that PPP is the most effective form of procurement for £100 million+ single or grouped infrastructure projects due to the significant effects of whole life costing providing enhanced long term service provision to the public.

PPP is now being utilized around the world as an efficient tool for service provision allowing transfer of significant risk to the private sector.

There have been concerns that PPP contracts are inappropriately expensive, and that private sector providers have been making excessive profits from investing in PPP projects. Meridiam believes strongly that PPP is the most effective form of procurement however it does recognize that PPP procurement in the UK can and should be improved.

*What are the strengths and weaknesses of the different public procurement methods?*

1. The main strength of PPP is that it delivers projects on time and on budget through fixed contractual arrangements agreed at the outset. The PPP contractor takes responsibility for the construction and the maintenance of the projects and so eliminates the need for new spending to meet unexpected demands.

2. It used to be the norm in the public sector (see a number of Ministry of Defence projects for example) that constantly changing specifications not only delayed any construction but greatly inflated the cost. And in the past the public sector often had to meet unexpected maintenance costs as the fabric of buildings deteriorated and resources were depleted through wear and tear.

3. Before PPP was introduced infrastructure development in the UK lagged behind other European countries. There are now more PPP infrastructure projects in the UK than in any other country. Without access to PPP funding the new build of hospitals, schools and other infrastructure projects would not have been possible. Its success is reflected in the number of countries now adopting it. Meridiam believes that it will be difficult for the UK to meet its National Infrastructure Plan targets of expenditure of £200 billion on infrastructure without PPP as it is a well supported and effective route for mobilising private sector capital.

4. The PPP process can be improved. Too often it begins before the ‘clients’ have a clear idea of what they want to achieve, and bidding processes have been far too long, some projects taking two to three years to come to fruition. Protracted negotiations can cause high costs to all amid indecision about final outcomes. Understandably individual purchasers within the public sector often do not have the procurement expertise—we believe the UK should look at the Canadian model which has central procurement bodies on a province by province basis.

5. Long term approaches are the most effective but need real up front agreement between public and private sector. Meridiam supports partnerships between the public and private sectors together with sharing of risk and return. This is particularly the case in respect of refinancing, establishing ceilings for returns together with sharing of upside benefits on a balanced basis.

6. Changes in policy and technology cause strain and are invariably costly. Projects that prove the best value for money are those clearly defined from the outset, least subject to interference from the procuring authorities, and funded over the long term on fixed rates.

7. It is however recognised that the public sector requires flexibility as policy changes—Meridiam believes that such changes are better incorporated through formula incorporated under the overall umbrella of long term contracts rather than shortening the overall horizon of PPP contracts. For example, if the public sector wished to incorporate a “de-scoping” of service provision that resulted in lower cost then the availability payment could be decreased taking into account the overall costs of the PPP.

8. Traditional procurement allows for direct control and management of contracts, competitive processes, lowest cost Government funding, potential to reach the lowest price for a defined asset, comfort in obtaining control of design. We would argue that the strengths are outweighed by the weaknesses of no long term maintenance, no protection from claims or cost over-runs, the need to dedicate from day one public budgetary resources to finance the totality of the project’s costs upfront, interface risk assumed by the Government, directly incurred management costs.

9. Several projects using the traditional procurement route have experienced significant cost over-runs and delays. In the UK, the following projects: Millenium Dome, Jubilee Line and Wembley Stadium. Elsewhere in Europe: major projects such as the Stade de France, the Spanish high speed line rail programme or the construction part of the Dutch high speed line rail programme. It is not always easy to prove that a PPP route would have been more successful but the L2 project in Marseille (France) is an interesting example: due to numerous delays, notably caused by difficulties in providing budgetary resources to the project in a timely manner, the project, initiated before World War II, has experienced significant cost overruns and redesign, eventually leading the French Government to decide to implement it as a PPP.

10. PPPs have provided strong value for money, consistently delivering high quality outcomes on-time and on-budget. Indeed the performance of PPPs has been so impressive that over 20 OECD countries use PPP procurement.

11. The whole-life costing is a key component: it considers what maintenance will be required over the PPP contract as well as the cost of the asset. Usually under traditional procurement only the building cost was considered and no funding for the running costs allocated at the outset of the project.

12. PPP procurement incorporates dedicated and focused private sector operational management allowing the public sector to focus on such areas as policy and regulation.

13. PPP projects involve long term risk transfer from the public to the private sector and incorporate a whole series of costs beyond funding. They include bidding, delays, development costs, land acquisition, lack of income from the outset in greenfield projects, contingencies for construction risk/delay and operational risk, management costs and contingencies for risk sharing with the public sector.

14. Under PPP, subcontractors may be replaced for poor performance or bankruptcy without any cost to the public sector. Under traditional procurement the costs of such replacements usually impacted on the public sector purse after long and protracted negotiations which also resulted in delays in the project.

15. All these factors are potential risks to the private sector and therefore add a premium to the government risk free rate. And because the risks are priced from the outset and are reflected in the contract it is not appropriate just to focus on the funding cost when comparing traditional and PPP procurement.

16. There have been concerns that PPP projects are inappropriately expensive and that private sector providers have been making excessive projects from investing in PPP projects. Sometimes this may be due to a lack of understanding of the PPP methodology. Individual items purchased under a PPP contract are rarely priced in the same way as items in a supermarket so it is not sensible to compare costs of individual items. Items purchased under a PPP contract should be considered as part of the total package of cost including the pricing of the risks above and the cost of outsourced management of these risks.

17. The capital structure of a PPP project contains both debt and equity (on around an 85:15 to 90:10 ratio). Equity, the repayment of which is not guaranteed, is required to act as a buffer for risks. And while it is more expensive because of the uncertainty that surrounds it, without equity funders would require guarantees from the government, as is the case in the 'forfeiting' model for infrastructure procurement in Germany.

18. The direct comparison between actual cost of funding for Government and for PPP SPVs is therefore unfair at best and disingenuous at worst as it does not take into the different allocation of risks in the two situations.

*If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much? How should PFI deals be accounted for?*

19. Accounting for PPP projects off-balance sheet was a stimulus for more projects to be undertaken when there was an apparent lack of funds for the creation of new infrastructure, and many countries, not only the UK, aimed to remain within the Maastricht rules. With the changes in the accounting methods used, and the fact that many countries are entirely in breach of Maastricht rules in 2011, this question really just has historical interest now. The much closer scrutiny of government balance sheets mean that off balance sheet contingencies are more often being included in total indebtedness, and that reasons for doing PPP procurement are now to gain efficiency in delivery rather than some apparent benefit in getting round rules that are not longer apparently relevant.

20. Of the 22 countries surveyed at the annual OECD PPP meeting in April 2010, 20 countries are using PPP and only four said PPP would be more attractive if the debt was not on the balance sheet. Indeed in a number of countries, until recently less financially constrained, such as the Netherlands, Denmark, Finland and Norway PPP was explored and is being utilized as a long term delivery method.

*How far can risk really be transferred from the public to the private sector?*

21. Construction risk is transferred in PPP projects from the public sector to the private sector. Fixed price, date certain contracts are the norm with no facility to make new claims on the public sector purse if unforeseen difficulties arise. There are a number of examples where major construction problems have arisen but a facility has been delivered for public use such as the A13 PPP road project, Dudley Hospital and the Croydon Tramlink. Even if a project has to be cancelled due to construction failure, due to the financial structure with private sector equity and debt being drawn down to pay for construction and there being no payment until the end of construction this mean that there will be no public sector payment for failure. Where public sector grants are involved, such payments are usually made only when construction milestones are reached.

22. Maintenance contractors, if they are incompetent, can be also be terminated at no cost to the public sector as the risk relationship is not between the public sector and that contractor, but between the public sector and the PPP SPV and it is the SPV that will face payment deductions in the event of poor maintenance performance.

23. Equity risk is transferred—investors who put money into PPP SPVs as providers of equity are not protected in relation to their return or indeed the security of their investment. Debt risk is not transferred as comprehensively as debt funders have more access to potential public sector compensation due to contracted termination payments.

24. Bidding cost and development risk have largely been transferred to the private sector as consortia winning for projects rarely have a stipend to cover their lost costs if they are unsuccessful and such costs end up on company balance sheets. A majority of the funding, and liquidity risks have been transferred to the private sector. It is appropriate to consider whether the cost of transferring risks to the private sector is appropriate to their benefit. There are a series of shared risks such as insurance, archaeological risk, certain environmental risks that have partially been transferred to the private sector at a cost and consideration should be given to whether this cost indeed presents the best value for money for PPP procurement.

*Are there particular kinds of risk which are particularly appropriate for transfer through PFI deals or particular projects which are suited for PFI*

25. PPP can ensure that a wide variety of risks may be transferred but cost and experience are key. There is no point in the private sector taking on a risk and making a huge contingency in their pricing to take account of the effects of that risk or being unable to cope with such a risk that would cause the collapse of the company running the PPP. PPP risk transfer needs to look closely at whether risks being transferred are at the right cost. All the risks we say are transferable may be done so at a cost that still meets a government private sector comparator under competitive conditions.

26. Partial user paid risk in PPP projects can be transferred where there is existing income from an existing route (Nottingham Tram), public sector revenue support (Limerick Tunnel), where an extension is involved (A5 Germany), where user risk relates to block movements (Tours-Bordeaux High Speed Rail), where there are limited alternative routes or to ease heavy congestion (Texas motorways). Existing revenue makes the prospect more palatable for investors and Meridiam (all Meridiam projects in brackets) believes this risk can be fully transferred as part of a user paid PPP project.

27. The benefits of using the PPP procurement focus relate to the creation of long term and stable assets that are the results of long term planning, and technology based PPP projects do not exhibit these features. Meridiam believes that IT projects are not really appropriate for PPP treatment as they tend to require a series of technology upgrades and long term corporate guarantees.

28. Best suited are road and rail construction projects, bridges, tunnels, urban and high speed travel, energy, social accommodation and environmental projects such as wastewater and waste management that can be created as part of a long term and agreed partnership between public and private sectors.

29. Size is another criterion—given the development costs of PPP projects unless a project has a particular mass, of say £100 million or more, then the costs of around £1–2 million per project can be disproportionate to the long term benefits gain from whole life costing.

*What State guarantees are explicit or implicit in PFI deals?*

30. The state has always tried to avoid having explicit guarantees in PPP deals where the aim was to present PPP transactions as being off balance sheet.

31. Certain countries such as France do use explicit state guarantees in PPP projects. In France the “cession Dailly” is used, which is a financial mechanism enabling lenders to bypass the project company to get direct payment by the public authority as soon as the asset construction is considered to have fulfilled the public authority’s requirements. It is Meridiam’s conviction that such mechanisms, may create misalignment of interests and therefore reduce the economic rationale of the use of a PPP. There are no such mechanisms in the UK.

32. Some state guarantees may be implicit in that if there is a project with a compensation on termination structure, if there is project failure then the state will pay amounts agreed under such compensation but there are a lot of stages that need to be gone through before payment is made—it is never an on demand guarantee from the state. If the project is strategic and falls into difficulty then the state will be likely to repurchase the project to ensure that it keeps working and will effectively ‘buy’ the capital value of the project from the banks.

33. PPP project creditworthiness relies on the credit of public authorities, which under availability schemes remunerate the private partner in exchange for performance. Investors expect the public authority to respect its financial commitments as soon as the private partner meets the predefined performance requirements.

*In what circumstances are PFI deals suitable for delivery of services*

34. Meridiam’s vision of any PPP is that it is linked to the delivery of services, the underlying infrastructure asset being only a way to reach the objective in terms of service provided to the public. The essence of PPP, compared with the traditional procurement route, is notably to put the idea of service and performance at the core of the infrastructure project.

35. Nevertheless, the rationale of PPP deals for a “service only scheme”, ie without the existence of an underlying infrastructure asset, may prove not obvious and appears close to already existing “outsourcing”.

#### ABOUT MERIDIAM

36. Meridiam Infrastructure is an infrastructure fund manager focused solely on public private partnership equity investment in the transport, social and environment sectors. Based in Luxembourg with offices in Paris, New York and Toronto, the fund manages assets of c €1.5 billion and invests in countries that are members of the EU, OECD in Europe and North America.

37. Meridiam acts as a bidder and developer of PPP infrastructure projects from the first bid stage, as investor and operational manager, and invests with no divestment for a period of 25 years. By the end of 2011 it will have invested in 17 projects in nine countries, including the UK, with an average investment per project of £40 million.

38. Meridiam's investors are mainly state and municipal pension funds, insurance companies and development institutions (EIB and the Development Bank of Japan) from member countries of the OECD. Meridiam looks for stable returns for its investors over the 25 year life of the fund with annual cash yields of around 5% rising to 10%–15% in the latter years of the fund.

39. The Meridiam infrastructure team is highly experienced, bringing together international engineers, ex-government officials, project financiers and project operators each of whom have 10 to 20 years' background in procurement in the public and private sectors. They have experience of different procurement approaches and are convinced that PPP is the most efficient and cost effective procurement vehicle in the long run.

40. PPP is used interchangeably in this note with PFI as Meridiam believes there is really no difference between the two descriptions in the segments where Meridiam operates.

*April 2011*

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### Written evidence submitted by the PPP Forum

Established in 2001, the PPP Forum is the private sector industry body for public private partnerships delivering UK infrastructure. Across our membership we have been involved in the UK PFI industry since its inception as constructors, lenders, advisers and service providers and this expertise is now being exported globally. The majority of our membership is also involved in other types of UK government procurement and as such we can lend a credible voice to the benefits and negatives of this approach to procurement.

The PPP Forum's objectives are to:

- Demonstrate the success the private sector is achieving in delivering modern public services infrastructure.
- Engage with government departments and related organisations to develop infrastructure procurement policy and contracts.
- Take part in public debate and present an informed and business based perspective on infrastructure procurement and the surrounding issues.

Since our formation, we have engaged extensively with the main spending departments in consultation both of a formal and informal nature in the evolution of PPP/PFI policy to meet the Government's objectives in the delivery of public social infrastructure. We have been involved in broad policy initiatives such as the drafting of the standardisation documents through to more technical areas such as the effects of the implementation of the insurance mediation directive and the move to IFRS accounting for PFI projects.

We welcome the opportunity this inquiry presents to offer a more balanced perspective on the PFI programme in contrast to some of the skewed media reporting we have witnessed recently. We would be happy to offer oral evidence in person at the Select Committee if this is of interest.

#### VIEWS OF THE PPP FORUM

On 8 March 2011, the Treasury Select Committee called for evidence on the future of the Private Finance Initiative. This note provides the response of the PPP Forum and its members.

##### 1. Introduction

1.1 The Private Finance Initiative (PFI) was established by the Conservative Government in 1992. It was aimed at improving the poor public sector track record in infrastructure procurement and its associated long term management: as recently as 2003, the National Audit Office estimated that 73% of procurement under non-PFI methods was delivered over budget and 70% was late.

1.2 PFI is one of a range of procurement tools available to government. It uses well established project finance techniques for the procurement of social infrastructure assets and services, on behalf of tax payers. Project finance is a well established private sector discipline for the construction and long term operation of new assets (typically in capital intensive industries) in the most financially efficient manner.

1.3 Project finance has wide application in the utility, energy power and natural resource sectors. These sectors believe it delivers more precise risk allocation, better risk management and improved value for money. Large multinational corporations choose to use project finance, even though the cost of debt finance to a stand-alone project is higher than their own cost of debt, because of the overall efficiency gains it achieves.

1.4 Applying project finance to public sector infrastructure originated in the UK but was rapidly adopted by other nations: originally France and Australia and increasingly in continental Europe, the Middle East, Asia and, most recently, the USA. The PFI has proven a valuable export commodity for the UK economy.

1.5 There are a number of reasons why the PFI was introduced in the UK and why it is now being adopted globally, including to:

- (a) improve delivery outcomes of complex procurement, when measured against historic time and cost overrun performance;
- (b) focus on the public service, not the asset that delivers it;
- (c) improve whole life design and whole life cost planning and management of public sector infrastructure—put bluntly emergency maintenance is more expensive in the long-run than planned maintenance but this is hard to deliver outside a long-term contract framework such as PFI;
- (d) generate data to show how the relationship between build cost and operating expenditure can be optimised;
- (e) facilitate the reform of the public sector through the introduction of innovative delivery techniques and a greater degree of transparency and accountability; and
- (f) provide long time stability of asset management, to guard against short term decisions leading to long term asset degradation.

1.6 PFI is not about accounting and balance sheet treatment. The level of risk transfer inherent in most PFI deals means that the debt and assets had to be classified as off balance sheet. In the early years of PFI, government insisted this balance sheet test was met as evidence that a minimum level of risk transfer was achieved. However, this off balance sheet classification was seen by some as a benefit in itself. As we describe later, the PPP Forum believes that balance sheet classification should not be a determining factor in favouring PFI procurement.

1.7 While the track record of PFI has been demonstrated in numerous studies to have been beneficial, much of the popular rhetoric and public debate has focused on criticisms of the initiative, magnifying apparent difficulties. Criticisms of rates of return and requests for rebates when projects are successful do not take account of the protection to the public purse where significant losses have been absorbed (usually unreported) by the private sector investors, funders and contractors.

1.8 Historic coverage of PFI has often been characterised by misunderstanding and selective reporting, with two common examples of this being:

- (a) the often claimed: “£200 to change a plug socket”. The PPP Forum recognises early examples of this syndrome, but does not accept this is a common issue in the majority of well structured schemes (a view supported by high user satisfaction ratings); and
- (b) the invariable media reporting of the thirty year nominal cost of the PFI contract as a comparison to the capital cost of the original asset—a perception that is facilitated (indeed, enhanced) by the relative absence of asset management data on the public sector side.

1.9 This second point is critical, because it undermines the real value to Government of PFI-style procurement. The true comparison that should be made (and indeed is made on individual projects when a public sector comparator is considered) is between:

- (a) the overall cost of the private sector PFI deal, which includes its capital cost, operating and life cycle costs as well as its cost of finance; against; and
- (b) the aggregate public sector capital, operating, life cycle and finance costs, in each case, over the life of the asset. PFI detractors focus on the private sector’s higher cost of capital and take this as evidence that PFI must be more expensive. But this fails to understand the positive impact that using a PFI approach has on capital costs, operating and life cycle costs, where the efficiencies typically outweigh the cost of finance. Lack of adequate public sector data exacerbates this issue.

1.10 The issue is best illustrated by an example. Under a typical PFI hospital, the total finance raised could equal, say, £200 million against capital build costs of £180–190 million. Operating and life cycle costs over a 30 year period would be in the region of £600–900 million. Given these relativities, it is easy to see how higher finance costs can be outweighed if the use of PFI results in efficiencies far smaller in percentage terms across the total capital and operating costs of the project. The discipline that PFI entails allows these efficiencies to be delivered effectively and with much greater long term certainty than through alternative means.

1.11 The UK PPP industry recognises that the PFI is not a panacea. However, in agreeing where and to what extent to deploy the PFI going forward, a more collaborative approach to public messaging between public and private sectors, and a more rational analysis of the true comparators with the PFI, would be welcome. This current review is an ideal opportunity for the Government to facilitate this.

## 2. *What are the strengths and weaknesses of different public procurement methods?*

2.1 It is instructive to scope some of the basic features of public services procured under a PFI structure:

- (a) Every service is procured using a competitive process in a largely liquid market. This gives the public sector confidence that it will secure the best possible pricing available in the market at the time.
- (b) The private sector bears the risk of delivering the project to an agreed budget and of commencing the service no later than an agreed start date, each set out in a comprehensive contract.
- (c) Some risk is retained by the public sector’s direct counterparty (the “project company”), but most of it is allocated and managed by a contractual supply chain.

- (d) The public sector pays nothing until the service is delivered and only continues to pay to the extent that the service is delivered to agreed standards.
- (e) There are extensive structural safeguards to ensure service continuity at no additional cost to the public sector, regardless of a failure in any one component of the private sector supply chain. These safeguards have been proven to work in practice.

2.2 In the space available, it is not possible to compare every potential public procurement approach. However, it is instructive to contrast these basic features with a “traditional” procurement model: where government procures a capital asset out of general taxation (or with gilts) with no long term commitment to maintenance:

- (a) *Public sector expertise*: PFI requires different skills: those of intelligent client rather than service delivery agent and asset manager. This places an increased demand on public servants that needs to be supported.
- (b) *Third party oversight*: Whilst it may not be a politically attractive message in the current climate, oversight by third party financiers has driven a rigour in PFI structuring that has been lacking in traditional procurement. Explicitly, lenders will expect good performance as long as there is debt outstanding in order to ensure they are paid ie almost the whole contract period.
- (c) *Whole life cost*: It is clear that PFI drives optimal whole life cost solutions in a way that the disaggregated traditional model cannot.
- (d) *Flexibility*: The PFI is often accused of lacking the flexibility of traditional procurement methods: but one needs to consider separately the flexibility of the underlying asset and that of the PFI contract:
  - (i) PFIs have been used to procure specialised new assets such as defence equipment, hospitals and schools. In some cases changes in demand over time mean that these assets turn out to be the wrong size. In many cases, they are also the wrong specification for efficient alternative use. This is not an inefficiency of PFI—it is a risk taken wherever the public sector builds new assets. In traditional procurement, the cost of an asset is reflected in the cost of the gilt finance used to pay for its construction: just as it is inherent in the finance cost of PFI. The only difference is one of visibility. There is no hiding from the sunk cost of having financed a redundant asset.
  - (ii) PFI contracts are designed to transfer long term risk for assets, so that they are built and maintained at the most economic and efficient cost possible over their life. Asking a PFI company to cut its costs, for instance to defer maintenance expenditure, would be to undermine this fundamental risk transfer. So not surprisingly PFI contracts are fixed and difficult to alter. We see this as an advantage of PFI, as assets are maintained at their long term efficient level. For those desperate to cut costs, they may not see that inflexibility as being so desirable.
- (e) *Operational variation*: we do not accept that PFI is fundamentally inflexible when it comes to operational change but appreciate that the number of stakeholders involved may make contractual change issues more complicated. Supply chain overhead needs to be addressed in the cost of making changes—but this is also the case in the public sector without the transparency of the private model—and transaction costs can be high due to the number of stakeholders involved. A PFI invoice and the unit cost of a light bulb is a false comparison.
- (f) *Performance related pay*: the PFI achieves a level of incentivisation through performance related payments that far exceeds the majority of conventional procurement.
- (g) *Procurement costs*: for the PFI appears much higher when compared with traditional procurement but this is due to having a more rigorously scoped project and the level of due diligence involved. Nevertheless, initiatives are underway to improve PFI procurement costs, particularly in the field of competitive dialogue processes.

3. *If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much? How should PFI deals be accounted for?*

3.1 The PPP Forum believe the only reason that PFI deals should be carried out is because they offer value for money compared to alternative methods of procurement. Their balance sheet treatment should be incidental to this decision.

3.2 This has been recognised by Government, as many PFI deals have been let that are on balance sheet; normally when the project is not purely new build (so the risk transfer on the incremental expenditure is not sufficient to get the whole asset, including its existing part, off balance sheet).

3.3 Because of the risk transfer inherent in PFIs, most of them can be classified as off balance sheet under ESA 95, the European accounting standard applied to measuring national debt. But we think it right that the underlying future obligations of Government for the payments inherent in PFIs are disclosed in public sector accounts. This approach now applies to Whole Government Accounts under IFRS which has been adopted in the UK. This removes the false argument that the only reason PFI is being used is for accounting purposes, to focus attention on the real question—is a particular deal value for money? Now that the UK discloses its PFI obligations, which we would encourage at a relatively detailed and year on year basis, we believe the question of balance sheet treatment should be largely redundant.

#### 4. *How far can risk really be transferred from the public to the private sector?*

4.1 The PPP Forum believes that there is substantial risk transfer to the private sector under a PFI procurement:

- (a) PFI is a sub-set of project finance, where risk is allocated and managed across a number of sub-contractors and financiers. Developers of project finance transactions believe that substantial risk transfer takes place: it should be no different in a public-private context.
- (b) There is a whole industry that underpins the PFI regime that takes on board large construction and delivery risks at competitive prices. The liquidity of the PFI market ensures these are appropriately allocated and priced.
- (c) The project company's supply chain contracts clearly allocate risk, by specifying the price at which service components are delivered: a contractual obligation come what may to deliver with very material liquidated damages should they fail to do so.
- (d) Frequently supply chain contractors will incur losses to meet their contractual obligations—every contractor has examples of where they have made losses. But the loss is invisible to government, because the supply chain continues to meet its obligations.
- (e) At the project company level many risks are taken that cannot be sub-contracted—eg life cycle costs, insurance premia, systems integration risks and sub-contractor solvency. Equity bears these risks, again without frequent visibility to government.
- (f) If there are project difficulties Government is either oblivious to these as contractors meet their commitments, pays less until such time as the prescribed services are delivered or (in extremis) only pays fair value for the assets if the project company defaults.
- (g) There are real signs of the cost of finance and operating expenditure falling over time as the risks become familiar: reductions passed on to the tax payer. This is a clear benefit of PFI that is conveniently forgotten by its critics. Recent high debt margins are a market issue, not a PFI issue.

4.2 We recognise that this question is closely related to the question answered at our paragraph 6 below: namely, is there an explicit or implicit state guarantee that underpins a PFI project in a way that undermines the substance of this risk allocation. We do not believe this to be the case.

4.3 There are a small number of PPP projects that did not fully demonstrate these core risk transfer principles: the high-profile LUL PPPs that involved 95% senior debt underpinning for example. However, projects that do not have these characteristics are not a good benchmark to measure against the PFI: they are better seen as broader public-private partnership arrangements that used some PFI techniques but diverge from core PFI principles due to their political sensitivity, size and complexity. We do not think it relevant to assess these projects in the context of a PFI review, although it is instructive to note that even where the risk allocation was skewed towards the providers of private senior finance, investors in the parts of the LUL transaction were exposed to considerable risk transfer.

#### 5. *Are there particular kinds of risk which are particularly appropriate for transfer through PFI deals, or particular projects which are suited for PFI?*

##### 5.1 Deals which are suited:

- (a) Any complex asset provision where there is a whole life asset management requirement and long term certainty over demand for the service it produces (ie where best value is not necessarily to build as cheaply as possible and then make do and mend).
- (b) Deals need to be of a certain size (which depends on the degree of commoditisation) in order that the higher procurement costs (of better scoping) are not disproportionate.
- (c) Sectors where there is a pipeline of similar transactions that can benefit from the standardisation which comes with a PFI approach. Bespoke, one-off deals need to be larger to bear project development costs.
- (d) Even where the above conditions are satisfied, PFI is not suitable for deals with only short term technology certainty (eg IT deals and projects involving novel technology risk). Certain defence projects have demonstrated that PFI is not appropriate in all circumstances.

##### 5.2 Risks which are suited:

- (a) Risks need to be measurable and/or manageable or they cannot be priced transparently. Risk transfer beyond this threshold risks not being value for money.
- (b) There is a history of government advisors being aggressive in transferring risk where the market has tried to say that it would not be value for money to do so. Examples include insurance cost premia, indexation, political risk (eg around major planning or certain regulation), public sector credit risk, change in law capex risk. A revised approach to these issues would improve value for money.
- (c) Further operational risks could also be transferred, in the way that prison outcomes are now being measured in terms of reoffending rates. Further introduction of payment by results could be achieved (eg, in healthcare and education) if there was political appetite to do so.

6. *What state guarantees are explicit or implicit in PFI deals?*

6.1 There are no explicit or implicit state guarantees in PFI. The market assumes that it will only get paid for the services it delivers or the fair value of the assets it builds: that the public sector will meet its obligations to provide essential public services. If there were ever an example of this not happening, then the ramifications for future costs, not just in PFI but also any public-private sector such as power, utilities and franchising, would be severe.

7. *In what circumstances are PFI deals suitable for delivery of services?*

7.1 PFI is just one example of private involvement in public services. We believe there is significant scope for private involvement in the delivery of public services: in our view the limiting factor is political rather than capability or suitability for application of PPP techniques.

7.2 Use of PPP should be a pricing and service quality issue, not a trades union or political token. The government's role is to set the scope of publicly delivered services and the decision on how those services are provided should come down to value for money.

7.3 The members of the PPP Forum believe that the asset delivery and management skills learned over the last 18 years could be applied more widely to the delivery of public services to enhance the quality and improve the productivity of the UK's public services.

April 2011

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**Written evidence submitted by Dundas & Wilson C.S. LLP**

OUR CREDENTIALS

Dundas & Wilson is a leading legal adviser on PFI/PPP Projects throughout the UK. We have been involved in PFI projects since their inception in the mid 1990s and have a team of over 50 specialist lawyers advising public sector sponsors, bidding consortia and funders on all aspects of PFI/PPP across sectors including health, education, street lighting, transport, waste and water/wastewater. Our teams are active in the origination of PFI deals, secondary market transactions and advising infrastructure funds holding portfolios of operational PFI/PPP assets. We have advised on around 200 PFI projects and have developed particular experience in relation to distressed PFI projects having advised on a number of high profile rescue refinancings.

Our extensive and prolonged experience in the area has given us genuine insight into issues surrounding use of PFI as a procurement method and we gave evidence to the Scottish Parliament Finance Committee Inquiry into the Financing of Capital Projects which reported in December 2009.

EXECUTIVE SUMMARY

The need for infrastructure investment is clear, in the UK and across the globe, despite constraints on public spending. It is an important catalyst to stimulate growth and support the economy. It is also clear that one cannot apply a "one size fits all" approach to infrastructure investment. Contracting authorities should be empowered to utilise whichever procurement method will derive best value for money for the taxpayer considering long term risk adjusted cost of outputs or outcomes. In some cases PFI will offer value for money and in others not. The desired outcome is not to champion one form of procurement over another but rather to focus on delivery of better public services and outcomes for the tax payer at better value for money. To this end better evidence is required to support quantitative evaluation of procurement approaches and objective comparisons.

BACKGROUND

PFI was initially developed in 1992 by the Conservative Government but was expanded significantly from 1997 onwards by the New Labour Governments on a systematic basis to deliver over £64 billion of investment in UK infrastructure whilst maintaining Public Sector Net Debt within targeted levels. By the time of the 2011 election over 800 deals had been signed including 100 new hospitals. To put this in context, PFI typically accounts for around only 10–15% of public sector investment in infrastructure.

Despite its prevalence, PFI has generally been regarded with scepticism by the public and in the media as controversial, expensive and inflexible. Much of the adverse perception stems from experience on early PFI deals where the public sector experience was limited and early adopters in the private sector derived disproportionate returns relative to the risks transferred. The Labour Government moved swiftly to develop public sector procurement skills and set up the Treasury Taskforce to standardise contract terms and issue guidance to procuring authorities to assist contract negotiation. During this period of standardisation, the costs of funding reduced considerably with debt tenures extending to 30 years and gearing ratios of around 93% not being uncommon as understanding of contract structures and risk transfer matured and competition for deals increased. The credit crisis has severely curbed the appetite of senior lenders to invest on longer tenors and funding margins have increased sharply.

As the market matured over time, a number of inquiries and reports have been commissioned into a variety of specific PFI deals and use of PFI as a procurement model which have generally concluded that projects delivered under the procurement model are more likely to be delivered on time and on budget than projects procured conventionally (although the gap appears to be narrowing as public sector procurement skills continue to develop and private sector-type rigour and due diligence is deployed on conventionally procured projects) and that whole life costing of projects is essential in assessing value for money of all projects whether procured under PFI or conventionally. However, such inquiries have been constrained by the lack of quantitative evidence against which to assess the performance of PFI when compared to other procurement approaches.

A number of developments have also presented challenges for the model, namely the advent of competitive dialogue procurement procedure applying to PFI deals resulting in significant increase in bid costs in bidding for PFI projects and the adoption of IFRS leading to the majority of signed PFI deals being “on balance sheet”.

## COMMITTEE QUESTIONS

### 1. *What are the strengths and weaknesses of different public procurement methods?*

In our experience (which is reinforced by the various reports and inquiries prepared by NAO and other bodies into PFI and specific projects), it appears to be a matter of general acceptance that the strengths and weaknesses of different procurement methods are as follows:

<i>Procurement Method</i>	<i>Strengths</i>	<i>Weaknesses</i>
Conventional procurement	<ul style="list-style-type: none"> <li>— Conventional procurement tends to involve less rigid contract structures than privately financed investments resulting in lower procurement costs and greater flexibility during the operational phase.</li> <li>— Public sector faces a lower cost of borrowing based on its covenant and divorced from risk transfer (whereas private sector cost of borrowing reflects risks transferred).</li> <li>— There is no ring fencing of maintenance budgets allowing for greater financial flexibility over the life of the asset (albeit at the expense of proper lifecycle maintenance of the asset).</li> <li>— There is a perception of greater flexibility in the use of conventionally procured assets (eg to close a school or hospital) without having to “buy-out” a PFI contract. However, this assumes that there is a zero cost of doing so where the asset has been conventionally procured (which cannot be the case given the asset has been paid for in full up front).</li> <li>— Public sector procurement skill sets have improved significantly over the last 10 years.</li> </ul>	<ul style="list-style-type: none"> <li>— Public procurement has not typically taken into account the whole life costs of investment in infrastructure and has largely divorced design and construction from maintenance and lifecycle of infrastructure assets.</li> <li>— Public procurement has not typically been subjected to the same level of due diligence, risk analysis and general rigour as investment involving private finance.</li> <li>— Public procurement has typically resulted in more delays and cost overruns in delivery of projects than privately financed projects.</li> <li>— Public sector procurement skill base has typically been considered less sophisticated than that of private sector opposite numbers.</li> <li>— Risk transfer under conventional procurement is typically limited to construction risk depending on contracting model thus resulting in the public sector retaining more risks and exposure to contractor insolvency.</li> <li>— Whilst it is fair to say that the public sector (and indeed the private sector) has made huge strides in the above areas as a consequence of experience gained on PFI, traditional procurement cannot realistically replicate the incentives that drive performance on privately financed investments (eg in terms of penalising poor performance on a whole life basis and loss of equity return if the project does not perform in accordance with expectations).</li> </ul>

<i>Procurement Method</i>	<i>Strengths</i>	<i>Weaknesses</i>
Private Finance	— Privately financed projects take into account the whole life costs of infrastructure investments and “join up” design and construction, maintenance and lifecycle of infrastructure assets and delivery of soft services.	— There is a lack of data on the performance of conventionally procured assets which makes effective comparisons with privately financed assets very difficult.
	— Privately financed projects are subjected to rigorous due diligence and risk analysis.	— Privately financed projects involve more rigid contract structures than conventionally procured assets resulting in higher procurement costs and inflexibility during the operational phase both for major strategic changes and in dealing with small variations.
	— Privately financed projects have typically resulted in fewer delays and cost overruns in delivery than conventionally procured projects.	— Early PFI contracts (prior to standardisation) were arguably, and with the benefit of hindsight, overly beneficial to the private sector allowing generation of disproportionate investor returns relative to the risk transferred.
	— Private sector skill base is often more sophisticated than public sector opposite numbers.	— Private finance is best suited to projects where the need for the asset is well understood and risks can be managed effectively by the private sector at a price which represents value for money to the taxpayer.
	— Privately financed projects incentivise performance (eg by penalising poor performance on a whole life basis and the prospect of loss of equity return if the project does not perform in accordance with expectations).	— The “one off” nature of a PFI contract tends to result in a more adversarial approach to contract issues than partnering structures.
	— Privately financed projects transfer risk on a whole life basis to private sector leading to greater risk transfer and risk management and private sector exposure to contractor performance and insolvency.	— Procurement costs for privately financed projects are typically high under competitive dialogue compared to the capital value of the project.
	— Asset maintenance budgets under private finance projects are ring fenced ensuring the quality and performance of the asset over its life.	— Skills developed by the public sector on private finance procurements may only be deployed on the single project rather than utilised on a pipeline of projects.
	— Private finance contract terms have evolved over time to derive best value for money for the tax payer.	— Cost of debt financed and equity return means costs are higher.
	— Private finance models have been tested on distressed projects such as East Lothian Schools PPP and Aberdeen City Schools 3Rs projects. In these cases, cost overruns and consequences of delays (resulting from subcontractor and senior funder insolvency respectively) were absorbed by the private sector and not passed on to the public sector.	— There is a lack of data on the performance of conventionally procured assets which makes comparisons with privately financed assets very difficult.

<i>Procurement Method</i>	<i>Strengths</i>	<i>Weaknesses</i>
Strategic Partnering Models (NHS LIFT)	— There is a virtuous circle between pension investment needs and financing infrastructure investment which has yet to be fully recognised by government and political parties.	— There is a perception that such models are expensive and bureaucratic.
	— Models such as NHS LIFTY and the hub initiative in Scotland and BSF in England involve the benefits and weaknesses of both privately finances and conventionally procured projects but additionally involve a joint venture vehicle between the public and private sector which allows for a more partnering approach and both parties to share in the benefits/ returns from projects.	
	— The joint venture models are expected to demonstrate savings in procurement costs and cost savings over time through incentivising efficiencies as well as greater transparency through open book accounting and contestability through open supply chain management.	

2. *If PFI debt had been on-balance sheet rather than off balance sheet would PFI projects have been used as much?*

The key test for proceeding with a procurement using PFI is not whether the project is on or off balance sheet. The key test is whether or not the project represents value for money (vfm) in terms of HM Treasury Guidance. However it will be more difficult to pass this test if the project had remained on balance sheet. Having said that there is evidence from a number of PFI projects could still pass the vfm test notwithstanding that they remained on balance sheet. One could argue that a consequence of this is that a number of existing PFI projects may not have passed the vfm test had they been on balance sheet, but that ignores the fact that a number of traditionally procured projects that remained on balance sheet were never tested in the same way to ascertain if PFI would represent vfm. Given that the value of capital spending through traditional procurement far outweighs that through PFI, that could have produced some interesting results.

3. *How should PFI deals be accounted for?*

We have declined to answer this questions as it concerns a matter beyond a legal adviser's area of remit or expertise.

4. *How far can risk really be transferred from the public to the private sector?*

In our experience of over 15 years advising public sector bodies, project vehicles, investors and sub-contractors, (and ignoring for this purpose high profile failures such as Metronet) where PFI is used on suitable projects, PFI contract structures are robust and transfer risks effectively to the private sector.

This is perhaps best illustrated by our experience on the distressed projects (East Lothian Schools PPP and Aberdeen City Schools 3Rs PPP). We advised the project vehicle on East Lothian Schools. The building contractor and FM provider on the project became insolvent during the most risky phase of the project (ie construction phase) following insolvency of Ballast Group UK companies. The project involved the refurbishment of 6 secondary schools and new build of two community facilities. Even after enforcement of bonds and parent company guarantees against Ballast group companies, the appointment of a replacement building subcontractor involved a significant cost increases (due to the refurbishment nature of the project and the delay/replacement costs). The facilities were ultimately delivered in accordance with the PFI contract at the price originally agreed with the Authority despite the costs of construction having increased substantially resulting in investors injecting additional equity and sub debt and senior lenders advancing additional facilities. Aside from the disruption and delay faced by the Authority, it was fully insulated from the resulting cost increases and additional financing required. The investors stepped in to rescue the project to protect their equity and sub debt investments.

A similar set of circumstances applied on the Aberdeen Schools project although in that case the funder was an Icelandic bank which collapsed during the credit crisis. Again, the private sector responded to rescue the projects injecting additional investment but without any increase to payments by the Authority despite increases in the costs of construction and financing costs.

Had the public sector been faced with these collapses under a conventionally procured project it would have been fully exposed to the resultant cost increases rather than fully insulated from such cost over-runs. Thankfully such experiences of market failure are exceptional but they do demonstrate that PFI structures have been stress tested and found to be effective and that equity investors are incentivised under the structures to step in to rescue projects to protect their investment and reputation.

In our experience advising infrastructure funds holding a portfolio of PFI assets we see on a daily basis evidence of effective risk transfer to the private sector on PFI projects—whether through the application of payment mechanism penalties for poor performance, on lifecycle maintenance issues, pursuing building contractors for latent defects and dealing with contractual mechanisms such as benchmarking and market testing and variations. Project vehicles actively manage such risks on a daily basis as they manage PFI concession contracts, enforce contractual entitlements against subcontractors, comply with funding covenants and, where possible, deliver investor returns.

In summary, risks can be and are transferred to the private sector, recognising that ultimately the public sector has the obligation to deliver the service to the public (eg in health or education) and cannot therefore “walk away” from projects.

*5. Are there any particular kinds of risk which are particularly appropriate for transfer through PFI deals, or particular projects which are suited for PFI?*

In our experience and as reinforced by the reports and studies of the NAO and other bodies, PFI works best where the risks passed to the private sector are understood and can be managed by the private sector at a price which represents value for money to the taxpayer.

PFI has operated successfully on social infrastructure projects such as schools, hospitals, street lighting, transport, waste, water and waste water projects. In such projects, in essence risks such as design, build, maintenance, financing and operation of accommodation assets are transferred routinely to the private sector and operate effectively. We have also seen examples of other projects where the private sector has successfully taken on more “frontline” service provision such as the provision of training services in a training facility.

In our experience, projects involving significant refurbishment of existing facilities present a particular challenge to PFI structures given the difficulty in pricing such risks at a price which represents value for money.

It is also important that the public sector has established a long term need for the facilities in question (eg a school or hospital). Where the public service delivered is likely to change significantly over time (eg on IT projects) PFI is generally unsuitable given the long term commitment it represents and the relative inflexibility of the contracts.

There is currently debate in the industry on whether transferring certain risks such as change of law risk and insurance risk is beneficial and whether the public sector should retain such risks.

*6. What state guarantees are explicit or implicit in PFI deals?*

Except where the procuring authority is the state (eg a government department), explicit state guarantees are unusual in PFI contracts. In NHS projects, there is Department of Health underwriting of certain liabilities of NHS trusts where a Trust which has signed a PFI contract becomes a Foundation Trust but this is specific to the health sector.

More typically there are no explicit state guarantees where PFI contracts are entered into by local authorities or other public sector bodies. Generally speaking their covenant is such is that such guarantees are not required.

PFI contract structures commit contracting authorities to pay for the service it is receiving over the life of the asset and on early termination of the contract to pay compensation payments to the private sector counterparties. It is for the contracting authority to ensure the project is affordable. To this end, contracting authorities (such as local authorities) will generally require confirmation of central revenue support funding for PFI commitments as a precondition to entering into PFI contracts.

There is an implied state guarantee on substantial schemes tied to delivery of essential public revenues recognising that ultimately the public sector has the obligation to deliver the service to the public (eg in health or education) and cannot therefore “walk away” from projects as reflected in rating agencies’ assessment of certain bodies/non departmental bodies.

7. *In what circumstances are PFI deals suitable for delivery of services?*

Please refer to our answer to Question 5 above.

April 2011

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**Written evidence submitted by The Foundation Trust Network**

INTRODUCTION

1. The Foundation Trust Network (FTN) is the membership organisation for authorised NHS foundation trusts and those aspiring to achieve foundation trust status. We have over 200 member organisations from the acute healthcare, mental health, ambulance and community services sectors.

2. The FTN welcomes the opportunity to respond to the call for evidence on the future of PFI. We have recently hosted seminars with members, the DH and representatives of banks to discuss future options for capital investment in the NHS.

EXECUTIVE SUMMARY

3. Many of the issues identified and discussed below are not in fact unique to PFI but relate to wider issues about access to capital and investment in the NHS.

4. Much of the public debate has been critical about PFI contracts (including in the NHS). However, it is important the debate acknowledges that without PFI there would have been few alternative sources of capital funding for large projects. Projects financed through PFI have given the NHS a number of vitally important buildings to replace ones which were often in urgent need of repair (usually delivered in time and to cost).

5. We welcome efforts to get the maximum value out of existing contracts but believe the government must be wary about making radical changes that might discourage future private investors.

6. The Foundation Trust policy was intended to bring greater commercial skills and awareness into the NHS. However, at the time PFI was introduced several years before, there was insufficient skill and experience at a local level in dealing with both contract negotiation and management. Although the foundation trust movement has started to address this there is still a way to go.

7. PFI schemes may be one option for future access to capital for the NHS. However, there should be other alternatives from public capital to additional commercial schemes and joint ventures. Historically there has been insufficient support for capital investment and maintenance, PFI was an attempt to correct this but will not be sufficient on its own in the future.

*What are the strengths and weaknesses of different means of securing capital investment for public services (including PFI)? What are the options for the future?*

8. In most cases traditional public procurement methods (ie where the public sector funds and organises everything) have been seen as overly bureaucratic, risk averse, time consuming and usually taking longer to complete.

9. The main strength of traditional public procurement is the fact that the Treasury can provide capital or borrowing at far lower costs (rates of interest) than the private sector. However, the current state of public finances means that such access to capital is significantly reduced.

10. The private finance initiative when established, sought to bring to the public sector the innovation experience by the private sector in the manner in which it finances and engages in large capital projects. Similarly other forms of commercial lending should also encourage such learning in the public sector. Under the early PFI however the private sector had the edge on contract clauses and contract negotiations. Eg the very early PFI contracts did not allow for any clawback by the public sector when loan rates and bond rates were subsequently re-negotiated after contract completion such that the private sector received all of the benefit.

11. Some FTN members consider that the LIFT model (Local Improvement Finance Trust) is more inclusive and can establish more collaborative partnership working, learning from mistakes or experience in each tranche of investment or going forward. Whether large hospital projects could have been realised through the LIFT type schemes is a difficult question to answer but if the NHS had looked at all the PFI schemes as a series of investment and project tranches (as per LIFT), a better result may well have occurred. Once the PFI contractor has the contract and builds the building there is less incentive to work with the NHS organisations (as identified in previous National Audit Office reports), whereas the incentive for LIFT providers is that they may not be guaranteed further work in the future.

12. Future use of PFI contracts (in their current form) may be restricted due to the uncertainty over stable income flows created by the NHS reforms. PFI creates a fixed obligation and income needs to be maintained to meet costs for the length of the long term contract. When PFI contracts were planned, future income looked

stable. However, under the proposed reforms to the NHS there will be greater competition between healthcare provider organisations, potentially making income less stable.

13. Future PFI and non-PFI funded capital projects need to consider whether contracts can be designed to more easily permit organisations to change the way they operate and adapt to a more competitive market. For example high termination costs and a lack of flexibility in being able to adapt buildings for long term service need are a barrier to necessary changes in healthcare delivery eg increasingly moving services into the community and closer to the patient.

14. Borrowing costs could be kept low if underwritten by the UK Government, however if no such guarantees are in place then lending to individual foundation trusts could be seen as a high risk and therefore costly proposition.

15. Hospital providers' own balance sheets are unlikely to be of sufficient scale to support a wide-ranging investment programme in the medium term. Additionally the current uncertainty in the system around the failure regime and the status of Public Dividend Capital (PDC) makes it difficult for investors to accurately assess the risk of lending to NHS bodies.

16. The proposals for loans in the current Health Bill (clause 160 post-Bill Committee stage) could provide a source of public money for working capital and investment capital, using a commercial rules based system; additionally it could be an intermediary and a point of access to commercial lenders via pooling the risk of individual NHS providers. Another potential advantage (which we are keen to explore further) would be a pooling of skills that are not available easily to individual foundation trusts.

17. This body will however need to be set up with a sufficient level of independence from the Department of Health and operate with clear rules and transparency, in order to maintain foundation trust freedoms and remain free of politically motivated interventions.

18. Public funding for capital development and maintenance could also be resourced through the NHS tariff. Historically this has never been explicitly addressed and an attempt to do so now would be highly complex and potentially lead to additional burdens on the public purse which would reflect the true underlying need. This will need to be part of decisions by government and the new NHS Commissioning Board on the various priorities for the NHS.

19. There also needs to be consideration of access to public capital in relation to designated/protected services, which may potentially be provided by independent organisations in the future. This raises level playing field issues for the future nature of NHS providers.

*If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much? How should PFI deals be accounted for?*

20. In general it would be preferable if future investment was on balance sheet, however, this may at the time have reduced the number of schemes due to concerns over the potential impact on Departmental Expenditure Limits and public sector net debt. As the use of PFI schemes has matured and IFRS has been introduced this has been shown not to be a key block to PFI. What might need to be allowed for is an NHS reporting regime which allows for "technical deficits" as a result of the excessive costs of PFI deals incurred by individual organisations over and above that which would normally be expected.

*How far can risk really be transferred from the public to the private sector and what kinds of risk are appropriate?*

21. In general we are sceptical about the degree that risk can be transferred from the public sector to the private sector. Risk is only transferred at a price and the private sector has responsibilities to future dividends and profits that mean they are likely to accurately demand higher premiums for higher risk. The incentive for shareholders and managers of private firms is if anything to overprice the risk to ensure their future performance.

22. The aim should be to seek to risk share with the private sector in future in a way that mitigates the cost of capital rather than to transfer all risk, which will inevitably come at a high a price and not provide value for money.

## Written evidence submitted by The International Project Finance Association

### 1. INTRODUCTION TO IPFA

1.1 The International Project Finance Association (IPFA) is delighted, on behalf of its members, to prepare and deliver this submission to the Treasury Committee of The House of Commons in response to the call for evidence in preparation for an inquiry on the “Private Finance Initiative”.

1.2 IPFA was established in London in 1998 as a not-for-profit trade organisation and operates as a company limited by guarantee. IPFA is the only international and independent association dedicated to promoting and representing the interests of private sector companies involved in project finance and Public Private Partnerships (PPPs) throughout the world.

1.3 IPFA currently has in excess of 360 members, comprising companies and organisations drawn from the full range of the project finance industry, including project sponsors, contractors, lawyers, financial advisors, banks, consultants, accountants, insurers and equity investors. IPFA also provides public sector members the opportunity to become honorary or observer members. A large number of multilateral organisations and government agencies also regularly attend IPFA meetings across the globe.

1.4 We welcome that the Treasury Committee is calling for evidence on the future of the Private Finance Initiative (PFI).

1.5 IPFA believes that PPPs/PFIs have played an important role in the delivery of major infrastructure projects in the United Kingdom over the past fifteen years and can continue to do so.

### 2. EXECUTIVE SUMMARY

2.1 The Government’s recently published plans for some £200 billion to be invested in the UK economic infrastructure over the next five years is welcomed.<sup>1</sup> Of the £200 billion, around 70% of this will be sourced through private sector investment, c £140 billion.

2.2 Both the HM Treasury report, “*PFI: Strengthening Long Term Partnerships*” and the recent National Infrastructure Plan 2010 recognises that UK’s public services were suffering from a legacy of under-investment, particularly when compared to other G7 countries between 1970s and 1990s.

2.3 PFI/PPP projects have delivered a wide range of public services/assets addressing infrastructure need, coupled with providing increasing standards of service delivery and quality against value for money requirements. There are now over 700 PFI/PPP projects currently in operation in the United Kingdom.<sup>2</sup> However, projects involving PFI/PPP techniques represent only a small number of the procurement routes for the public sector to adopt to deliver and manage public services. At present, it is estimated that PFI accounts for only around 10 to 15% of the total investment in public services.<sup>3</sup>

2.4 IPFA welcomes recent Government support for PFI/PPPs as playing an important role in delivering infrastructure.<sup>4</sup> Our members consider that political will is a vital component to achieving delivery of successful infrastructure projects.

2.5 Our members do however acknowledge that recent press reports have highlighted criticism of the current PFI/PPP model as burdensome on public resources, inflexible and expensive.

2.6 The IPFA and its members welcome the opportunity to put forward evidence to the Treasury Committee in order to contribute to a balanced debate on the future role of PFI/PPP in delivering long-term infrastructure within the UK. In the current climate of fiscal constraint, the role and appropriate deployment of long-term third party private capital to delivering UK’s long-term infrastructure ambitions has never been so vital.

2.7 It is also important to recognise the role that is being played by the UK PFI/PPP industry and the huge opportunities open to UK contractors and advisers in the implementation of overseas PPP bringing real benefits to the wider UK economy—with over 100 countries currently looking to implement PFI/PPP procurement techniques (with over 40 nations already having some form of PPP unit to oversee implementation of PPP policy/procurement).

2.8 In a manner consistent with the Government’s approach to furthering UK competitiveness and the promotion of UK economic growth through exports, many UK based PFI/PPP contractors and advisory firms are taking the opportunity to exploit their PPP expertise and expand their services overseas employing staff not only in the UK but overseas. UK contractors and advisors face strong competition from overseas contractors and advisory firms. The UK’s unrivalled experience in PFI/PPP does, however, provide firms with a competitive advantage in terms of the depth and breadth of experience.

2.9 A number of our UK based members have indicated that a number of jurisdictions have been picking up on the recent criticisms of the UK PFI/PPP model within the mainstream press, making the task of promoting UK PFI/PPP contracting and advisory expertise more difficult overseas.

2.10 The IPFA is committed to contribute to a balanced debate on the future of PFI and assisting in facilitating opportunities for both the private sector and the public sector (including sources of private sector capital) to work together to develop and improve upon the current PFI procurement models to enable PFI to continue to be considered as a key procurement model for the delivery of world class long-term infrastructure in the UK.

### 3. RESPONSE

The IPFA responds to the call for evidence to each of the six questions below:

Question 1: *What are the strengths and weaknesses of the different public procurement methods?*

Q1.1 IPFA recognises that the use of “Private Finance” (ie PFI/PPP) is only one part of the overall toolkit of procurement options open to UK Government. At present, it is estimated that PFI based procurements accounts for only around 10 to 15% of the total investment in public services.<sup>5</sup>

Q1.2 For the purposes of responding to Question 1, we have concentrated our responses to the comparison between PFI/PPP based procurements to those using conventional style public procurement (ie design and build contracts, with separate maintenance arrangements).

Q1.3 It is worth noting that there is a lack of information/data on the performance of conventionally procured infrastructure;<sup>6</sup> in particular, there has been little, if any, data collected on outcomes of traditional procurement. However, in the case of PFI/PPP there have been numerous reports and studies commissioned/written by HM Treasury and the NAO highlighting the benefits of PFI/PPP projects over traditionally procured projects,<sup>7</sup> along with independent studies on their wider benefits.<sup>8</sup> We recommend that further work is commissioned to assess the outcomes of traditional procured projects, so the comparison can be assessed in a balanced manner.

Q1.4 The key strengths attributed to a PFI/PPP based procurement method over a conventional style public procurement, are as follows:

- *Ability to transfer risk*—The often cited benefits of PFI/PPP Projects over a conventional procurement relate to the key risks transferred to the private sector, in particular, (i) construction risk; and (ii) completion risk to time and cost. There is an overwhelming amount of evidence to substantiate that PFI/PPP projects are being delivered on time and on budget (see below).
- *Cost & Time Certainty (cf. public procured projects)*—Certainty of both cost and time project delivery is a key strength. The Mott MacDonald Report (below) and various NAO Reports<sup>9</sup> (including “*Modernising Construction*”<sup>10</sup>) noted significant deficiencies in the traditional procurement methodology. The Mott MacDonald Report, “*Review of Large Public Procurement in the UK*” published in July 2002 examined 50 projects procured traditionally over a 20 year period (each with a capital value in excess of £40 million in 2001 prices), all of the projects had been delivered late and over budget. The 2003 NAO Report on PFI Construction Performance<sup>11</sup> found that only 22% of PFI procured projects had exceeded the cost expected by the public sector on contract award, most of these cost overruns being due to variations demanded by public sector sponsors. In contrast, the NAO noted previous surveys show that over 70% of buildings delivered to the public sector procured conventionally were over budget. Further, the 2003 NAO Report found that under PFI only 24% of public building projects had been delivered late, in contrast to data on traditional procurement which found that 70% of building projects had been delivered late.
- *Quality, maintenance of assets and focus on whole life costs*—A key feature of PFI/PPP projects is that the whole-life cost of the project is assessed, including long-term maintenance. A number of our members have indicated that this rigour ensures that tangible benefits can be achieved through design and asset quality, incentivised through the long-term nature of the contracted payments made possible by the involvement of private sector capital. This perspective also encourages a focus on service delivery and long-term performance. For example, repairs and maintenance requirements are planned at the outset with allocated long-term budgets and consequently assets and services are maintained at a predetermined level over the life of the project.
- *Long-term partnership*—Where PFI/PPP is suitable and is deployed, it can provide an enduring partnership between the public and private sector, providing rigour and long-term asset stewardship. A number of our members suggested the growth in the use of long-term capital from pension funds, insurers and long-term infrastructure funds will enhance and align interests between the public and private sector shifting the focus from short-term financial returns to long-term asset management and service delivery.

- *Performance*—There is little monitoring of the performance of traditional public sector procurement projects, particularly over the asset life. In contrast, there is extensive monitoring of the private sector’s performance during both construction and the operational phase of a PFI/PPP project. Most PFI/PPP projects include a performance and payment mechanism to ensure the private sector is incentivised to perform to a required standard throughout the concession period (which may be 30 years or more). Extensive monitoring and information provision obligations are included in such contracts, both as requirements of debt funders and procuring authorities. The Attachment to this Submission provides a powerful illustration of the payment profiles of conventional versus PFI/PPP contracts.

Q1.5 We also recognise that PFI/PPP based procurement methods are not without its critics. Indeed, as the Treasury Committee’s own website states, “...[c]ritics argue that many PFI projects are inflexible and expensive, or worse, that the PFI is inherently wasteful of public resources...”

Q1.6 Against this, the potential weaknesses to the PFI/PPP based procurement method can be cited as follows:

- *Inflexibility*—Inflexibility is often cited as a major flaw with PFI/PPP procurements. However, the evidence suggests the contrary, namely that PFI/PPP contracts provide sufficient flexibility for the public sector end-users<sup>12</sup> and sponsors. PFI/PPP projects that are well-scoped in terms of design and the scope of services from initial procurement stages are less likely to require in-built, often expensive flexibility.
- The National Audit Office (NAO) Report on “Making Changes in Operational PFI Projects” highlighted that PFI deals provided sufficient flexibility, ensured changes were handled in a timely manner, change processes were handled well and PFI changes achieved better value for money than conventionally outsourced work. The PFI/PPP contractual model forces public sector procurement teams to carefully assess their operational needs prior to embarking on procurement of a long-term PFI/PPP contract—based upon a “whole life” cost appraisal. This represents, a significant change in the behaviour by procurement officials, one of the early objectives of PFI.
- Notwithstanding this, where there is a need for a change (whether policy, fiscal or operationally driven), there is in reality little difference between a PFI/PPP contract and a project procured through a traditional method. For changes within a PFI/PPP contract, the parties will have already negotiated and agreed a change procedure for the parameters, implementation and adoption of change/variations. There is no equivalent “change” regime within conventional procurement.
- *Expensive*—A recurring theme is that PFI/PPP projects are too expensive. This has been linked in part to post credit crisis movements in senior debt pricing. Our members have reiterated that there is a more important seldom understood linkage between the amount of risk transferred to the private sector and the overall cost of the PFI/PPP project. The causal link and analysis between risk transfer and price needs to be better assessed and understood by the public sector. The over specification of PFI/PPP projects impacts affordability. The initial cost of procuring a building through conventional procurement cannot be easily compared to the whole life cost of a well maintained PFI/PPP asset over 30 years.
- *Complex and Lengthy Procurement Timetables*—PFI/PPP are often cited as taking too long to procure. This is not entirely the fault of PFI/PPP, but the procurement processes themselves. We welcome the recommendations contained in the recent review of the competitive dialogue procedure undertaken by HMT<sup>13</sup> to address this weakness. Our members have suggested procurement timetables and PFI/PP could also be improved through a combination of: (i) greater use of public sector initial design work, avoiding three separate bidders incurring significant upfront design costs; (ii) adoption of a more centralised procurement agency-led approach, similar to successful agencies in the Canadian provinces (Infrastructure Ontario/Partnerships BC), to avoid over fragmentation/inconsistency of public sector procurement expertise; (iii) greater use of input specification where the public authority is clear on its requirements; and (iv) avoidance of over specification, as setting lower service standards/handback requirements may not impact materially on service provision.

Question 2: *If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much? How should PFI deals be accounted for?*

Q2.1 Our members believe that the key driver for the use of PFI/PPP should be the definition and demonstration of affordable “value for money”, rather than whether or not a particular project is included within the public sector balance sheet. Our private sector members are largely unaffected by the ultimate balance sheet treatment of a particular project.

Q2.2 The harmonisation of statistical reporting and budget treatment for public sector accounts amongst EU Member States is becoming increasingly important to our members, particularly for those who transact across the European Union and where the United Kingdom could be seen to be disadvantaged, if other Member States were working under a different system to the UK. This also improves both transparency and comparability of government debt across the EU.

Q2.3 Ultimately, however, our members do not believe the public sector balance sheet treatment of a project should be the determining factor as to whether a PFI/PPP solution should be adopted.

Question 3: *How far can risk really be transferred from public to the private sector?*

Q3.1 On risk transfer, many of our members recalled the often quoted, “...*risk should be borne by the party most able to price and manage the risk...*”.

Q3.2 Whilst the extent of risk transfer between the public and private sector differs from project to project, there are a few key parameters.

Q3.3 In broad terms, risks that are capable of being priced, managed and controllable (and in some instances insurable) by the private sector are suitable to be transferred on an affordable value for money basis.

Q3.4 There has been a track record of significant risk transfer to the private sector with PFI/PPP projects. However, there has been little, if any, work undertaken on risk identification and analysis in traditional procurement, as the public sector retains most, if not all, of the major risks associated with a traditional procurement.

Q3.5 As PFI/PPP models evolve, our members have indicated that the public sector has sought to push the boundaries of risk transfer, seeking to transfer risks that have previously been retained by the public sector. This approach has two consequences. First, the transfer of risk is accompanied by an increase in price to reflect the risk transferred. Second, the timetable to procure the project is extended to enable the private sector and their funders to assess the new risk to be transferred. Once this new risk has been transferred across a number of projects the market can adapt, but the private sector needs time to adapt, assess and price any new risks being transferred—this can impact both price and the extend the procurement timetable.

Q3.6 A number of our members have pointed out that this risk transfer is not illusory. There have been a limited number of high profile events at both a corporate (ie Jarvis, Ballast) and project level (ie Royal Armouries Museum in Leeds, Defence Animal Centre PPP, Cornwall Schools, the National Physical Laboratory at Teddington and Croydon Tramlink) in the PFI industry where the private sector finance has been used to absorb significant risks and financial exposure to save the projects from performance failure. It is questionable whether this would have happened in a conventional procurement.

Question 4: *Are there any particular kinds of risk which are particularly appropriate for transfer through PFI deals or particular projects suited for PFI?*

Q4.1 Construction risk has been very successfully transferred to the private sector, with a number of PFI/PPP projects that have been delivered late, where the private sector has absorbed the financial consequences of late delivery, technical failure and cost overruns. In all such cases the costs and related losses would have been borne by the public sector in traditional procurements.

Q4.2 Our members indicated there are some risks that are difficult from a value for money or bankability perspective to pass to the private sector within a PFI/PPP contract; for example, (i) IT/ICT and related technology risks; (ii) complex interface issues (ie many arose in the London Underground Contracts); (iv) property value risks; (v) services requiring material and frequent changes; and (vi) risks associated with assets that are likely to require frequent changes; (vii) volume/demand risk; and (viii) protracted construction periods (ie HS2) where support may be needed from Government to optimise risk transfer.

Question 5: *What state guarantees are explicit or implicit in PFI deals?*

Q5.1 The vast majority of PFI/PPP deals are contracted by public sector bodies whose payment and performance obligations are underwritten, usually by statute or contractual covenant, by UK Central Government.

Q5.2 It has been critical, in terms of credit analysis and bankability of projects, that the payment obligations (in particular obligations to pay unitary payments or compensation on termination) are viewed and can be analysed as ultimately deriving from UK Central Government whether through statute or direct contractual covenants in the relevant project contracts.

Q5.3 There have been exceptions to this approach, in the case of NHS Foundation Trusts, there is no such underpinning or support from Central Government captured in statute or covenant. In order to achieve a bankable PFI/PPP project opposite an NHS Foundation Trust counterparty, the Secretary of State for Health has provided a deed of safeguard on a project-by-project basis which provides comfort to the private sector sponsor and its funders that in the case of failure of the NHS Foundation Trust, the Secretary of State for

Health will effectively step-in. The importance of a deed of safeguard to the bankability of a 20–30 year PFI/PPP deal cannot be underestimated, without this, it is unlikely senior debt beyond 5–7 years would be available.

Q5.4 Even where bankability and a credit analysis can be traced to a Central Government’s covenant to pay through statute or contract, it is important to note that there has been no underwriting of performance. In circumstances where a private sector contractor has failed to perform, there are mechanisms to deduct payments or on termination, retender the project, which places both the sponsor’s equity and senior funders’ debt at risk.

Question 6: *In what circumstances are PFI deals suitable for delivery of services?*

Q6.1 PFI/PPP projects have delivered a huge range of assets and services to the public sector. Services are generally categorised as “hard” and “soft” services, with “hard” services being linked to the maintenance of the fabric of the building or asset. In contrast, “soft” services those non-core services which are usually ancillary to the core government services (ie delivering clinical services or teaching) such as catering, cleaning etc.

Q6.2 In circumstances where the private sector are delivering new build assets within a PFI/PPP project there are strong arguments for including the provision of “hard” services within the project scope. Where the private sector have been responsible for design and building the asset, it is likely to be best placed to ensure the fabric of the building or asset is maintained through their understanding of the building design, materials, supply chain, lifecycle assumptions and access to warranties etc.

Q6.3 The case for the inclusion of “soft” non-core services is not so clear for long-term PFI/PPP projects and where these “soft” services are included many are subject to regular market assessment through benchmarking and market testing to ensure value for money is maintained during the life of the project concession and to mitigate potential changes in service requirements.

Q6.4 The case for inclusion of core services appears even weaker within a PFI/PPP project and where Government is minded to involve the private sector in the delivery of core or front line services, this may be better undertaken through an outsourcing model, which is better equipped to manage significant policy or operational changes.

Q6.5 Ultimately, the inclusion of any services with PFI/PPP is likely to succeed in circumstances where the public sector’s service requirements are well scoped, required for a long period of time and are unlikely to materially change over the project term (or market test period).

Whilst we have sought and received feedback from a large number of our members, this submission does not necessarily represent the views of all of the IPFA’s membership.

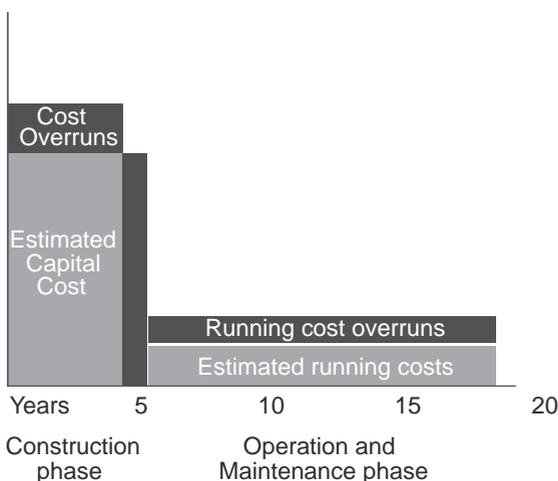
April 2011

**Attachment**

**CONTRASTING PUBLIC SECTOR PAYMENT PROFILES OF CONVENTIONAL AND PPP/PFI PROCUREMENT MODELS**

**Traditional Government procurement**

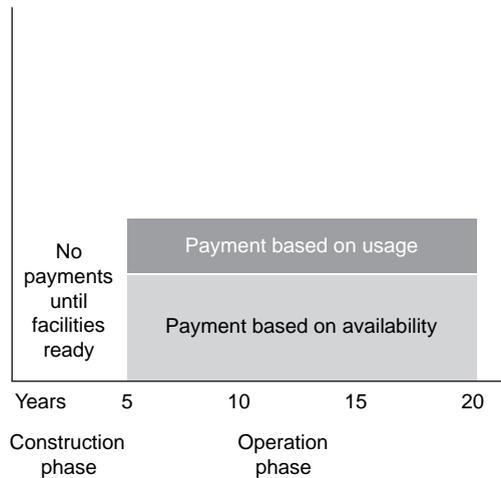
Payment profile can be depicted as follows:



- Capital and operating costs are paid for by the public sector, who take the risk of cost overruns and late delivery.

## PPP procurement

### Payment profile for the public sector



Source: PricewaterhouseCoopers

- The public sector only pays over the long term as services are delivered. The private sector funds itself using a large portion of debt plus shareholder equity. The returns on their equity will depend on the quality of services.

(Source—PWC—Delivering the PPP Promise—A review of PPP issues and activity, 2005  
<http://www.pwc.com/gx/en/government-infrastructure/pdf/promisereport.pdf> )

#### REFERENCES

- <sup>1</sup> HM Treasury/Infrastructure UK—“National Infrastructure Plan 2010” (see [http://www.hm-treasury.gov.uk/ppp\\_national\\_infrastructure\\_plan.htm](http://www.hm-treasury.gov.uk/ppp_national_infrastructure_plan.htm) )
- <sup>2</sup> Partnerships UK, Projects Database (see <http://www.partnershipsuk.org.uk/puk-projects-database-search.aspx>)
- <sup>3</sup> See endnote 6, below.
- <sup>4</sup> HM Treasury, Public Private Partnerships—Technical Update 2010 (see [http://www.hm-treasury.gov.uk/d/ppp\\_technical\\_update.pdf](http://www.hm-treasury.gov.uk/d/ppp_technical_update.pdf))
- <sup>5</sup> See endnote 6, below.
- <sup>6</sup> Refer to, paragraph 2.25 of “PFI: Strengthening long-term partnerships”, HM Treasury, March 2006 ([http://www.hm-treasury.gov.uk/d/bud06\\_pfi\\_618.pdf](http://www.hm-treasury.gov.uk/d/bud06_pfi_618.pdf)). Please also refer to HM Treasury, “PFI: Meeting the Investment Challenge”, published July 2003 ([http://www.nao.org.uk/publications/0708/making\\_changes\\_operational\\_pfi.aspx](http://www.nao.org.uk/publications/0708/making_changes_operational_pfi.aspx)) and “Infrastructure Procurement: delivering long-term value”, HM Treasury, March 2008 ([http://www.hm-treasury.gov.uk/d/bud08\\_procurement\\_533.pdf](http://www.hm-treasury.gov.uk/d/bud08_procurement_533.pdf)).
- <sup>7</sup> Since 1997, the NAO have published over 60 reports of investigations into PFI and PPP deals. Please refer to the National Audit Office (NAO) website site, section on “Private Finance” ([http://www.nao.org.uk/areas\\_of\\_specialist\\_expertise/private\\_finance/recommendations.aspx](http://www.nao.org.uk/areas_of_specialist_expertise/private_finance/recommendations.aspx))
- <sup>8</sup> However, please refer to “PFI in school building—does it influence educational outcomes?” KPMG’s Infrastructure Spotlight Report, 2009 Edition (<http://www.kpmg.com/SiteCollectionDocuments/PFI-in-school-building.pdf>)
- <sup>9</sup> Please refer to the NAO Report on “PFI: Construction Performance”, published 5 February 2003 ([http://www.nao.org.uk/publications/0203/pfi\\_construction\\_performance.aspx](http://www.nao.org.uk/publications/0203/pfi_construction_performance.aspx))
- <sup>10</sup> Please refer to the NAO Report on “Modernising Construction” published 11 January 2001 (<http://www.nao.org.uk/news/0001/0001187.aspx>)
- <sup>11</sup> NAO Report on “PFI: Construction Performance”, published 5 February 2003 ([http://www.nao.org.uk/publications/0203/pfi\\_construction\\_performance.aspx](http://www.nao.org.uk/publications/0203/pfi_construction_performance.aspx))
- <sup>12</sup> NAO Report on “Making Changes in Operational PFI Projects”, published 17 January 2008 ([http://www.nao.org.uk/publications/0708/making\\_changes\\_operational\\_pfi.aspx](http://www.nao.org.uk/publications/0708/making_changes_operational_pfi.aspx))

<sup>13</sup> See “HM Treasury Review of Competitive Dialogue”, November 2010 ([http://www.hm-treasury.gov.uk/d/ppp\\_competitive\\_dialogue.pdf](http://www.hm-treasury.gov.uk/d/ppp_competitive_dialogue.pdf))

**Written evidence submitted by Dr Andrew Edkins, Graham Ive and Alex Murray,  
University of London**

Evidence submission representing the views of Dr Andrew Edkins (Senior Lecturer), Graham Ive (Senior Lecturer) and Alex Murray (Research Assistant), all of whom are employed within the Bartlett School of Construction and Project Management, University College London (UCL). Graham and Andrew are experienced academics in the fields of construction economics and project management respectively. They have worked with Alex over the past two years in developing comparative benchmarks of the operational performance of PFI and non-PFI social infrastructure (schools and hospitals).

EXECUTIVE SUMMARY

- Different procurement methods offer different and inconsistent benefits to the purchaser. The purchaser should consider what aspect they place the greatest importance on achieving.
- The level to which risk can be transferred from the public to the private sector depends on three main aspects:
  1. extent to which specifications and standards of the asset or service can be defined;
  2. ability to put in place objective measurement systems accurately to determine if contractual performance has been achieved; and
  3. private capital expenditure should be realised before payment to maintain incentives for delivery.
- To date, based on limited public information, relatively few PFI projects have failed. Without access to commercially confidential information to ascertain project specific performance, this suggests PFI is performing, in terms of delivery, certainly no worse than publicly funded projects.
- Comparisons with non-PFI operated social infrastructure suggest PFI facilities are performing comparably in terms of cost, with some higher levels of performance and evidence of investment in the long term maintenance of physical infrastructure.

1. *What are the strengths and weaknesses of different public procurement methods?*

1.1 A full answer to this would exceed the word limit. This submission will therefore only consider procurement method involved in the provision of substantial assets, such as buildings, civil engineering works or complex IT systems. A summary of generally accepted strengths and weaknesses for a broad category of procurement methods is presented:

<i>Procurement</i>	<i>Strengths</i>	<i>Weaknesses</i>
<i>Fragmented:</i> Separate procurement for design, build, operation and maintenance contracts (D+B+O)	— Choose separate tailored parties for each phase	— Can take longer to deliver with opportunities for disagreement — Opportunities for difference between bid prices and out-turn costs and delivery times
<i>Partially integrated:</i> Single contract for design and build, separated from operation (D&B+O)	— Reduced contracting so lower transaction costs — Incentivises for communications between D & B to improve “buildability”	— Reduced input from client in design process — “Buildability” may be achieved at cost of operational performance
<i>Professional:</i> outsourced procurement process as a form of cost plus procurement	— Operational specifications guide design and build — Able to deliver novel projects quickly	— Client retains significant final cost risk

<i>Procurement</i>	<i>Strengths</i>	<i>Weaknesses</i>
<i>Fully integrated:</i>	— Fully incentivised whole life factors between D, B & O	— Inherently inflexible beyond contract close
Design, build, finance and operation	— Risk transfer, client does not pay if agreed service/availability is not delivered	— Risk transfer can be costly
wrapped up together into one contract eg PFI (DBFO)	— Access to private capital for public infrastructure	— Private capital is more expensive than public

1.2 Construction clients suffer both hold-up and quality measurement problems. No procurement method is best at mitigating both problems.<sup>73</sup> By making the constructor (and project company which it part owns) bear the consequences of inferior quality (lower service payments, higher maintenance and life cycle costs), PFI can claim to be superior at solving the problem that some construction contracts give the contractor a perverse incentive to “shade” construction quality.

1.3 However PFI also makes the client particularly vulnerable, potentially, to opportunistic pricing of post-contract changes introduced by the client (the form the hold-up problem usually takes in construction projects). It therefore will tend to be a good choice for the public client in cases where there is little risk of requiring changes, and where the quality giving attributes of an asset are capable of objective measurement and can be linked to contract payments.

1.4 PFI will also tend to be a good choice where the constructor has strong reasons not to take advantage of client vulnerability post contract signature, because they are trying to build a reputation and thus be selected (out of many competitors) to bid for future PFI projects. This is particularly relevant where the public client has an active public programme and where the number of competitors is fairly high.

2. *If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much? How should PFI deals be accounted for?*

2.1 The authors of this submission are not qualified accountants and do not reside in an accountancy orientated academic department. We therefore consider ourselves not qualified to answer these two questions. However, we are of the view that the fundamental objective of the PFI is to achieve better value for money for the delivery of services.

3. *How far can risk really be transferred from the public to the private sector?*

3.1 A fundamental principle of PFI is the allocation of risk to the party best placed to manage it. The types of risks and duration over which risks are considered are generally service orientated, wide-ranging and long term. This has the fundamental effect of reframing the nature of the challenge to one that includes whole life cost considerations and stable provision.

3.2 Three aspects are relevant in considering limits to the kind of risks that can be transferred. The first is the extent to which specifications of required services or standards can be clearly defined in testable, measurable ways. It is this problem that bedevilled the early and most complex IT projects (NIRS2) and Ministry Of Defence equipment projects (FSTA). The second is the ability to put in place objective performance measurement systems. These are often associated with human assessment where there is no objective test. Soft FM services (such as reception services) present such a challenge in determining standards. It is to be noted that this is a tractable problem as the highly successful prison PFI projects have proved, where performance standards are largely driven by measurements and metrics relating to human performance. It is therefore an exercise of development and refinement of appropriate metrics and measurement systems that frame the questions of how far risks can be transferred. The third aspect is that PFI projects realise capital expenditure before public payments begin, so lenders are at risk (with no government guarantees of debt, except in instances such as the London Underground PPPs). In effect, the public sector relies on the lenders to ensure that project sponsors perform.

3.3 The extent to which risk has and is being transferred in present projects can be deduced from two streams of evidence. The first is where either too much or the wrong type of risk has been transferred, and the consequences are such that the project fundamentally fails. The extreme would require the public sector to take back the risks and responsibility for the project. Examples include the Croydon Tramlink and the two major London underground PPPs. We are not aware of a definitive national list of these failed projects being currently available. Compiling such an official list would be a valuable exercise so that further analysis of any common factors can be undertaken.

3.4 The second stream of evidence to inform the limits of risk transfer is the inverse of the first. Here the evidence base is the population of projects that are operational. The definitive source for this is the HM Treasury

<sup>73</sup> Ive, G and Chang, C-Y (2007) The principle of inconsistent trinity in the selection of procurement systems. *Construction Management and Economics*, Vol 25, pp 677–690.

PFI signed projects list.<sup>74</sup> This only includes active projects (operational or in-construction). Considering just the operational projects, 569 projects are recorded as being in receipt of unitary charge payments (UCPs) in 2008–09 with a total value of £6.49 billion.<sup>75</sup> The respective figure for 2009–10 is 619 projects being in receipt of UCPs with a total value of £7.37 billion. The net gain in the number of projects and increase in UCPs value has factored in the removal of instances of projects that have been taken back to public sector responsibility, such as Croydon tramlink and the two London Underground upgrade projects. The logical deduction from this is that for the 619 projects in receipt of UCPs, risk of the type and size considered “normal” (construction, maintenance and life cycle cost risks) has been transferred and is being managed by the private sector. The number of projects and sum of UCPs, is therefore evidence of real risk being transferred.

3.5 The presumption for these operational PFI projects is that UCPs are only being made after due assessment that the service provided meets contractual obligations for delivery of acceptable standards of service. Where such service standards or availability are not, as specified, being provided, it has to be assumed that penalty points are being incurred and payment deductions made. Sufficient data to provide more detailed commentary on the performance of individual projects is not publicly available for commercial confidentiality reasons. We believe such data would be extremely useful in providing a true evidence base for the consideration of the extent to which risk has been transferred in such projects. The presence of very few instances of project failure (not all of which were due to issues of risk), coupled with the requirement in such projects for transfer of design, construction and operational risk, reinforces the evidence that significant risk has been transferred.

*4. Are there particular kinds of risk which are particularly appropriate for transfer through PFI deals, or particular projects which are suited for PFI?*

4.1 Others such as the National Audit Office have examined and reported on the issue of design and construction risk performance in PFI.<sup>76, 77</sup> The body of evidence is that PFI has tended to handle this risk relatively well. There is less objective evidence of the risks that lie within the operational services provided by such PFI contracts. For the majority of asset-based projects, these can be broadly considered as the risks associated with soft (people centric) and hard (asset centric) facility management.

4.2 The authors, as research active staff within the Bartlett School of Construction and Project Management at UCL, have developed an ability to benchmark the operational cost and performance of aspects of soft and hard services within core social infrastructures, specifically hospitals and schools. This research has been driven by our curiosity to look at the impact of the procurement method on the operational performance of facilities and wider infrastructure.

4.3 We have developed comparisons derived from independently collected data sources in a bid to provide objective evidence to what has largely been a debate driven by perception. This is an area that is poorly developed and served. This is a view held by others, including Infrastructure UK which notes that data on the cost and performance of infrastructure is “uncoordinated”.<sup>78</sup> We believe that our endeavours have demonstrated that it is possible to generate objective assessment of the cost and performance of operational services and the assets that underpin them. It is our recommendation that to help solve this issue of poor data on public infrastructure, a national asset register be established to record at the individual asset level, the key information on the asset’s creation, expected lifespan, and its operational performance and associated costs. Such an undertaking is recognised as significant. The Canadian Statistical Office collate such data setting a precedent for what can be achieved.<sup>79</sup>

4.4 Taking the example of what our research revealed in the important area of hospital cleaning, the findings from our analyses comparing new hospitals conclude that PFI facilities witness higher levels of cleanliness and quality of patient environment, with no associated statistically significant higher cost of cleaning services.<sup>80</sup> In fact, the dispersion of cleaning costs seen within PFI facilities is significantly lower than in non-PFI new hospitals. We consider this provides procuring authorities with greater certainty on the on going cost of operation. These findings are based on publicly assessed and available data.

4.5 A forthcoming paper of ours,<sup>81</sup> looking into the operational services expenditure between schools renewed via PFI and non-PFI, reveals PFI costs to be higher in six of the nine years into operation. However, these differences are not statistically significant and PFI schools cost less overall in three of the nine years examined. What can also be observed also is PFI facilities are allocating funds to invest in building maintenance with considerable increases in hard FM expenditure following the fifth year of operation. The corresponding expenditure in public funded renewed schools remains roughly flat throughout. The issue of responsible stewardship of infrastructure is as relevant today as it was when PFI was developed in the early nineties.

<sup>74</sup> Updated in March 2011 and available at: [www.hm-treasury.gov.uk/ppp\\_pfi\\_stats](http://www.hm-treasury.gov.uk/ppp_pfi_stats)

<sup>75</sup> Un-indexed values used.

<sup>76</sup> Performance of PFI Construction, National Audit Office, 2009.

<sup>77</sup> PFI: Construction Performance, NAO, 2003.

<sup>78</sup> Point 3.36, National Infrastructure Plan, Infrastructure UK.

<sup>79</sup> Age of Public Infrastructure: A Provincial Perspective, by Mychèle Gagnon, Valérie Gaudreault and Donald Overton, Investment and Capital Stock Division, Statistics Canada, 2009.

<sup>80</sup> G Ive, A Murray, A Edkins and K Rintala, Cost and performance comparison of PFI and non-PFI Healthcare Infrastructure in England, presented at the 3rd Annual Conference of the Health and Care Infrastructure Research and Innovation Centre, Edinburgh, September, 2010.

<sup>81</sup> Finding of initial analyses to be presented at the 2011 RICS COBRA conference. Paper to be submitted early June.

Emerging pressures to cut these budgets in PFI facilities is a case of falling back into old habits. This is an area at the heart of the recent James Review.<sup>82</sup>

4.6 The main risk that cannot be transferred is the reputational risk that is inherent with any public service. The general public will not, and indeed should not, seek to hold accountable any party other than the public sector for any major failing in a public service that is then made the subject of a PFI/PPP contract. However, the alternative is also true, with the public sector enjoying the reputational benefits from improved services from such deals.

4.7 Those projects where clearly understood fixed assets are at the centre of the service delivery are well suited for the transfer of risk for the successful completion of the design, build, financing and operation of the asset. Examples of these include schools, hospitals, residential and office accommodation buildings that make up much of the present PFI/PPP market. Additionally, there are civil engineering dominated projects that form parts of the road, rail, water, and energy sectors.

##### 5. *What state guarantees are explicit or implicit in PFI deals?*

5.1 We are not aware of any general area where explicit guarantees are made in PFI projects, but would defer to those legal practitioners in the area of PFI contract law for more detailed comment.

5.2 As we understand the question, the foremost implicit guarantee is of persistence of presence. Without such surety, the private sector would place higher prices on the risks of both “walk-away” and or “hold-up”. It is the implicit trust in the State, its government and its agencies that they will endure and be obligated by their pre-existing contractual obligations that provides the comfort needed by the private sector and its financiers. The prevalence of availability payments means that the private sector is guaranteed the equivalent of off-take agreements. Whether the service made available is actually needed (so for example a school building that is open, but for which there are no pupils to require teaching) is a concern for the wider society and tax-payer.

##### 6. *In what circumstances are PFI deals suitable for delivery of services?*

6.1 There must always be a strong service element in any PFI as otherwise it is just a form of lease or affermage. The circumstances where the service is best suited for PFI are those where there is a combination of clarity of the output to be specified and established and agreed protocols and metrics for assessing the performance of the service. This set of criteria is most easily accomplished in projects dominated by the technical performance of a relatively stable asset—such as road or simple building. These represent clearly understood entities where not only is the “*what is required*” clearly defined, but so is the “*way it will be measured*”. This leads to a set of limits where if there is too much novelty, complexity or opportunity for principled disagreement, PFI is not suitable.

6.2 Where straight forward objectively measurable service outputs can be specified, risk of delivery can be priced and wrapped into an integrated contract. Where complex subjective service outcomes are present, risk of delivery will be impossible to price accurately, so will likely include margins of safety which render them not value for money. The recent decision to incentivise the Doncaster prison service provider for the reduction of reoffending rates can be considered as objectively measurable, except it is not a service output (directly within control of the provider), rather an outcome (a result of interaction between service outputs and service users, such as prisoners). In this case, the service provider is not taking the risk of deductions from increased re-offending rates.

April 2011

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#### **Written evidence submitted by the Chartered Institute of Public Finance and Accountancy**

CIPFA, the Chartered Institute of Public Finance and Accountancy, is the professional body for people in public finance. Our 14,000 members work throughout the public services, in national audit agencies, in major accountancy firms, and in other bodies where public money needs to be effectively and efficiently managed.

As the world’s only professional accountancy body to specialise in public services, CIPFA’s portfolio of qualifications are the foundation for a career in public finance. They include the benchmark professional qualification for public sector accountants as well as a postgraduate diploma for people already working in leadership positions. They are taught by our in-house CIPFA Education and Training Centre as well as other places of learning around the world.

We also champion high performance in public services, translating our experience and insight into clear advice and practical services. They include information and guidance, courses and conferences, property and asset management solutions, consultancy and interim people for a range of public sector clients.

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<sup>82</sup> Review of Education Capital, Sebastian James, April 2011.

Globally, CIPFA shows the way in public finance by standing up for sound public financial management and good governance. We work with donors, partner governments, accountancy bodies and the public sector around the world to advance public finance and support better public services.

#### EXECUTIVE SUMMARY

The Chartered Institute of Public Finance and Accountancy (CIPFA) welcomes the opportunity to provide evidence to the Select Committee on the Private Finance Initiative. CIPFA is one of the leading professional accountancy bodies in the UK and the only one which specialises in the public services. It is responsible for the education and training of professional accountants and for their regulation through the setting and monitoring of professional standards.

CIPFA has a key role in local authority accounting. We are responsible for the Code of Practice on Local Authority Accounting in the United Kingdom, which represents professional best practice in this area and which local authorities are required to follow under the 2003 Local Government Act. This is reinforced for CIPFA members through the Statement of Professional Practice with which all members are required to comply. In developing the Code of Practice, CIPFA works closely with HM Treasury and the other relevant authorities to ensure that financial reporting across the public sector is as consistent as possible.

CIPFA believes that the main emphasis of the enquiry should be around ensuring that the optimum procurement method is selected for each capital project, and that the accounting and budgeting requirements do not provide incentives for one form of procurement over another. The key conclusions from our submission are:

- PFI deals have a strong focus on the Outline Business Case and the Value for Money Test; but their long duration may make them less flexible.
- It is probable that there would have been fewer PFI projects if the debt had more usually been scored on-balance sheet.
- The control approach adopted in IFRIC 12 and which is being developed for the public sector by the IPSASB is the appropriate basis on which to account for PFI arrangements in financial statements.
- The UK Government should seek to influence the development of requirements for economic and statistical reporting, so that balance sheets in the UK and other government National Accounts show PFI debt as assessed under the “control approach”.
- Only those risks which the private sector are best placed to manage should be transferred.
- Business cases should consider all methods of making available the assets required to meet service needs, including the use of partnerships with the private sector; value for money should be paramount.

CIPFA is happy to offer the Select Committee whatever assistance it is able in the consideration of the Private Finance Initiative.

#### INTRODUCTION

1. The UK has used PFI arrangements since 1992. The first schemes were in central government, with other parts of the public sector adopting PFI arrangements at a later date.

*What are the strengths and weaknesses of different public procurement methods?*

2. A strength of PFI has been the strong focus placed on the Outline Business Case and the Value for Money Test. CIPFA's Prudential Code for Capital supports strong asset management of which the Business Case is a part. In considering capital projects, however procured, public bodies need to apply rigorous cost benefit analysis and ensure all projects are sustainable and affordable.

3. A potential weakness of PFI is the long duration of the contracts, such that there may be less flexibility to adapt the arrangements to changing circumstances.

*If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much? How should PFI deals be accounted for?*

4. When PFI arrangements were first introduced, the accounting issues had not been addressed in accounting standards. Accounting treatments were developed initially by analogy with leases. The risk and rewards approach that underpinned leasing standards was adapted for PFI deals, and similar approaches are used in the requirements for statistical and economic reporting (eg under the European System of National and Regional Accounts, referred to as ESA 95). ESA 95 requirements are used for National Accounts which inform HM Treasury's economic planning process.

5. In September 1998 the Accounting Standards Board issued an amendment to Financial Reporting Standard 5 (FRS 5) “Reporting the Substance of Transactions” in the form of Application Note F “Private Finance Initiative and similar contracts”.

6. Application Note F set out the accounting requirements for PFI schemes. Assets and liabilities were treated as on-balance sheet or off-balance sheet based on an assessment of the relative balance of risks and rewards. Under Application Note F, retention by the public sector of demand risk and residual value risk was regarded as generally decisive.

7. In 1999, the Treasury Taskforce issued Technical Note No. 1 “How to Account for PFI Transactions”. This was intended to be an interpretation of Application Note F, but in practice acquired the position of a competitor standard, allowing for a wider spectrum of risks to be considered<sup>83</sup>. As a result, risks and rewards were not assessed on a consistent basis across the whole of the public sector.

8. The risk and rewards approach in Application Note F (and Technical Note No 1) was similar to that used in ESA 95, and became the effective basis on which the funding and approval of projects was decided.

9. The use of PFI deals to keep debt off-balance sheet appears to have been viewed positively by both the previous Conservative and Labour governments. This is best shown by considering the funding arrangements for local government, where central government funding for PFI deals was typically only available where the scheme was off-balance sheet. PFI funding was in addition to schemes funded through more traditional procurement methods. This provided local government with an incentive to enter into PFI deals that were off-balance sheet. The incentive for local government related to the additional funding rather than the off-balance sheet treatment per se. However, during much of this time HM Treasury sought to manage the PSBR within certain limits and it is unlikely that as much funding would have been made available had more PFI schemes been on-balance sheet. CIPFA would therefore conclude that it is probable that there would have been fewer PFI projects if the debt had been on-balance sheet. This conclusion is based on the effect on the PSBR, and does not reflect whether or not the schemes provided value for money; this is a separate consideration.

10. In 2006 the International Financial Reporting Interpretations Committee (IFRIC) of the International Accounting Standards Board (IASB) issued Interpretation No 12 (IFRIC 12), “Service Concession Arrangements”. Under the accounting requirements set out in IFRIC 12, which covers most UK PFI deals, assets are treated as off-balance sheet for the private sector operator where the public sector has control of the assets. IFRIC 12 does not cover the public sector accounting, but the clear implication is that the assets (and related liabilities) should be on-balance sheet for the public sector. Since 2009–10, this has been the approach taken in the Financial Reporting Manual (FReM) issued by HM Treasury, the Code of Practice on Local Authority Accounting in the United Kingdom issued by CIPFA/LASAAC and the similar manuals in the health service (issued by the Department of Health and Monitor).

11. It should be noted that the references above to the UK public sector having adopted the control approach refer to the accounting within an entity’s financial statements produced under the FReM (and equivalent guidance in other parts of the public sector). The treatment of PFI deals in the National Accounts produced under ESA 95 continues to be based on a risk and rewards basis.

12. There is currently no international standard that covers the public sector accounting for PFI schemes, although the International Public Sector Accounting Standards Board (IPSASB) is currently developing such a standard. A Consultation Paper was issued in 2008, and this was followed by an Exposure Draft in 2010. CIPFA continues to work with the IPSASB to develop this standard.

13. The proposed IPSASB standard adopts the control approach of IFRIC 12; the proposed standard is intended to provide a “mirror approach” to IFRIC 12, such that an asset will either be on the private sector balance sheet or the public sector balance sheet.

14. The control approach is seen as less subjective than the risk and reward approach, and is more likely to result in assets (and related liabilities) being on-balance sheet for the public sector. CIPFA strongly supports this approach.

15. The control approach considers which party has ultimate control of the assets, rather than day to day control. This is consistent with the definition of an asset in both IFRS and IPSAS as “resources controlled by an entity as a result of past events...”.

16. Concentrating on who has ultimate control of the asset provides a solid basis for recognising assets and, where appropriate, related liabilities. This approach is also likely to be less susceptible to attempts to structure deals in such a way as to provide a desired accounting outcome.

17. This emphasis on control also helps to align the balance sheet with accountability for services. The public sector will enter into PFI deals to meet service delivery objectives through the construction, renovation, or improved operation of the underlying property. The public sector will generally remain ultimately accountable for the delivery of the service provided through the property, and is therefore accountable for the operation of the property, even though its operation is being undertaken by the operator. Because of this, and

<sup>83</sup> Heald, D A and G Georgiou (2010) “Accounting for Public-Private Partnerships in a converging world”, in Hodge, G, C Greve and A Boardman (eds), *International Handbook on Public-Private Partnerships*, Cheltenham, Edward Elgar, pp 237–261.

because of the general public perception that the service being provided through a PFI arrangement is a public service, political risk associated with the delivery of services through the underlying property remains with the public sector, notwithstanding the fact that some service delivery risk may fall to the operator.

18. For these reasons, CIPFA believes that the control approach adopted in IFRIC 12 and which is being developed for the public sector by the IPSASB is the appropriate basis on which to account for PFI arrangements. This approach, which the UK public sector has followed since 2009/10, provides for a more consistent treatment than the risk and rewards approach previously followed, particularly given the potential conflict between Application Note F and Technical Note No. 1. This improvement in accounting should also help to reduce, if not eliminate, the number of occasions on which an asset appears on neither the public sector nor private sector balance sheet.

19. As the UK budgeting framework is based on the National Accounts (and therefore ESA 95), budgets and financial statements are inconsistent in relation to PFI deals. Whilst these differing treatment remain in place, there remains the possibility that PFI deals may be structured to achieve an off-balance sheet treatment within National Accounts (and therefore within the budget), notwithstanding the fact that the deal will be on-balance sheet within the financial statements of the entity and within the Whole of Government Accounts.

20. It should be noted that accounting standards and standards for economic and statistical reporting such as ESA 95 need to reflect a balance between the conceptual and the pragmatic approaches. Because of the vulnerability of the risk and rewards approach to structuring, and the greater possibility of assets appearing on neither the private sector nor the public sector balance sheet, CIPFA believes that the control approach would be more appropriate for economic and statistical reporting.

21. As CIPFA considers that the control approach to PFI arrangements provides better accounting, we would recommend that the UK Government seek to influence the development of requirements for economic and statistical reporting, so that balance sheets in the UK and other government National Accounts show PFI debt as assessed under the “control approach”. This would not only help ensure that National Accounts better avoid the risks of structuring, and the risk that assets do not appear anywhere in National Accounts, but would also remove the disconnect between budgets and financial statements.

*How far can risk really be transferred from the public to the private sector? Are there particular kinds of risk which are particularly appropriate for transfer through PFI deals, or particular projects which are suited for PFI?*

22. As the public sector will ultimately remain accountable for the delivery of services, it is inevitable that some risks, including a degree of delivery risk, will remain with the public sector.

23. Whilst almost any level of risk can be transferred from the public to the private sector, the real issue is at what level is risk transfer cost-effective and appropriate. Only those risks which the private sector are best placed to manage should be transferred as the private sector will price in to contracts significant premiums for risks that it cannot directly manage. An example of risks that may attract an undue premium would include environmental risks and under occupancy (except where there is the potential to replace public sector with private sector use).

24. Adoption of the control approach to balance sheet classification should encourage a different view to be taken of risk transfer and bring a focus on the transfer of costs that the private sector is best placed to manage, such as construction, maintenance and third party income risks. With the current determination there may be a danger that risks are transferred to support a balance sheet treatment.

*In what circumstances are PFI deals suitable for delivery of services?*

25. The key to the identification of circumstances where PFI deals are suitable for the delivery of services is effective Capital Strategy and Asset Management Planning processes. These should be focussed on meeting service needs rather than the acquisition of capital assets. Where a future service need is identified the business case should consider all methods of making available the assets required to meet service needs, including the use of partnerships with the private sector.

26. Value for money should be paramount in arriving at a decision as to the appropriate manner in which to deliver the service and related assets. Robust option appraisal methodologies should be used to ensure that each option is assessed on a level playing field. PFI deals will be a suitable method of delivering services where it can be demonstrated that such a scheme can deliver the best value for money over the life of the contract, taking into account the possible need for flexibility regarding changing circumstances.

## CONCLUSION

27. PFI deals have been useful in delivering assets and services that otherwise might not have been available to the public. PFI deals still have a role to play in delivering assets, but value for money is paramount, and a level playing field is required when assessing differing procurement options.

28. Previous accounting and budgeting arrangements may have obscured the level of future commitments being taken on by the public sector. In the current economic climate, it is important that such deals are as transparent as possible, and this is best achieved by using the control approach for financial statements, National Accounts and budgets.

April 2011

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#### Written evidence submitted by Oxon PFI Alert Group

Darent Valley Hospital, part of the Dartford and Gravesham NHS Trust, cost £94 million to build in a PFI scheme. By the end of the 2010–11 financial year, the Trust had made £289 million in PFI payments to the companies involved (Treasury figures) and there are still some 20 years to run in the PFI contract! No wonder an ever-increasing body of opinion is against the use of PFI.

Please note the following in a *Daily Telegraph* story (3 April 2011):

“Health Emergency said it had also discovered ‘asset stripping’ sales of land and property as NHS Trusts also have to cope with the current round of public spending cuts.

“Land is being sold by PFI-built hospitals in London, while a growing number of nursing and other jobs are being cut across the country, including hundreds at the new £256 million 1,200 bed Queen Alexandra Hospital in Portsmouth, said the group.

“Many other PFI hospitals are facing financial problems but have yet to announce cuts, claimed Health Emergency.

“Its information director, Dr John Lister, said: ‘PFI means that hospitals face rising bills each year, regardless of their income.

‘It also means that private sector profits are protected by legally binding contracts taking an increased share of declining Trust budgets, while clinical services, patient care and the jobs of NHS staff are sacrificed, in an impossible battle to balance the books as the NHS faces real-terms cuts for the first time in a decade.

‘Isn’t it significant that Health Secretary Andrew Lansley’s massive and controversial Health and Social Care Bill is seeking to break up almost every structure in our NHS, claiming to make the system more efficient, but leaving PFI intact, and instead opening even more ways for the private sector to rip off the taxpayer and undermine public services?’

“The Tories appeared opportunistically critical of their own PFI policy when Labour was implementing it, but are now happy to see this growing haemorrhage of cash from the NHS’.”

In our view, PFI schemes are a disaster and no new PFI schemes should be set up. Those that exist should be cancelled. Future funding for hospitals, schools or other public buildings should be direct by the government. This is cheaper, and allows more democratic control.

April 2011

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#### Written evidence submitted by Frances Kelly

Many more eloquent than I have dissected the effects of PFI. I would like to say the following:

In the late 1990s I wrote and submitted a letter to Manchester Health Authority on behalf of the Unison Branch covering South Manchester Health Services. In it I set out the excess costs of the proposed PFI scheme to rebuild Wythenshawe hospital, over a publicly-financed scheme. The Finance Director of the HA agreed but the scheme went ahead. In about 2005 figures became available through the Board papers of Central Manchester PCT showing that every NHS organisation in Greater Manchester was being top-sliced to provide funds or the debt thereby incurred to “South Manchester”—ie UHSM—that is all NHS organisations in Greater Manchester were losing funds for services to pay for the PFI scheme. Later the funding arrangements were changed so the transactions were no longer visible.

It is a disgrace that the Government authorises PFI and thereby puts excessive profits into these private companies. It is even worse that no extra funding is provided so that the NHS has to pay out of money which should be providing services. It is a final disgrace that this present Government has condemned PFI yet is allowing a large number of new schemes to proceed including the Royal Liverpool hospital. Liverpool is an area of deprivation and can ill afford to lose any monies which should be dedicated to providing NHS services not paying into companies’ profits.

April 2011

## Written evidence submitted by Dr James Robertson

### SUMMARY

Which financing approach provides best value for money in public service provision cannot be determined a priori. All approaches have several potential advantages and disadvantages. Advantages *may* offset other factors even when disadvantages become more marked. Assessment must consider all relevant elements and not highlight any one in making a case. Value for money may remain at risk whatever accounting system is used if controls do not prevent distortion of contracts in order to obtain financing. The successful transfer of risk to private contractors at good value for money requires careful assessment of who can best bear a risk and good due diligence.

### DETAILED RESPONSES ON ISSUES RAISED BY THE COMMITTEE

*What are the strengths and weaknesses of different public procurement methods?*

*Are there particular kinds of risk which are particularly appropriate for transfer through PFI deals, or particular projects which are suited for PFI?*

A simple classification of a number of important *possible* advantages and disadvantages of the use of private finance is as follows:

POSSIBLE BENEFITS	RISKS & POSSIBLE PROBLEMS
<ul style="list-style-type: none"> <li>■ Output based specification – helps get what you need</li> <li>■ Agreed price</li> <li>■ Payment made only once services are provided</li> <li>■ Delivery to time</li> <li>■ Whole life costing/sustainability approach</li> <li>■ Planned maintenance built in</li> <li>■ May open up domestic markets to overseas competition</li> <li>■ Risks can in principle be allocated to those best able to handle them</li> <li>■ New ideas from outside public sector</li> </ul>	<ul style="list-style-type: none"> <li>■ Competition among providers of services and capital may be muted, weakening VFM</li> <li>■ Higher cost of private capital</li> <li>■ Expensive procurement process</li> <li>■ Risk of lengthy procurements</li> <li>■ Lack of public sector skills to obtain good VFM</li> <li>■ Long contract term lock in and needs may change</li> <li>■ Refinancing gains may not go to public sector</li> <li>■ Outputs may not be affordable as economic circumstances change</li> <li>■ VFM may suffer to achieve favourable accounting treatment</li> <li>■ Private sector may take cautious view of innovative approaches</li> <li>■ Making changes may be expensive or difficult</li> </ul>

Value for money of Public Private Partnerships, PPP, depends on many factors. No one factor by itself provides an a priori VFM justification for PPP and no one factor, for example, the higher cost of capital for the private sector, provides an a priori justification for not using PPP. The question is whether advantages *as a whole* outweigh disadvantages.

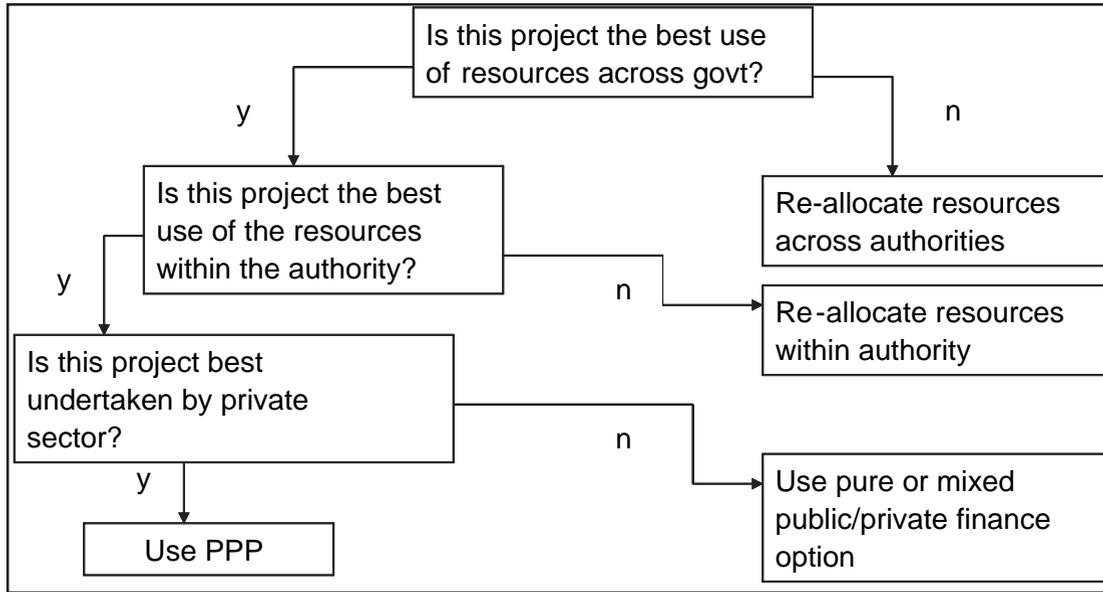
At the current moment, any increase in the cost of private finance will all else equal make this financing route less attractive than public finance, but other factors may continue to outweigh even a higher cost of capital. In particular, a genuine transfer of delivery and cost risk may be valuable characteristics of a PFI.

It should also be borne in mind that while private finance is rationed through the price of capital in the market, public sector investment is currently rationed through quantity or budget constraints. A level playing field would imply the use of an implicitly higher cost of public capital in economic investment appraisals of value for money, compared to the Treasury Green Book rate of 3½% real per year.

*In what circumstances are PFI deals suitable for delivery of services?*

Generalisations about how to achieve best VFM are elusive and may well be unhelpful. As above, all methods of financing public services have advantages and disadvantages, though as set out in Treasury Standard Contracting guidance, some types of procurement may not be suitable for PFI, for example, because the costs of the procurement are high in relation to the size of the contract, as for individual small contracts, or where projects involve assets with short physical or economic lives. Where public service requirements are known to be changeable in the future, long term contracting may not be suitable. It may not be economic to enter into short term contracts with the private sector.

Beyond this, choice of procurement method and financing should be based on a careful review of circumstances of the type of public services in question and then on a project by project basis. A general analysis of the following type may be informative.



At the highest level, reviewing resource use across Government is the subject of periodic Spending Reviews. Within public authorities, it is beneficial to take a cross department view of the suitability of possible financing options, and at the lowest level, the financing of individual proposals to supply public services should be considered on the complete range of relevant factors.

*How should PFI deals be accounted for?*

The question is less one of accounting treatment per se, but whether there are sufficient controls to ensure that PFI contracts are not distorted, either in terms of risk and reward, or in regard to control, to obtain finance at the risk of reduced value for money. Transfer of risk to parties able to bear it only at excessive cost is an example of a possible distortion.

*How far can risk really be transferred from the public to the private sector?*

*What state guarantees are explicit or implicit in PFI deals?*

While PFI inherently transfers infrastructure and service delivery risk to the private sector, risk transfer is only meaningful if the public sector has a genuine Plan B in the event that a project fails badly. Under PFI the public sector makes no payments until services come on line and it is protected in financial terms. The required services will not be available as planned however, and the public sector might feel it had no choice but to relax the terms of a PFI contract, or to cover service delivery failures itself in some way, for instance, in the case of health services.

Risk transfer can therefore never be guaranteed fully, and involvement of the private sector requires careful up front financial due diligence and assessment of its construction and operating abilities. It should be noted however that the same service failure issues and possible associated costs also arise if a publicly financed project fails to deliver in some way.

There should be few if any explicit guarantees beyond the decision of which party should bear which risk, provided PFI or PPP projects can be allowed to fail if the private sector cannot deliver. Implicit guarantees exist to the extent that a PFI project cannot be allowed to fail and this possibility should be addressed up front in the consideration of the best financing route.

May 2011

## Written evidence submitted by Globalise Resistance

### ABOUT GLOBALISE RESISTANCE

Globalise Resistance brings together groups and individuals opposed to the global growth of corporate power.

### EXECUTIVE SUMMARY

The many problems of Public Private Partnerships and Private Finance Initiatives have been documented by government, academics and activists alike.

Reports from the House of Lords Economic Affairs Committee and the National Audit Office and the comprehensive research of Allyson Pollock and Dexter Whitfield are testimony to this. Globalise Resistance will not repeat these facts here but instead call for three things.

Firstly, an alternative method of public procurement needs to be established. Below we point to some alternative models in use in other countries and invite the Treasury Committee to examine them in detail.

Secondly, we believe the public debt incurred under PPP/PFI should be independently audited. Forensic analysis of the accounting practices, tendering of contracts and public consultation of the project should be conducted and, if specific consortia or companies are found to have worked outside of the we believe that the public's debt to these companies should be chalked off as odious debt.

Thirdly, if PFI is to continue there are some areas that are clearly in need of reform. Again, we highlight these and invite the committee to scrutinise them further.

### ALTERNATIVES TO PFI

1. Following its investigation into PFI housing and hospital projects, The NAO recently remarked: "There were instances where PFI may have been used where there was no evidence that it was the best procurement route. Local authorities and health trusts used PFI because there was no realistic alternative, not because it represented best value for money."<sup>84</sup>

2. It is our view that the government should now investigate alternative methods of public procurement. One possible solution would be the creation of a national infrastructure investment bank. This could direct capital to areas where markets are less willing to provide it and, by pulling disparate departments together, create economies of scale and leveraging power for the government.

3. The idea has been proposed by various parties, including Vince Cable in 2009, who recognised that the PFI model's dependence on bank finance was a problem. In a national infrastructure bank model, "There are various financing structures that can be envisaged involving different combinations of private and public equity and loan (or bond) finance and different governance structures."<sup>85</sup>

4. The Institute of Civil Engineers authored a report in December 2009 calling for a national infrastructure bank. Among the benefits it would bring it cited the bank's ability to "Provid[e] capital or guarantees where private financial markets are unwilling or unable to provide all the funds required for projects which have high social, environmental and economic benefits."<sup>86</sup>

5. In Europe, such a model exists. For instance, in Germany, the state-development bank KfW provides capital effectively to public infrastructure projects. According to World Bank Logistics Performance Index, Germany has an infrastructure rating of 4.34<sup>87</sup> (on a scale of 1-low and 5-high). The UK stands at 3.95 while Germany's rating is also higher than Norway, Sweden, France, Canada & the US. Many factors, of course, contribute to strong infrastructure but it may be that the UK could learn something from Germany.

6. Alternatively, the Treasury could evaluate the merits and pitfalls of the SNP's Scottish Futures Trust programme, established as an alternative to PFI. In 2010, the party claimed to have delivered £114 million in public procurement savings to the taxpayer. These figures were audited by the London School of Economics and the accountants Grant Thornton.<sup>88</sup>

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<sup>84</sup> House of Commons Committee of Public Accounts (2011) PFI in Housing and Hospitals—page 3.

<sup>85</sup> Vince Cable speech to Civilisation Congress (2009)  
[http://www.nickclegg.com/speeches\\_detail.aspx?title=Vince\\_Cable\\_launches\\_proposals\\_for\\_a\\_National\\_Infrastructure\\_Bank&pPK=441f7ef6-5e78-44b4-888b-c7115c191479](http://www.nickclegg.com/speeches_detail.aspx?title=Vince_Cable_launches_proposals_for_a_National_Infrastructure_Bank&pPK=441f7ef6-5e78-44b4-888b-c7115c191479)

<sup>86</sup> Institute of Civil Engineers (2009) A National Infrastructure Investment Bank: An ICE briefing and discussion paper page 4.

<sup>87</sup> World Bank Logistics Performance Index: Infrastructure by country  
<http://info.worldbank.org/etools/tradesurvey/mode1b.asp?sorder=q11rank&cgroup=i4>

<sup>88</sup> Edinburgh Southern SNP : "PPP/PFI Rip off for Edinburgh"  
[http://www.edinburghsouthern SNP.org/index.php?option=com\\_content&view=article&id=9&Itemid=8](http://www.edinburghsouthern SNP.org/index.php?option=com_content&view=article&id=9&Itemid=8)

7. Neither of these models may be suitable for Britain. However, it remains imperative to establish an alternative to PFI and we would encourage the Treasury Committee to investigate further options.

#### PFI AUDIT

8. If PFI continues to be used as a public procurement tool we believe, to get the best out of it, the public debt incurred under PFI must be audited and the scheme itself must be reformed.

9. The NAO's investigation into PFI Housing and Hospitals concluded: "The Departments do not routinely collate sufficient accurate data on the costs and performance of their PFI contracts."<sup>89</sup>

10. We would like to see government go a step further than collating data and instead establish a commission to audit Britain's total liabilities for privately financed public sector procurement. If the audit commission finds that players in the PFI game repeatedly broke rules or exploited the system we would request them to consider writing off the debts incurred with their involvement as odious, as defined below:

"Odious debt [...] holds that debt should not be transferable to successor regimes if (a) it was incurred without the consent of the people and (b) was not for their benefit"<sup>90</sup> (Alexander N. Sack, 1927; Ernst Feilchenfeld, 1931)."

The terms of such an investigation would need to be defined meticulously. At present this is merely suggestion and something we ask the committee to consider.

11. A parallel output of this investigation, in line with the NAO's comments, would be the creation of a central data store that holds information on all previous signed PFI projects. This will improve decision making in government as the information will allow departments to negotiate fair prices and systematically discern which types of PFI projects are susceptible to delays, overspends and other failures and which projects are not.

#### REFORMING THE PFI

12. Ideas for reform will come as a result of an audit but there are already some areas that are in evident need of address.

13. Transparency: the routine publication of the vital statistics of PFI projects will ensure that public scrutiny enforces efficiency and best practice from government and consortia. Currently, some details are available under the Freedom of Information Act but other important information is exempt for reasons such as commercial sensitivity. An information package for each PFI contract should be published before it is signed that includes details of the projects.

14. Accounting: The practice of off balance sheet accounting has been condemned by the House of Lords Economic Affairs Committee for obscuring the real cost of PPP/PFI programmes. The Treasury's solution of keeping two sets of books has also been condemned.

- capital value and projected cost;
- areas and amount of risk transferred to the private sector;
- portion of project's finance underwritten by government;
- contract between consortium and government; and
- individual companies obligations and remunerations within the contract.

It seems self evident that in the context of a national debt crisis, the full cost of any PPP/PFI programme should be made abundantly clear. A standardised accounting practice that puts all debt on-balance sheet, regardless of risk transfer, should be mandatory. If this cannot be achieved we endorse the Economic Affairs Committee's recommendation, "that the Government should publish figures for total liabilities for privately-financed public sector procurement as a separate item alongside figures for Public Sector Net Debt."<sup>91</sup>

15. The transfer of risk: currently, the percentage of risk transferred is left to departments and consortia to determine. We believe that 100% of construction risk should be transferred to the private sector on a mandatory basis. In some PFI projects, such as the failed MetroNet<sup>92</sup> there have also cases of government underwriting privately sourced debt. This is fundamentally counter-productive and should be outlawed.

16. NDPBs: the role of Non Departmental Public Bodies in PFIs should be examined. Having submitted a FoI request to Defra recently, I was told that the department held no contractual information on PFI because all the contracts had been tendered by non-departmental public bodies (NDPBs). According to Treasury figures, Defra is one of the biggest PFI spenders, with £422 million due for the year 2011–12.<sup>93</sup> No report so far seems to have addressed the role of NDPBs and an investigation into their funding, performance and methods of working would be welcome too.

<sup>89</sup> House of Commons Committee of Public Accounts (2011) PFI in Housing and Hospitals—page 5.

<sup>90</sup> Seema Jayachandran and Michael Kremer (2006) "Odious Debt" in American Economic Review—pages 82–92.

<sup>91</sup> House of Lords Economic Affairs Committee (2010) Private Finance Projects and off- balance sheet debt—page 34.

<sup>92</sup> House of Lords Economic Affairs Committee (2010) Private Finance Projects and off- balance sheet debt—pages 22–24.

<sup>93</sup> Treasury Spending Data (2011) UK Private Finance Initiative Projects: Summary Data.

17. Secondary markets: many PFI consortia sell their contracts in secondary markets after the initial construction phase is complete. Yet this violates one of the key principles of PFI; the idea of “whole-life costing”,<sup>94</sup> that is, that the consortium is responsible for the construction and maintenance of the project for a length of time and therefore has the incentive to build a higher quality structure.

May 2011

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### **Written evidence submitted by Barclays Infrastructure Funds Management Ltd**

#### 1. INTRODUCTION

1.1 Barclays Infrastructure Funds Management Limited (Barclays Infrastructure Funds or BIF) is pleased to submit comments on the Private Finance Initiative (PFI) to the Treasury Select Committee to assist with its inquiry into PFI. In this submission, both PFI projects and other forms of Public Private Partnership are termed generically “PFI” projects.

1.2 Barclays Infrastructure Funds is a business unit of Barclays Capital (the Investment Banking division of Barclays Bank PLC) and has raised six funds from institutional investors since 1996 with total funds currently under management of approximately £1.2 billion. The investment objective of Barclays Infrastructure Funds is to generate significant long-term yield-based investment returns through its experience of investing in PFI and similarly financed social infrastructure projects in the UK and the Eurozone countries.

1.3 Barclays Infrastructure Funds has, in its role as manager of six infrastructure equity funds, invested in 142 PFI projects since 1997. In addition, BZW (Barclays de Zoete Wedd) was actively involved with one of the very first PFI projects—the second Severn Crossing, where it was advisor and underwriter of the junior capital.

1.4 Our submission will concentrate on the role that we have fulfilled in financing and managing PFI projects rather than the accounting treatment and public sector evaluation of these projects, as these are areas where we are not qualified to comment.

#### 2. EXECUTIVE SUMMARY

2.1 The public sector has developed several approaches to procurement, and subsequent management and maintenance, of capital assets. The various approaches can be characterised by different levels of transfer of risk including construction and maintenance over the working life of the asset.

2.2 There is a balance between the public sector taking and managing the risk and the price that is paid to have specific risks transferred. PFI has, for example, shown itself to enable construction costs and delay risks to be successfully transferred to the private sector.

2.3 Whilst PFI is a suitable means of procurement for a wide range of projects there are some (including where the capital asset has a relatively short useful life or where the cost and risk associated with project development will result in a high cost of capital for infrastructure finance) that are not suitable for PFI.

2.4 PFI has helped significantly with the creation of infrastructure as an asset class (particularly in social infrastructure) and also creating export opportunities for the UK financial services, construction and facilities management industries.

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<sup>94</sup> House of Lords Economic Affairs Committee (2010) Private Finance Projects and off-balance sheet debt—page 25.

2.5 The capital required for the UK's future infrastructure investment will need to come from both public and private sector sources. The public and private sectors should work together on infrastructure projects contemporaneously with shared objectives—the improvement to the quality and quantity of infrastructure, promoting improved value for money in the long-term.

### 3. *What are the strengths and weaknesses of different public procurement methods?*

3.1 The public sector has developed several approaches to procurement, and subsequent management and maintenance, of capital assets. The various approaches can be characterised by different levels of transfer of risk.

- 3.1.1 Traditional procurement involves the public sector developing a specification and, through use of internal resources or external consultancy, developing a detailed design of the asset to be procured. Construction of the asset is typically tendered in competition to the private sector construction industry. Commercially, construction risk and asset management risk are treated and procured independently and often many years apart.
- 3.1.2 The risk of operation and maintenance continues to lie with the public sector, even though these activities (or parts of these activities) may be subsequently outsourced to the private sector.
- 3.1.3 Traditional procurement does not appear to take into account the cost of the long-term maintenance post-commissioning, and the availability of capital to fund this essential maintenance is uncertain. This could lead to an undefined maintenance strategy resulting in assets neither lasting their design life nor fulfilling the requirements for service delivery expected at time of procurement.
- 3.1.4 The public sector is exposed to financial risks associated with changes to the specification or design of the project, and any delays in the process.
- 3.1.5 The public sector client is actively involved in the project during the construction period, which can lead to changes in specification, frequently resulting in cost increases and subsequent delays. Client derived variations are a significant factor in delays and cost increases to the construction process.

3.2 When PFI was first introduced in 1992 it included in its general objectives:

- 3.2.1 the aim of transferring risk to the party most appropriate for managing, pricing and financing such risk;
- 3.2.2 that projected maintenance costs should be included as part of the procurement to ensure that public sector assets are maintained in such a way as to maximise their design life;
- 3.2.3 that by aggregating design, construction and maintenance into one contract, whole life costing would be encouraged, asset value would be maximised and long-term maintenance provided for; and
- 3.2.4 that the aggregation of construction, maintenance and operations allowed for optimisation of space planning and utilisation, and greater efficiency of energy usage.

3.3 PFI projects generally transfer substantially all construction risk to the private sector as well as the risk of maintaining an asset over a substantial part of its useful life.

3.4 Many large scale capital projects, the construction of which have been delivered through traditional public procurement, have been subject to severe delay and cost overruns for which the public sector has borne substantial cost and disruption. High profile examples include the construction of the British Library and the Scottish Parliament building.

3.5 In PFI projects the risk of construction cost overruns and the financial cost of delays is effectively transferred to the private sector. The construction of capital assets through a PFI approach has a well-documented history of completion to time and budget compared to traditional procurement. In our experience, where difficulties have arisen in construction, the private sector parties involved, particularly the independent equity investors, have responded quickly to remedy the problems arising with no additional cost being borne by the public sector (see 4.2 for an example).

3.6 Traditional procurement requires the public sector to fund the capital cost and, therefore, disburse funds prior to commissioning of the asset and commencement of the service for which the asset is required.

3.7 PFI procurement demonstrates the mirror image of these problems:

- 3.7.1 The public sector is not exposed to the incremental cost of overruns, although it will bear certain consequences of delay. As noted above, however, the proportion of PFI projects which encounter delay is much fewer than in traditional procurement.
- 3.7.2 Under PFI, the private sector is obliged to reserve sufficient capital to ensure assets are maintained to standards agreed with the public sector at the signing of the agreements.

- 3.7.3 The public sector only pays when the service it has specified is delivered.
- 3.8 There are other advantages offered by PFI compared with traditional procurement:
- 3.8.1 PFI procurement encourages whole life costing, whereas traditional procurement focuses mainly on the initial construction costs.
- 3.8.2 PFI procurement involves considerable independent scrutiny of both the feasibility of the project and costs relating to the capital asset and its whole life maintenance as part of the due diligence required by equity investors and lenders to the project, from which the public sector benefits.
- 3.8.3 Under PFI project structures, the performance of the asset and the related service delivery is actively managed throughout the concession by the private sector parties involved in the project. Asset performance is measured continuously as part of the PFI project arrangements.
- 3.8.4 PFI contracts provide a high level of transparency on the cost and performance of any particular asset over a long period of time. Detailed performance measures for the project are agreed by the public sector at the outset and updated asset registers are maintained throughout the life of the project.
- 3.9 Some of the perceived criticisms of PFI are discussed below:
- 3.9.1 PFI projects are often criticised for being inflexible. The reality of the provision of complex capital assets is that once designed and built, subsequent major changes to the asset can be difficult to implement. This applies whether or not the complex capital asset was procured by traditional means or by PFI. The inflexibility of PFI is often attributed to the expense and difficulty of changing aspects of the PFI transaction. These problems are accentuated by the capital structure used in most PFI transactions, where leverage is  $\geq 90\%$  and hence all variations require multi-party involvement and consent. Such leverage results in a low cost of capital but is restrictive to future change as there is little incentive on lenders (who are the dominant capital providers) to facilitate change.
- 3.9.2 The procurement of PFI projects is more complex than traditional procurement because, in addition to the procurement of a capital asset, PFI projects involve provision for whole life maintenance and other services, all procured at the outset. This complexity leads to higher costs for bidding consortia. With long procurement cycles abort costs can be very high, increasing barriers to entry and long-term costs.
- 3.9.3 The divergence of procuring bodies in the public sector does not facilitate the development of expertise in what is a sophisticated and complex procurement methodology. This further increases the cost of bidding, with a resulting increase in the cost of PFI projects.
- 3.9.4 Techniques used to determine best value for money by the public sector have been adapted to recognise whole life costs and, in part, the risk transfer associated with PFI procurement. Comparative evaluation works well where risks can be evaluated by reference to a reliable body of data and relevant experience, such as construction costs bid under traditional procurement and the cost over-runs incurred by the public sector under such procurement. The use of such evaluation is restricted where there is limited reliable data, such as historical costs of long-term maintenance of capital assets by the public sector. Historically, the true costs and risks of maintaining capital assets have been distorted by deferring such costs on a discretionary basis, even though the useful life of the capital asset is compromised.
- 3.9.5 The evaluation of PFI tenders is undertaken assuming a static business, whereas most PFI projects have been implemented in areas which are subject to significant potential change during the life of the asset. No account is taken in comparative evaluation of PFI bids of the value of flexibility during the operating period.

#### 4. *How far can risk really be transferred from public to private sector?*

4.1 We comment below on the transfer of risk to the private sector in each phase of a typical PFI project. During construction:

- 4.1.1 the risk of cost overruns is successfully transferred to the private sector;
- 4.1.2 the financial risk of delays can be passed to the private sector. The consequential costs of delay in utilisation of the asset cannot be transferred completely but, in many cases, are mitigated by the private sector providing alternative assets and services during the delay period and/or contributing to the public sector's costs through the payment of liquidated damages;
- 4.1.3 design risk can be transferred to the private sector to the extent that the detailed design and asset construction has to meet the public sector's output specification. The private sector cannot easily take the risk of future design changes required to meet changes in the public sector's requirements which are not anticipated at the construction stage.

4.2 One example evidencing transfer of construction risk to the private sector in PFI projects involved several schools and other local authority buildings being built by Jarvis, where BIF was an investor in these projects. Jarvis Group experienced financial difficulties in late 2004 which resulted in the construction on several projects (including schools at Rhondda, Croydon and Kirklees, and fire stations at Tyne & Wear)

stalling. To remedy this problem, BIF and other third party shareholders committed significant human resources to restructure the finance, identify and negotiate with contractors to fulfil the role of Jarvis on the failing projects and to commit more capital to meet the incremental costs to ensure that contract obligations were fulfilled and facilities were completed to specification. The public sector incurred no additional direct costs, although completion of construction was delayed. Under traditional procurement, the public sector would have met the incremental construction cost in full and would have incurred additional costs for consultants and advisers.

4.3 There is proven risk transfer to the private sector during the operational phase of PFI projects as follows:

4.3.1 Building maintenance and compliance with building regulations is integral to the whole life approach implicit in PFI procurement and is successfully transferred to the private sector under these arrangements.

4.3.2 Through financial incentives included in the payment mechanisms of PFI projects, risk of asset performance is successfully transferred to the private sector together with the risk of continuity of performance to the standard demanded by the public sector at the start of the project.

4.4 Insurance risk can be transferred to the private sector, which provides for the adequacy of capital to remedy problems that are insurable. Government self-insuring does not necessarily provide the adequacy of capital in a timely manner.

4.5 Force majeure risk cannot be transferred effectively.

*5. Are there particular kinds of risk which are particularly appropriate for transfer through PFI deals or particular projects which are riskier to PFI?*

5.1 The risks described in the previous section can appropriately be transferred to the private sector: cost overruns, asset construction and commissioning, continuity of asset performance, asset based service delivery and maintenance of asset condition throughout concession life.

5.2 Projects which require the construction or renovation, and subsequent maintenance of specific assets are applicable to PFI deals.

5.3 Other types of project where there is a high degree of certainty of usage over time are also suitable for PFI.

5.4 Projects and risks that are not suited to PFI procurement include:

5.4.1 where the capital asset has a relatively short useful life, and/or where there is a considerable risk of technological obsolescence;

5.4.2 where there is a high cost and risk associated with project development—bearing such risks will not result in a low cost of capital for infrastructure finance.

5.5 Small capital projects which are let on an individual basis are unlikely to be procured cost effectively as PFI projects. However, bundling small projects of a similar type can be successfully procured using PFI.

5.6 Very large complex capital projects can be procured successfully through a PFI approach, but the procurement needs to address the capacity constraints that arise from time to time in the private sector capital markets if good value for money is to be secured. Very large projects tend not to attract independent investors, so much of the due diligence and independence of management which benefits most of PFI is lost. Alternative procurement strategies utilising private sector capital may be more appropriate for these projects (the recent auction for HS1 is a good example).

*6. What state guarantees are applicable or implicit in PFI deals?*

6.1 Most PFI projects are structured in such a way that the revenue is received from a contractual relationship with a government entity based upon the delivery of a pre-determined service or the availability of a particular asset. Although such arrangements, being contractual, present a very strong covenant supporting a PFI project, there are no explicit guarantees from government and none are assumed by the private sector.

6.2 In some cases, there are obligations on the government to facilitate transfer of the payment obligation of a failing public sector counterparty to a financially sound alternative. These arrangements support the very strong covenant behind PFI projects but are not, of themselves, a guarantee of a payment regardless of performance of obligations by the private sector.

6.3 There are no general implicit guarantees in PFI projects. If the private sector counterparty fails, the project will be allowed to fail (on terms that are generally favourable to the public sector). If the public sector counterparty fails, the project could also fail if the government wishes it to.

6.4 The contractual nature of PFI and its acceptance by international investors is dependant upon the acceptance of the government covenant of payment, and may in the minds of some infer that there is a form of guarantee.

### 7. In what circumstances are PFI deals suitable for delivery of services?

7.1 Services that are associated with maintaining the capital asset over its useful life, and hence part of the optimisation of whole life cost are integral to a PFI arrangement.

7.2 Services that are capable of objective measurement and are quantifiable are suitable for transfer in PFI contracts.

7.3 Services that can be priced over a long period of time are, within the current structure of PFI, suitable for transfer.

7.4 A wide range of support services not associated with the capital asset has historically been procured as part of certain PFI projects. This can be achieved successfully but there may be other procurement strategies for such services that offer the public sector more flexibility and/or better value for money.

### 8. Other aspects of PFI

8.1 PFI has been referred to as “being like a mortgage.” This is misleading as the mortgage provider does not have any ongoing obligations for the long-term maintenance of assets nor for the delivery of any related services.

8.2 PFI structures have been successfully implemented by a number of countries, creating potential for export opportunities for participants from the construction, facilities management and financial services industries.

8.3 The introduction of PFI has led to the creation of infrastructure as an asset class—particularly the social infrastructure asset class. This is an attractive asset class for pension funds and both institutional and private financial investors, together with international Sovereign Wealth Funds seeking long-term low-volatility investment opportunities. This increases inward investment into the UK.

8.4 Successful PFI encourages the public and private sectors to work together with common objectives for long periods of time which breaks down barriers and, given the capital requirement for new and refurbished infrastructure, it appears that both parties will need to work together in the future.

8.5 Greater flexibility could be created in PFI structures if financial structures, performance and public sector requirements were reviewed during operations and less focus was put on the lowest cost of capital at financial close. If more focus was placed on the long-term operation of the asset and the management of outcomes between the public and private partners, greater flexibility would follow.

8.6 Service delivery under PFI can be and is frequently characterised as a zero-sum business. The construction and long-term management of infrastructure should be seen as a non-zero sum business with the shared objective of improving the quality and quantity of infrastructure.

8.7 Most PFI projects are financed using project finance techniques. Project finance was primarily developed to finance assets with reducing value over time—for example oil and mineral reserves. This structure allows very high leverage but does not encourage active management of the asset for incremental value post construction. Within PFI the main focus is on construction and it is the cost of construction that dominates evaluation, yet it is arguably the operation of assets that is far more important and valuable to the public sector in the long-term.

8.8 The efficiency and incremental value added by of different methods of capital procurement can be enhanced by the public and private sectors working together on infrastructure projects from inception through to operation with the same objectives—the improvement of the quality and quantity of infrastructure. In structures such as NHS LIFT, the public and private sectors worked together on the development, construction and operation of infrastructure with shared objectives and rewards.

8.9 The Infrastructure Plan for the UK presented by Infrastructure UK recently indicated that capital expenditure on infrastructure for the next five years will be in the region of £200 billion. To fulfil this objective, capital and management input from both the public and private sectors will be required.

## APPENDIX

### PROJECT LIST

	<i>PFI Projects</i>	<i>Location</i>	<i>Financial close date</i>	<i>Build cost (£m)</i>
1	Aberdeenshire Schools	Scotland	01-Feb-01	14.3
2	Addenbrookes Hospital	London & SE	27-Oct-04	70.9
3	A249	South East	04-Jun-04	79.0
4	A92	Scotland	01-Oct-03	53.5
5	Alert Communications	N/a	01-Jun-00	53.0
6	Argyll & Bute Schools	Scotland	01-Dec-06	120.0
7	Bangor Schools	Northern Ireland	01-Sep-06	34.7
8	Bannockburn Homes (MoD)	Scotland	01-Jul-99	37.0

<i>PFI Projects</i>	<i>Location</i>	<i>Financial close date</i>	<i>Build cost (£m)</i>	
9	Barking & Dagenham Schools	London & SE	30-Mar-04	47.0
10	Bexley Leisure	London & SE	05-Jul-02	21.0
11	Bodmin Hospital	South West	08-Jan-01	16.4
12	Boldon School	North East	13-Apr-05	18.0
13	Bolton Schools	North West	12-Apr-02	9.2
14	Bournemouth Library	South West	30-Nov-00	10.0
15	Bridlington Schools	North East	31-Dec-00	18.0
16	Brighton Schools	South East	08-Mar-02	21.0
17	Bromley Hospital	London & SE	30-Nov-98	114.0
18	Bury Hospital	South East	24-Jan-01	5.8
19	Caerphilly Schools	Wales	01-Apr-01	26.9
20	Calderdale Hospital	North West	31-Jul-98	76.0
21	Castlehill Hospital	Midlands	01-Jul-00	8.9
22	Catchment Highland Waste Water	Scotland	01-Aug-97	34.7
23	Catchment Moray Waste Water	Scotland	01-Mar-01	63.4
24	Catchment Tay Waste Water	Scotland	01-Dec-99	86.1
25	CGL Rail	London & SE	11-Oct-96	202.0
26	Chepstow Community Hospital	Wales	01-Jan-98	9.0
27	Cheshire Police	North West	24-Nov-04	16.9
28	Chester-le-Street Hospital	North East	30-May-02	8.3
29	Clarendon College	Midlands	15-Jan-98	11.7
30	Connect A30/A35	South West	01-Oct-96	120.0
31	Connect A50	South West	01-Jul-96	35.0
32	Connect M1/A1	North East	01-Mar-96	250.0
33	Connect M77	Scotland	30-Apr-03	138.0
34	Covesea Homes (MoD)	Scotland	18-Jun-98	28.0
35	Croydon Schools	London & SE	20-May-04	20.5
36	Dartford & Gravesham Hospital	London & SE	31-Jul-97	92.0
37	Debden School	South East	31-Mar-00	14.0
38	Doncaster Mental Health	North East	11-Aug-03	15.0
39	Doncaster Schools	North East	14-May-07	48.5
40	Dorset Fire and Rescue	South West	04-Jul-07	52.0
41	Dudley Schools	Midlands	01-Jan-02	21.4
42	Dumfries Hospital	Scotland	01-May-00	9.2
43	Ealing Care Homes	London & SE	31-Mar-05	22.0
44	East Anglia Courts	London & SE	31-Oct-02	26.0
45	East Ayrshire Schools	Scotland	01-Jun-06	78.3
46	East Lothian Schools	Scotland	01-Dec-02	54.5
47	Eastbrook Accommodation (DEFRA)	South East	01-Mar-02	25.0
48	Edinburgh Royal Infirmary Hospital	Scotland	01-Aug-98	208.0
49	Edinburgh Schools	Scotland	01-Jan-01	132.0
50	Exchequer Partnership 1	London & SE	17-Jul-00	14.1
51	Exchequer Partnership 2	London & SE	20-Dec-02	143.0
52	Fasttrax (HET)	South West	14-Dec-01	65.0
53	Fife Schools	Scotland	01-Nov-05	63.4
54	Forfar Community Hospital	Scotland	02-Sep-03	11.7
55	FPMS Marine Services	South West	14-Dec-07	143.0
56	Genistics Power (FEPS)	North West	20-Jun-02	73.0
57	New Victoria & Stobhill Hospitals (Glasgow ACAD)	Scotland	22-Aug-06	178.0
58	Grannag School	South West	05-Mar-99	11.7
59	Guildhouse—Nottingham Police	Midlands	19-Dec-08	5.3
60	Guildhouse—Willesden Community Hospital	London & SE	31-Jul-08	25.9
61	Haringey Schools	London & SE	31-Oct-00	35.0
62	HMP Belmarsh West	London & SE	29-Jun-10	97.4
63	Humberside Courts	London & SE	31-Mar-00	18.8
64	Ingleby Schools	North East	23-Apr-02	9.4
65	James Watt College	Scotland	31-Mar-99	7.7
66	JSCSC Training College	South West	05-Jun-98	88.9
67	Kenton School	North East	30-Jan-01	33.0
68	King's College Hospital	London & SE	16-Dec-99	104.0
69	Kirklees Schools	North East	30-Mar-01	45.0
70	Larkfield Hospital	Scotland	25-May-99	103.0
71	Leeds BSF	North East	03-Apr-07	132.8
72	Leeds Schools	North East	01-Jan-01	36.6

<i>PFI Projects</i>	<i>Location</i>	<i>Financial close date</i>	<i>Build cost (£m)</i>	
73	Lewisham Hospital	London & SE	07-Jul-04	57.8
74	Liverpool Schools	North West	05-Oct-01	60.0
75	Lochgilphead Hospital	Scotland	02-Feb-04	17.0
76	Luton Hospital	London & SE	21-Nov-00	10.0
77	Manchester Schools	North West	01-Aug-05	29.1
78	Midlothian Schools	Scotland	01-Jul-06	41.2
79	Newham Hospital	London & SE	05-Sep-00	16.0
80	Newton Abbot Hospital	South West	12-Apr-07	19.7
81	Norfolk & Norwich Hospital	South East	30-Jan-98	187.0
82	North Ayrshire Schools	Scotland	01-Mar-06	83.5
83	North Durham Hospital	North East	01-Jan-98	70.3
84	Nuffield Hospital	London & SE	19-Apr-02	35.8
85	Oldham Library	North West	28-May-04	14.8
86	Oxford Churchill Oncology	South West	13-Dec-05	124.3
87	PCF Kilmarnock Prison	Scotland	10-Nov-97	32.4
88	PCF Lowdham Grange Prison	Midlands	07-Nov-96	26.6
89	PCF Medomsley Training Centre	North East	12-Nov-98	10.3
90	PCF Moreton Prison	Wales	27-Sep-99	69.6
91	PCF Pucklechurch Prison	South West	01-Jul-98	32.0
92	Penweddig School	Wales	16-Sep-99	10.0
93	Perth Council Offices	Scotland	30-Jun-99	16.2
94	Plymouth Schools	South West	27-Feb-07	37.3
95	Rhondda Cynon Taf Schools	Wales	31-Mar-04	29.9
96	Richmond Schools	London & SE	06-Jun-02	29.0
97	RMG A1(M)	London & SE	08-Feb-96	128.0
98	RMG A417/419	South West	08-Feb-96	110.0
99	RMS D2D (A1 Ferrybridge/Wetherby)	North East	07-May-03	245.0
100	Ryhurst Avon & Wilts	South West	01-Mar-04	64.0
101	Ryhurst Bexley	London & SE	23-Apr-02	13.0
102	Ryhurst Black Country	Midlands	23-Apr-02	5.0
103	Ryhurst Epping Forest	London & SE	05-Apr-05	14.0
104	Ryhurst Essex & Herts	South East	23-Apr-02	10.0
105	Ryhurst Hertford	London & SE	12-May-03	9.0
106	Ryhurst Liskeard	South West	17-Jul-02	7.0
107	Ryhurst Lymington	South West	18-Nov-04	29.0
108	Ryhurst Redbridge	London & SE	23-Apr-02	9.0
109	Ryhurst South Essex	London & SE	28-Jul-03	6.0
110	Ryhurst West Mendip	South West	21-Oct-03	7.0
111	Salford Schools	North West	20-Nov-06	37.0
112	Salford Schools—Eccles	North West	18-Mar-03	20.0
113	Salisbury Hospital	South West	31-Mar-04	22.4
114	Sandwell BSF	Midlands	31-Jul-09	177.0
115	Sedgefield Hospital	North East	19-Jul-01	7.7
116	South Tees Hospital	North East	31-Aug-99	122.0
117	St Georges Hospital	London & SE	20-Mar-00	61.8
118	St Helens BSF	North West	02-Dec-10	35.5
119	Staffordshire Street Lighting	Midlands	01-Mar-03	31.1
120	Stirling (Gateway) Schools	Scotland	01-Apr-06	102.0
121	Stirling Centre College	Scotland	20-Jan-97	2.9
122	Stobhill Hospital	Scotland	01-Jun-05	16.5
123	Sunderland Schools	North East	17-Aug-01	16.0
124	Swindon Hospital	South West	31-Oct-99	92.0
125	Tiverton Hospital	South West	04-Jul-02	11.1
126	Torbay Schools	South West	31-Mar-00	14.0
127	Traffic Information Services (TiS)	North West	27-Mar-01	81.8
128	Tyne & Wear Fire Stations	North East	28-Mar-03	24.0
129	Vinci Derby Schools	Midlands	23-Dec-04	38.9
130	Vinci Dorset Police	South West	16-Mar-00	16.2
131	Vinci Medway Police	South East	08-Jul-04	19.8
132	Vinci Newport Schools	Wales	14-Mar-08	15.7
133	Vinci Swindon Police	South West	20-Dec-03	19.8
134	Walsall Street Lighting	Midlands	28-Mar-02	17.0
135	Wansbeck Hospital	North East	01-Nov-00	14.4
136	West Cumbria Police HQ	North West	30-Jun-00	3.9
137	West Lothian Schools	Scotland	31-Aug-01	27.0

<i>PFI Projects</i>	<i>Location</i>	<i>Financial close date</i>	<i>Build cost (£m)</i>
138 Wirral Schools	North West	27-Mar-01	56.0
139 Wishaw Hospital	Scotland	26-Jun-98	148.4
140 Worcester Hospital	Midlands	22-Mar-99	108.0
141 Workington Community Hospital	North West	01-Aug-03	7.0
142 York Primary Schools	North East	12-Jan-05	14.9
<i>Non-PFI Projects</i>	<i>Location</i>	<i>Financial close date</i>	<i>Build cost (£m)</i>
143 AMP Medway LIFT	South East	24-May-05	15.5
144 AMP Redbridge LIFT	London & SE	04-Aug-04	15.1
145 CSPC Barnsley LIFT	North East	30-Jan-04	23.0
146 CSPC Bury LIFT	North West	29-Jun-07	29.8
147 CSPC Camden & Islington LIFT	London & SE	16-Jul-04	19.9
148 CSPC Doncaster LIFT	North East	01-Oct-05	26.4
149 CSPC East Hampshire & Gosport LIFT	South East	10-Feb-05	12.4
150 CSPC Plymouth LIFT	South West	30-Sep-08	4.1
151 CSPC PMP	N/A	01-Sep-06	38.8
152 ELIL Cumbria LIFT	North West	15-Dec-10	2.6
153 Guildhouse—Beswick Healthcare	North West	13-Jul-08	2.6
154 Guildhouse—Norfolk LIFT	South East	31-Jul-08	23.9
155 Guildhouse—South East Midlands LIFT	Midlands	19-Dec-08	6.6
156 London Luton Airport	London & SE	31-Aug-98	80.0
157 Manchester Student Village	North West	31-Dec-99	22.0
158 Primaria Barking & Havering LIFT	London & SE	04-Dec-03	20.5
159 Primaria Leeds LIFT	North East	15-Mar-04	58.8
160 Primaria Tees LIFT	North East	09-Dec-10	10.1
161 Prime Birmingham and Solihull LIFT (BaSS)	Midlands	31-Dec-04	33.5
162 Prime North Staffs LIFT	Midlands	03-Feb-05	12.7
163 Ryhurst Medway LIFT	N/A	24-May-05	16.0
164 Ryhurst Redbridge LIFT	N/A	04-Aug-04	15.0
165 Tricomm Bath Bristol & Portsmouth	South West	30-Nov-01	82.0
166 Tricomm Portsmouth	South East	28-Oct-05	28.3
167 UPP Duncreggan	Northern Ireland	22-May-02	9.0
168 UPP Exeter	South West	24-Sep-09	77.0
169 UPP Greenwich	London & SE	04-Dec-02	29.0
170 UPP Kent	South East	26-Oct-07	25.0
171 UPP Lancaster	North West	27-Feb-03	9.9
172 UPP Loughborough	Midlands	06-Jun-07	43.0
173 UPP NTU Clifton	Midlands	17-May-10	32.0
174 UPP Nottingham Broadgate Park	Midlands	04-Jun-03	80.0
175 UPP Plymouth	South West	31-Oct-98	12.0
176 UPP Plymouth II	South West	30-Jun-04	N/a
177 UPP Reading	South West	31-Oct-00	9.0
178 UPP Reading St Georges	South West	04-Jun-03	7.0
179 UPP RNCM	North West	30-Nov-00	16.0
180 UPP York	North East	28-Feb-01	42.2

May 2011

### Written evidence submitted by the North Tees and Hartlepool NHS Foundation Trust

#### BACKGROUND

North Tees and Hartlepool NHS Foundation Trust is a provider of acute and community healthcare services in the North East of England. Its services are provided to a population of c500,000 people predominantly located in the communities of Hartlepool, Stockton on Tees, Easington and Sedgefield.

The Trust operates from two district general hospitals, University Hospital of North Tees and University Hospital of Hartlepool, as well as a number of other smaller facilities which are particularly used in the delivery of community services.

Prior to achieving Foundation Trust status, a new management team was appointed and the organisation was then one of the first NHS Trusts to achieve financial turnaround having been operating a significant deficit. It has achieved a surplus for each of the following financial years and achieved Foundation Trust status in 2007.

The Trust was the first provider of acute services to be awarded a contract to provide community services in its locality and has done so since November 2008. This is now the most popular model for community service provision within the NHS.

The Trust and its PCT commissioners have a collective and whole system approach to delivering healthcare across the whole of North Teesside. A programme, the Momentum: Pathways to Healthcare programme, has been established with a Programme Board co-chaired by the Chief Executives of both the Trust and its main commissioners. This approach is a direct response to a number of reviews of healthcare provision in the locality, the most recent being by professor, now Lord, Darzi and the Independent Reconfiguration Panel. The latter recommended that a whole system healthcare approach be taken and that there be one (rather than two) district general hospitals serving the population of North Teesside and that this hospital be equally accessible to all communities the Trust serves. The Trust has taken equally positive and proactive steps to secure a new hospital in accordance with the IRP recommendation.

It has purchased a greenfield site, close to the local major trunk road, the A19 and has secured outline planning permission for the new hospital.

The new hospital scheme was originally to be publically funded but, following the review of capital commitments by the Coalition Government, the Trust was asked to consider other funding routes for its new facilities. The Trust has considered all available options and has concluded that private finance and the use of the private finance initiative is currently its preferred option.

Within the Trust's Executive Team there is a significant amount of PFI experience, both in terms of putting PFI schemes in place and in terms of running and managing PFI schemes. This extensive experience over five PFI hospitals, has given the team significant hands on learning and it therefore wishes to improve upon the existing model in delivering its new facilities. It continues to review all private finance options to seek to ensure that it obtains the best terms for any private funding.

This submission therefore focuses on the lessons learnt from the operational PFI schemes and the Trust's suggestions for improvement which the Trust wishes to adopt in its new hospital venture.

## LESSONS LEARNT

As mentioned above, members of the Trust's Executive Management Team have put three PFI schemes in place and managed the operation of two others. The experience gained was within other NHS Trusts. The Trust's Director of Operations also worked in the private sector for a company which provided facilities management and lifecycle investment to services in PFI environments and therefore understands PFI from two key perspectives.

The key issues which arose from an operational perspective are as follows:

<i>Issue</i>	<i>Commentary</i>
Cost of additional works and services	— Time taken for estimates often in excess of contract timescales. — Costs often had to be challenged and often were significantly reduced when checked by a cost consultant engaged by the Trust.
Services provided outside of PFI arrangements	— Some PFI schemes had services provided outside of PFI payment mechanism arrangements, but which were critical to the operation of the hospital. — Sole remedy clauses meant that the Trust was unable to incentivise performance or remedy issues easily.
Benchmarking/market testing	— No detailed arrangements were included for benchmarking or the parameters for comparisons to be used for benchmarking. — There were/are very few comparable sites and services with which to compare. — Benchmarking was exclusively the PFI providers' responsibility and would benefit from involvement of the Trust. — Requests for price increases as a result of benchmarking exercises across two PFI schemes varied between 7% and 20%. These were challenged. Subsequently a significant reduction was negotiated on one scheme and the benchmarking exercise re-run on the other. — On another contract a unique tailored arrangement was agreed for five years.
Keeping track of changes	— Logging changes and keeping the payment mechanism up to date was often overlooked. Change in personnel within both organisations meant a loss of corporate knowledge. This could be improved upon in any new contracts.

<i>Issue</i>	<i>Commentary</i>
Payment Mechanism	<ul style="list-style-type: none"> <li>— Often too compartmentalised in approach, with the Trust’s own commercial risks not mirrored sufficiently well. For example, NHS providers can also face deductions from commissioners where required service levels are not achieved. This means that:</li> <li>— The triggers for unavailability and service failures can often not reflect operational needs or working practices;</li> <li>— Self measurement of performance is not necessarily reliable and, to avoid challenge and queries, joint performance management may be more effective;</li> </ul> <p>Built environment condition should also be linked to the Trust’s own performance requirements for premises which are detailed in the Trust’s own commissioning contract.</p>
Payment Mechanism and Independent Tester overlap	A number of installations such as heating, ventilation, ICT and so on would benefit from some sort of bedding in period to demonstrate performance in accordance with contract requirements. These should not be signed off by an independent tester as fully functional units until the technology has proven itself in practice in normal operational conditions.
Insurance	Arrangements for insurance have usually placed responsibility with the PFI provider. This mechanism may or may not prove to be value for money and could be more flexible to allow for the entity best placed to secure insurance to be able to do so.
Lifecycle arrangements	Greater transparency on costing including pricing for risk and involvement of the public sector in determining replacement timing would be beneficial. Often expertise in such lifecycle planning within NHS Trusts and other public bodies has not been utilised effectively or at all within the PFI schemes.
Shareholding arrangements	Many shareholding arrangements are often for an initial period of one year post construction completion and then can often be amended with offshore and corporate shareholders/directors put in place. This often means that true ownership details of those ultimately running or managing the schemes are not easy to determine. Such arrangements lack transparency and can mean that a Trust or other public sector body does not know who it is truly contracting with or how well that business is performing. In a long term arrangement increased transparency would be helpful. In addition some control over shareholding and other changes may be useful to ensure that a true partnership can develop and continue.

There were a number of other project specific operational issues which arose which were unique to the drafting of the PFI contracts in question.

In all instances some vigilance and management at a high level within the Trust was needed to ensure that the correct amount was payable for all services provided.

The time taken to manage a PFI contract was in excess of that originally anticipated. The self monitoring of performance by the PFI providers whilst useful, did not mean that the Trust itself did not have to monitor the provision of services.

In all instances change is inevitable and early and continual appraisal of performance to match operational needs is essential.

#### SOFT MARKET TESTING

The Trust has undertaken three separate soft market testing exercises and in each instance met with at least five key private sector PFI providers. Discussions and interviews took place over a three year period and the following key themes were discussed:

- Lessons learnt from operation PFI schemes from both a public and private sector perspective.
- Funding availability and funder appetite for PFI..
- Costing of risk and which entity is best placed to take each risk.
- Approach to procurement including methodology and cost.
- Procurement timescales.
- The Trust’s preference to address each of the operational issues addressed in section on Lessons Learnt above and the private sector view on such issues.

In particular discussion took place in respect of the Trust’s wish to create a “new generation PFI” :

- to carry out “front of house” hard facilities management services eg. decoration, replacement of floor coverings, general wear and tear and thereby reduce the lifecycle costs paid to the private sector. Also, the Trust would undertake minor works such as hanging pictures, putting up shelves, moving sockets and so on;
- have the private sector continue to be responsible for hard infrastructure such as the energy centre, pipe and duct work, heating and ventilation, windows, roofs, masonry etc;
- to have joint contract performance monitoring;
- to have insurance purchased by the entity best placed to achieve value for money;
- to have the Payment Mechanism recalibrated to ensure that overall risk weighting remained as has traditionally been the case but that weightings within the mechanism reflect the true risk of loss of income to the Trust and better reflect commissioning contracts incentives and penalties; and
- that cost certainty for variations is ensured and represents value for money;

All considered in some depth and positively received as a sensible way forward by the private sector.

#### NEW GENERATION PFI

The Trust believes that in addressing the lessons learnt and revising PFI as detailed above would:

- build on the strengths of PFI;
- address operational concerns;
- ensure a facilities management model which would give better control to and input from the public sector;
- ensure lifecycle investment is carried out at an optimum level;
- ensure a truly tailored and incentivising payment regime;
- be more cost effective; and
- offer the opportunity for a greater sharing of benefits.

Whilst initially the proposed adjustments would take a little extra time to negotiate, thereafter the benefits of standardisation would apply.

Private sector and public sector costs would be reduced, there would be less duplication of effort by all parties involved, more appropriate risk transfer and sharing of risks would apply, funding institutions would remain confident in the model and staffing arrangements would be more stable than in early schemes.

The Trust is keen to exploit the benefits of PFI and learn from experience to date. It looks forward to involving private sector input both financially and operationally into its new scheme and feels that the above approach could harness all of these aspirations in a market acceptable way.

The Trust and key members of its Executive Management Team would be happy to give evidence at interview should you so wish.

We apologise for the late submission of this paper which resulted from overlapping annual leave during April.

May 2011

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#### Written evidence submitted by Dr Chris Lonsdale, University of Birmingham

##### EXECUTIVE SUMMARY

- Many of the shortcomings of the PFI have reflected more general problems within UK public sector procurement.
- In terms of commercial skills and capabilities, the UK public sector has spent the 20-year life of the PFI attempting to create the necessary capacity. For many years, there seemed to be too little appreciation in the higher civil service ranks of the extent of the difficulties of complex procurements.
- Genuine risk transfer is hard, although not at all impossible, for the public sector to achieve on major projects as a commercial team’s negotiation stance is often affected by both the need to perform, without interruption, statutory duties and political imperatives.
- Risk transfer under the PFI, and in public sector procurement generally, has been further affected by limited public sector commercial skills.
- Collaborative working under the PFI has been criticised in the past. However, “strategic supplier management” is a relatively weak area of procurement practice in general.

## INTRODUCTION

1. The Committee raises a number of pertinent questions in this inquiry. As the National Audit Office has said on a number of occasions, however, the evidence available makes it difficult to produce definitive answers. Nevertheless, some observations are possible and those here will mainly focus upon risk transfer.

2. A key task in any attempt to answer the type of questions posed by the Committee is to differentiate between those factors driving commercial outcomes that are inherent to the PFI and those that are common to UK public sector (and, for that matter, private sector) procurement practice more generally.

3. Issues related to the raising of finance, re-financing, excessive transaction costs and the designing of projects so that they are feasible for the PFI would appear to be, or have been, PFI-specific. Also specific to the PFI are concerns over the public sector comparator process and the “off-balance sheet” controversy.

4. However, other issues, including one of the Committee’s specific issues of concern, the transfer of risk, are more generic, either to UK public sector procurement or procurement practice in general. In this submission, I intend to focus on this latter category of issue, as my work extends beyond the confines of the PFI and therefore comparative observations can be made. Such a focus may also mean that this submission provides a different perspective from others.

## COMMERCIAL SKILLS AND CAPABILITIES

5. In the political arena, the PFI is often casually referred to as a form of privatisation. This is, of course, not the case, not least when it comes to the benefits that might accrue to the UK from its adoption. With privatisation, a set of economic activities is taken out of the public sector. With the PFI, economic activities remain a direct concern of the public sector and any benefits that the public sector obtains from private sector involvement have to be earned through effective procurement and contract management.

6. Many reports have claimed that the increased use of the private sector in delivering public services and infrastructure over the past 30 years or so has generated benefits for the UK taxpayer. For example, the Julius Report<sup>i</sup> cited cost savings of between 10% and 30%. These figures may or may not be accurate. However, value for money improvements (whether they be the aforementioned cost improvements or improvements from the other side of the value for money equation) cannot be assumed to automatically follow from private sector involvement, or from a deepening of such involvement (such as that which the PFI represents). Indeed, they will not follow if, as has been the case with the PFI, there has been a persistent, if by no means complete, lack of negotiation and contract management capability brought to bear on individual projects.

7. Recent talk of a “revolution” in local government, with the Nicholas Ridley vision of an enabling authority at last potentially coming into being, suggests that there is still an under-estimation within large parts of the UK public sector and political ranks of the difficulty of effective procurement and contract management, and the shortage of genuine talent, especially when it comes to complex procurements. The proposed local government “revolution” (and ambitious outsourcing plans generally within the UK public sector) is reminiscent of the PFI—a policy that is to be rolled out ahead of capacity.

8. Complex procurements, which PFIs usually are, contain relationship-specific investments and high switching costs (which render the threat of a return to the market less credible), uncertainty (which make negotiations over contract variations inevitable) and information asymmetries (which raise the possibility of moral hazard during contract delivery). These are highly challenging circumstances that test the best commercial minds. The extent of the team-building, preparation and internal political engagement that led to the successful procurement by National Savings and Investments in the late 1990s is instructive of the level of care and resources needed for success.<sup>ii</sup>

9. Part of this under-estimation of complex procurements would also appear to be related to a lack of appreciation on the part of some of the sophistication, determination and robustness with which some private sector organisations pursue their self-interest as suppliers. This is a controversial area in the procurement and related economic literature, both empirically and philosophically (ie there is a debate over the frequency and extent of private sector robustness and a debate over the ethics of such robustness), but often public sector procurement and contract management practice has seemed weak or naïve, or both. As a head of a PFI unit within an NHS Trust commented in 2007: “Without doubt, the private sector will try to come back for extra money for every risk they haven’t thought of before and do so by trying to pass off that risk as something new. They will use everything to increase costs, in particular any ambiguities in the trust’s requirements. It is like a game of chess and you need an experienced team who knows how to play the game in order to obtain value for money.”<sup>iii</sup>

10. To a significant extent, therefore, many of the weaknesses in practice that can be identified across a large range of PFI projects, and which have limited the benefits of the policy, are simply a reflection of weaknesses in UK public procurement in general—an observation that cuts a different way across the question of the strengths and weaknesses of different public procurement methods.

11. The problem of frequent asymmetries of skills and capabilities, vis-à-vis private sector counterparts, has also, as the National Audit Office continues to report, been supplemented by inadequate historical information held by government departments. Problems have existed at a number of levels.

## RISK TRANSFER

12. A key question being asked in this inquiry relates to risk transfer. A further question, regarding state guarantees, would appear to be related. The issue of risk transfer is affected by the aforementioned problems with commercial acumen, but is affected by other factors as well. Many of the problems with risk transfer under the PFI are not PFI-specific.

13. here are a number of ways in which the term “risk transfer” can be understood, but my understanding here is highlighted by two contrasting situations. In the aforementioned National Savings and Investments PPP, Siemens Business Services was expected to take the risk of being able to reduce the cost of the business operation being outsourced—that is, if target costs were not met, no further monies would be made available to cover the consequent losses. In the PPP between the Ministry of Defence and Devonport Management Limited, by contrast, there was a cost overrun of £283 million on the Devonport facilities upgrade.<sup>iv</sup> In this case, rightly or wrongly, the main responsibility for footing the bill ended up with the Ministry of Defence, despite the fact that the original agreement stipulated that the risk for such an eventuality had been passed to the supplier.

14. There often appears to be an underlying asymmetry in PFI and other significant public sector procurements in respect of risk transfer. There often seems to be an emphasis on the public sector body, given its statutory duties and wider political sensitivities, to both “do the deal” and ensure service continuity/project delivery. While an extreme example, the Libra project run by the Lord Chancellor’s Department, as was, highlighted this point.<sup>v</sup> The supplier simply had a greater ability to walk away from the project, which was a major factor in the negotiations. In short, it facilitated “hold-up”.

15. If true, this means that the public body needs to work hard to create a contractual arrangement that will allow risk to be genuinely transferred. This is possible, as the National Savings and Investments procurement showed, but again highlights the need for highly developed commercial functions. It also highlights how the EU procurement regulations can often make life no easier in this respect.

16. If we look at private sector practice, we see that one of the criteria for the selection of “strategic partners” (that is, suppliers used for complex, long-term contracts) is the amount of influence the private sector buying organisation has/will have over a supplier. This influence, in turn, is something that flows, in part, from the attractiveness to individual suppliers of the buying organisation’s offer of business. Different suppliers in a supply market will often view a buyer’s offer of business differently. A recent report by the highly-regarded consultancies Future Purchasing and Vantage Partners, referred to this as an analysis of “strategic interdependence”.<sup>vi</sup>

17. Private sector organisations can (and many do) include this criterion in their supplier selection methodology and explicitly seek to avoid selecting for complex, long-term projects those suppliers that are unlikely to be willing to accept a reasonable level of risk—because of how they view the buying organisation. Because of the EU procurement regulations, the inclusion of such a criterion in public sector procurements is much harder (although some things can be done and sometimes a project can, in its own right, be very attractive to even the most dominant players in the market). This fact, allied to the aforementioned lack of commercial acumen in many areas of the UK public sector and perceived need to “do the deal”, may explain why, in research I have undertaken with two colleagues, we found that in the private sector contractual strife decreased with the need for relationship-specific investments, while in the public sector it increased—not dramatically so, but to a statistically significant extent. Private sector buying organisations seem, on average, to be able to manage the dependencies that arise from the need for relationship-specific investments better than those in the public sector.

18. To refer back to the National Savings and Investments PPP again, the reason why National Savings and Investments was successful in transferring risk, whereas some other public sector bodies have been less successful, was that it succeeded in creating “private enforcement capital” during the procurement process—it made future business under the contract contingent on initial performance, posted a “hostage” and carefully crafted the contractual re-numeration arrangements. This success, in turn, was the result of a careful designing of the project, so as to generate market interest in an “attractive” project, a careful management of the competitive process, so that competitive pressure was maintained, a resistance of internal political pressure, especially over time, and extensive knowledge of the operation being outsourced under the PPP. Underlying all of this was also an appreciation of the need to manage the dependences that would inevitably arise out of the need for relationship-specific investments.

19. Therefore, the answer to the question regarding whether risk transfer can occur under the PFI (and in other complex public sector procurements) is yes, but that there are many factors that make it difficult.

20. As a supplement to above discussion, the frequent inability of public sector bodies to develop an interdependent relationship with a supplier may also be behind the findings of the National Audit Office that there is little evidence in many areas of the PFI of collaborative working—that is, in the cause of increasing the value created by the relationship.<sup>vii</sup> However, it should be noted that limited collaborative working is a broader issue within UK public sector procurement—and within procurement generally. A report by the International Procurement Leadership Forum in 2008 reported that “strategic supplier management was still in its infancy” both within the public and private sector.<sup>viii</sup>

## CONCLUSION

21. In this submission, it has been argued that some of the problems with the PFI, for example, those related to risk transfer, are part of broader shortcomings across UK public sector procurement—and, to some extent, procurement practice in general. Some of these issues and shortcomings appear to have been addressed, at least in part, over the years since the inception of the PFI in 1992, although problems remain.<sup>ix</sup> Having said this, while many problems of the PFI are generic, there is no question that the imperatives of the PFI have meant that, on many occasions, projects have been even more complex than they would have been using other procurement methods. This has put an even greater strain on a shaky commercial skill base.

May 2011

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### **Written evidence submitted by the Specialist Engineering Contractors' Group**

#### THE SPECIALIST ENGINEERING CONTRACTORS' (SEC) GROUP

1. SEC Group represents the specialist engineering sector which accounts for up to 40% of the work done on many PFI projects and facilities. SEC Group is an umbrella body for six of the construction industry's premier trade associations.

Association of Plumbing and Heating Contractors  
 British Constructional Steelwork Association  
 Electrical Contractors' Association  
 Heating and Ventilating Contractors' Association  
 Lift and Escalator Industry Association  
 SELECT (Electrical Contractors' Association for Scotland).

Together these organisations act on behalf of a sector comprising over 60,000 firms and a workforce of more than 300,000. They account for the largest single component (by value) of construction output. Further information is available on the SEC Group website— [www.secgroup.org.uk](http://www.secgroup.org.uk).

#### WEAKNESSES IN THE PFI PROCUREMENT METHOD

2. The primary driver in the development of the PFI model for delivering public assets has been the transfer of risk from the public sector to the private sector. In practice much of the private sector risk has been transferred to the firms in the construction supply chain delivering the asset or facility. Many of these firms are unable to accommodate the risks passed down to them either because of size and/or levels of capitalisation. Inappropriate risk allocation does not deliver value for money.

3. Construction contracts for PFI facilities are usually let using traditional procurement routes. Traditional construction procurement does not generally deliver modern facilities that are sustainable and efficient in respect of energy use and maintenance. Traditional construction procurement is characterised by the lack of any buy-in from the supply chain delivering the asset to decisions on design, risk and cost. Countless reports have advocated a solution to this which, in summary, requires that the asset should be delivered by an integrated

project team whose decisions on critical matters—especially design, risk and cost—should be underwritten by project insurance.

4. It is not proposed to develop this since the ground has already been covered in the various reports. Reference should be made to *Re-thinking Construction* (Sir John Egan, 1998); *Improving Public Services through better construction* (NAO, March 2005) and *Construction matters* (House of Commons Business and Enterprise Select Committee, 2008).

However we invite the Treasury Select Committee to recommend as follows:

There should only be financial close on pfi projects when it is demonstrated that the construction of the facility will be undertaken by integrated project teams. Furthermore the government should require departments to nominate pfi projects that are suitable to pilot project insurance that will underwrite the cost plan agreed by the team.

5. We have already made reference to the fact that there is inappropriate risk allocation in supply chain construction contracts on PFI projects. A major problem for construction firms in the supply chain is payment abuse such as lengthy payment periods and spurious grounds given for not discharging payments. We, therefore, invite the Treasury Select Committee to make two further recommendations:

- (a) All supply chain construction/maintenance contracts to be let using nec forms of contracts.<sup>95</sup> these should be unamended with the exception of the “z clauses” permitted by the cabinet office dealing with matters such as confidentiality and security.
- (b) All supply chain payments on pfi construction contracts, maintenance and facilities management contracts should be made through a project bank account. (The remaining part of this submission explains in rather more detail the concept of project bank accounts).

The House of Commons Business and Enterprise Committee’s ‘Construction matters’ Report of July 2008 stated that ‘both the Office of Government Commerce and the National Audit Office have endorsed the use of project bank accounts as a means of improving payment practices and facilitating integrated working. Central government procurers should now start to make use of project bank accounts, where practicable and cost-effective. The OGC should monitor take-up and evaluate benefits’.

In November 2010 the Cabinet Office recommended that public sector procurers should move towards the use of PBAs “unless there were compelling reasons not to do so”.

## 6. PROJECT BANK ACCOUNTS

The use of PBAs will establish a fair and transparent payment system which ensures that those firms delivering and managing the facility receive prompt payment for monies that are rightfully due to them through the payment mechanism in their contracts. The account could be, initially, set up by the Special Purpose Vehicle. The account should be ring-fenced through a trust deed and all authorised payments should be made directly by the bank to members of the supply chain delivering and managing the facility.<sup>96</sup>

With the money held independently in trust by the bank as a third party, there is increased transparency over cash flow. One can see exactly when and to whom monies are being transferred to. This gives assurance to the team that payments will be made promptly, thereby improving trust and collaboration (leading to fewer disputes, better value for money and increased productivity) and resulting in further savings over time through reduced overheads associated with debt collection and administration. In addition their use should, in theory at least, avoid the need for parties to price for insolvency risk, thereby providing a further cost benefit. A major advantage of project bank accounts is that the supply chain is protected from insolvency of firms higher up the chain since the monies, as trust monies, are not available to creditors; in the event of an upstream insolvency payments can still be made to the supply chain directly from the bank account.

## 7. BENEFITS AND SAVINGS ARISING FROM THE USE OF PBAS

The Government estimates savings of up to 2½% on project costs through using PBAs. As already mentioned PBAs will promote a culture of collaboration and trust along the supply chain delivering and managing PFI facilities which, in turn, helps to create greater efficiencies.

## 8. CONTRACTS PROVIDING FOR PBAS

The industry’s standard forms provide for PBAs. The NEC has published a project bank account Z clause.

## 9. USE OF PBAS

Crossrail—the largest construction project in Europe—has confirmed that it is using PBAs. The Defence Infrastructure Organisation (DIO) has announced that PBAs will be used on all their construction contracts from

<sup>95</sup> NEC refers to the Engineering and Construction Contract (and related contracts) published by Thomas Telford. The Cabinet Office considers that NEC contracts offer value for money since they require pro-active and efficient project management. NEC contracts were used by the Olympic Delivery Authority and are now being used by Crossrail.

<sup>96</sup> Barclays Bank, Bank of Scotland and HSBC have PBA documentation such as trust deeds and bank mandates.

2013 when work starts using the Next Generation Estate Contracts. A recent example was the redevelopment of RAD Wyton, the Midlands Medical Accommodation project in Lichfield. DIO expects to spend around £500m a year on housing for the services, training estate, and regional facilities under its new regional and national capital works frameworks.

The highways agency has also used project bank accounts. therefore there is already considerable experience in using accounts in the construction industry.

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**Written evidence submitted by Dexter Whitfield, Director, European Services Strategy Unit, and  
Adjunct Associate Professor, Australian Institute for Social Research, University of Adelaide**

**SALE OF EQUITY IN PFI COMPANIES**

**EXECUTIVE SUMMARY**

1. Government monitoring of the sale of equity in PFI companies is inadequate, infrequent and underestimates the scale of transactions. Meanwhile banks and construction companies are extracting large profits from what is ultimately publicly financed investment.

2. The sale of equity is significantly higher than that the sales identified in the HM Treasury PFI equity database and estimated by the National Audit Office. The ESSU PPP Equity Database identifies:

- 240 PPP equity transactions involved 1,229 PFI projects (including multiple sale of some projects) valued at £10.0 billion.
- Average profit was 50.6% (compared to average operating profits in PFI construction companies of 1.5% between 2003–09).
- £517.9 million profit from a sample of 154 PFI projects. If the same level of profit were maintained for the 622 PPP project equity transactions the total profit would be £2.2 billion.
- Profits could be as high as £4.2 billion if the same level of profits is obtained by the sale of secondary funds as in the direct sale of equity in PFI companies.
- Two sectors had higher than average profits, health (66.7%) and criminal justice (54.9%) with transport (47.1%) and education (34.1%) below average.
- An increasing number of PFI projects are registered in tax havens.

**SALE OF PFI EQUITY AND GROWTH OF THE SECONDARY MARKET**

3. There are basically two types of PFI equity transactions. Firstly, SPV shareholders selling equity in individual projects or in a group of projects. Secondly, the sale of secondary market infrastructure funds that have a portfolio of PFI equity stakes in SPVs. In both cases the partial or full ownership of equity in the SPV transfers to a new owner. PFI equity ownership also changes when a construction company is subject to a takeover or merger, however, the value of PFI assets will normally be reflected in the overall takeover price and will not be identified separately.

4. The PFI contract will normally impose a restriction on the sale of equity prior to the completion of the building works and commencement of the service. Once operational, contractors can sell their equity and are only required to inform the authority within 30 days of any change of ownership. Refinancing and the sale of PFI equity comprise the secondary market.

5. Some PFI companies have a policy of retaining ownership of equity in SPVs whilst others recycle their investments by selling equity to help finance new PFI projects. Four trends are evident in the secondary market:

- portfolio building by some construction companies;
- recycling and profit-taking by other construction companies;
- growth of joint ventures between PFI construction companies and banks, infrastructure funds and pension funds; and
- growth of secondary market infrastructure funds (listed and unlisted).

**GOVERNMENT ADOPTS “HANDS-OFF” ATTITUDE**

6. Although public sector consent and profit sharing is required when PFI projects are refinanced, there are no requirements when the equity of PFI companies is sold. The Treasury has regarded the sale of PFI equity as a transaction solely between private companies in which the government has no involvement. It argues that a change in the equity ownership of the project is part of the normal takeover or merger of companies and is different from refinancing projects. The National Audit Office (NAO) position is:

“In general, the shareholders of a project company are allowed to trade their PFI shares freely, as they would any normal shares of a limited company. Only occasionally would a public authority have a say in such trades, such as a right to consent (not unreasonably withheld) in certain Defence

contracts. The public authority is not a party to such trades and does not share in any proceeds. It is therefore important that the expected return to the shareholders over the course of the whole contract be carefully scrutinised during the contract tendering” (House of Lords, 2010b).

#### LONGER-TERM CONSEQUENCES IGNORED

7. The NAO recognises that the risk of the consolidation of PFI equity could lead to “...disproportionate market power, and particular asymmetry of power over small public authorities tendering and managing single PFI contracts. We would be concerned if we started to see a few consolidated owners dictating contract and commercial terms. We do not have evidence that this is happening” (ibid). It concedes that “...the lack of visibility over the secondary market it is difficult to ascertain the effects that the secondary market has had to date” (ibid).

8. The Treasury and NAO are either unaware, or have decided to ignore, the excessively high profit levels obtained in PFI equity transactions. The NAO assumes that the growing secondary market will have little or no effect on PFI projects, services users, staff and public bodies. However, *Global Auction of Public Assets* raises a number of important issues about the potential effects of the sale of PFI equity and the growth of secondary market infrastructure funds:

- invalidation of value for money claims because high profit levels appear to indicate significant overpayment for risk transfer;
- allocation of benefits from operational efficiencies;
- privatisation of gains from publicly financed investment and development;
- erosion of democratic control;
- increasing secrecy;
- acceleration of the marketisation of public services; and
- longer-term implications of the growth of secondary market funds and the potential effect on the delivery of core services (Whitfield, 2010).

#### NEW DATABASE

9. The ESSU Database was compiled from Stock Exchange Regulatory News Service and Company Notices and Press Releases; Company Interim and Annual Reports & Accounts; UK Companies Houses filings; Infrastructure fund share prospectuses; Construction and PFI company websites; HM Treasury PFI equity holders database; Partnerships UK Database; Securities & Exchange Commission 8K filings for US stock exchange companies; and financial, construction and infrastructure journals and web sites.

10. There are significant problems regarding access to, and the quality, of equity transactions in PFI companies. Many publicly listed companies will issue a Regulatory Notice or Stock Exchange announcement disclosing the acquisition or disposal of PFI equity, but in some cases companies consider the transaction is not of material financial interest. Privately-owned companies and private equity funds have no comparable disclosure requirements. A company may report the details of an equity sale or acquisition in their interim or annual report, but may not indicate the price, level of profit nor to whom they sold their shareholding. There is no common practice or standard requirement.

11. The SPV shareholders usually have pre-emption rights, which allow them the right to acquire the shares of other shareholders who want to sell their equity.

#### GROWTH OF PFI EQUITY SALES 1998–2010

12. The Database records 222 UK equity transactions between 1998–2010 covering 622 PFI projects. The annual rate of PFI equity transactions, not surprisingly, increased rapidly between 2000–04 during the formative years of the secondary market. There are inevitably variations in the number, and the total value, of transactions on an annual basis, reflecting the completion of PFI projects, recycling decisions of PFI contractors depending on their contract win-rates and secondary market funds seeking to expand their portfolios. The financial crisis appears to have had a minimal effect on PFI equity transactions.

**Table 1**

ANNUAL RATE AND VALUE OF UK PFI DIRECT EQUITY SALES

Year	No of equity transactions	No of PFI projects (includes those with multiple equity sales)	Value of equity sold (£m) (No of transactions)	Estimated total value based on average (£m)
1998	1	1	3.4 (1)	3.4
1999	1	1	n/a	n/a
2000	5	6	n/a	n/a
2001	5	15	117.4 (4)	146.7
2002	3	3	n/a	n/a

<i>Year</i>	<i>No of equity transactions</i>	<i>No of PFI projects (includes those with multiple equity sales)</i>	<i>Value of equity sold (£m) (No of transactions)</i>	<i>Estimated total value based on average (£m)</i>
2003	16	30	135.6 (8)	271.2
2004	33	95	190.6 (14)	449.3
2005	38	59	306.3 (16)	727.5
2006	35	127	1,431.7 (24)	2,087.9
2007	21	66	401.8 (16)	527.4
2008	16	92	333.0 (8)	666.0
2009	29	60	370.4 (20)	537.1
2010	19	67	586.7 (14)	796.2
<b>Total</b>	<b>228</b>	<b>622</b>	<b>3,876.9</b>	<b>6,212.7</b>

Sources: ESSU PPP Equity Database, 2011

#### SECTOR DIFFERENCES

13. Health and Education PFI projects account for half of individual PFI equity project sales between 1998–2010—see Table 2. Transport, primarily roads and motorways, public transport and street lighting projects account for just over 10% followed by criminal justice—prisons, courts, remand centres—with 9%.

**Table 2**

#### INDIVIDUAL PFI EQUITY TRANSACTIONS BY SECTOR 1998–2010

<i>Sector</i>	<i>No. of PFI projects in equity transactions</i>	<i>%</i>
Health—hospitals and health centres	166	26.7
Education—schools and collages	148	23.8
Transport—public transport, roads & street lighting	65	10.5
Criminal Justice—prisons, courts, remand centres	57	9.2
Waste/Water	17	2.7
Defence	14	2.2
Housing—rehab of council estates & MoD housing	10	1.6
Leisure	10	1.6
Misc	35	5.6
Unknown	100	16.1
<b>Total</b>	<b>622</b>	<b>100.0</b>

Source: ESSU PPP Equity Database, 2011

#### PFI PROJECTS SOLD MULTIPLE TIMES

14. The ESSU PPP Equity Database records 370 PPP projects in which equity in the SPV has been sold. For example, the equity in the Barnet Hospital PFI project was subject to five transactions as HSBC Infrastructure increased its equity from 30% to 100%. The Calderdale Hospital PFI company was involved in nine equity transactions between 2002–10 (Whitfield, 2011).

**Table 3**

#### PFI PROJECTS IN MULTIPLE SALE OF EQUITY

<i>No. of PFI projects</i>	<i>No. of transactions</i>
267	1
59	2
24	3
10	4
4	5
3	6
1	7
1	8
1	9

Source: ESSU PPP Equity Database, 2011

#### SALE OF SECONDARY FUNDS

15. Thirteen sales of secondary market funds between 2003–10 had a total value of £3.1 billion and involved an additional 607 PPP projects (Table 4).

**Table 4**

## SECONDARY FUND EQUITY SALES IN UK

<i>Owner</i>	<i>Sold to</i>	<i>No of PFI projects</i>	<i>Price £m</i>
Grosvenor House Group plc (2003)	n/a	5 (estimate)	4.0
Babcock Brown and Abbey National (2003)	Star Capital Partners, Bank of Scotland and AMP Capital Investors	23	n/a
Infrastructure Investors LP (Barclays, Societe Generale and 3i) (2005)	3i Group	31	150.0
HSBC Infrastructure Ltd and HSBC Infrastructure Fund (2006)	HSBC Infrastructure Company (HICL). PFI assets transferred to new listed company.	15	250.0
Investors in the Community Ltd (2007)	Trillium (Land Securities)	16	7.4
PFI Infrastructure Company (2007)	Infrastructure Investors LP (Barclays, Societe Generale and 3i)	22	156.0
Star Capital Partners, Halifax Bank of Scotland, AMP Capital Investors (2007)	Trillium (Land Securities)	79	927.0
Land Securities plc (2008)	Land Securities launches Trillium Investment Partners, a PPP Joint Venture	100 (estimate)	n/a
3i Group plc (2009)	Placed in market	n/a	60.8
Land Securities (2009)	Telereal	108	750.0
Telereal (2009)	Victorian Funds Management Corporation (Australia) and Transport for London Pension Fund	108	n/a
Infrastructure Investors LP—Barclays acquire Societe Generale (31.7%), 3i (31.7%) and Fleming (4.9%) (2009)	Barclay Private Equity Integrated Infrastructure Fund	84	558.6
John Laing (2010)	John Laing Infrastructure Fund (John Laing has 23% stake)	16	242.3
Total (13 transactions)		607	3,106.1 (10 transactions)

Source: ESSU PPP Equity Database, 2011

16. When the sale of equity in individual and group transactions is combined with the transfer of ownership when infrastructure funds are sold, the total number of equity transactions increases to 240 involving 1,229 PFI projects, including multiple transactions of some projects (Table 5).

**Table 5**

## TOTAL OF PFI EQUITY AND SECONDARY FUND EQUITY SALES

<i>Year</i>	<i>No of transactions</i>	<i>No of PFI projects (includes multiple sales)</i>	<i>Value of equity sold (£m) (No of transactions)</i>	<i>Estimated total value based on average transaction (£m)</i>
Sale of PFI equity	228	622	3,876.9	6,212.7
Sale of secondary funds	12	607	3,106.1	3,727.3
Total	240	1,229	6,983.0	9,940.0

Source: ESSU PPP Equity Database, 2011

17. Joint ventures between PFI companies and infrastructure funds accounted for about 10% of equity sales. The sale of secondary funds accounted for only 5% of transactions but nearly half (49%) of PFI project equity sales.

## PROFITS FROM PFI EQUITY SALES

18. The ESSU Database contains 63 transactions involving 154 PFI projects, where the sale price and profit from the equity transaction, are identified from reliable sources. The total value of equity sold was £1,026.6 million with £517.9 million declared profit (50.6%). The transactions were spread across the 2003–10 period with a diversity of construction companies and infrastructure funds, types of project, geographic location and size of project (Whitfield, 2011).

19. There are wide differences in the average profit rates between sectors with the average profit being 50.6%. Two sectors have higher than average profits, health (66.7%) and criminal justice (54.9%) with transport (47.1%) and education (34.1%) below average. The 'multiple' category in Table 6 includes transactions covering a number of different types of assets and where the total profit was stated for a group of projects.

**Table 6**  
PROFIT ON SALE OF PFI EQUITY IN UK (INCLUDES MULTIPLE EXAMPLES)

<i>Sector</i>	<i>No of PFI transactions</i>	<i>No of PFI projects</i>	<i>Value of equity sold (£m)</i>	<i>Total Profit (£m)</i>	<i>Average % profit</i>
Health	14	18	129.3	86.3	66.7
Education	6	8	47.8	16.3	34.1
Transport	8	12	101.8	48.0	47.1
Criminal Justice	6	15	122.4	67.2	54.9
Housing	1	1	5.2	4.2	80.8
Waste/Water	1	1	12.0	8.0	66.7
Leisure	1	5	6.5	5.6	86.2
Defence	2	2	9.3	12.5	134.4
Multiple	24	93	587.7	269.0	45.8
Total	63	154	1,022.0	517.1	50.6

Source: ESSU PPP Equity Database, 2011

20. If the same profit level of the sample of PFI projects were maintained for the 622 PFI projects involved in equity transactions, the total profit would be £2.2 billion.

21. Similarly, if the same rate of profit was achieved in the sale of secondary funds, the profit from PFI equity sales would be a further £2.0bn, giving a total profit of £4.2 billion

22. The rate of profit achieved by PFI construction companies is exceedingly high with two companies achieving over 70% (Lend Lease Corporation and Balfour Beatty) and four companies over 50% (John Laing, Interserve, Kajima Partnerships and Kier Group). Table 7 includes only the PFI equity transactions where profit information was available (none declared a loss) and does not reflect the full performance of PFI equity investment by these companies.

**Table 7**  
MAJOR SELLERS OF PFI EQUITY IN UK BETWEEN 1998–2010 (BASED ON TABLE 5)

<i>Company</i>	<i>No of PFI projects</i>	<i>Sale value (£m)</i>	<i>Profit (£m)</i>	<i>%</i>
Carillion plc	24	278.8	114.1	40.9
John Laing	22	170.3	100.6	59.1
Interserve plc	15	70.3	37.9	53.9
Lend Lease Corporation	11	14.7	11.5	78.2
Costain Group plc	8	37.1	16.2	42.9
Serco Group plc	7	79.9	16.0	20.0
Balfour Beatty plc	5	37.8	27.0	71.4
Kajima Partnerships	6	30.2	18.0	59.6
Kier Group plc	4	26.1	14.7	56.3

Source: ESSU PPP Equity Database, 2011

23. The profits in PFI projects contrast sharply with construction operating profit rates of the same contractors. These have remained low throughout the last decade. The average operating profit in UK construction/building activities for four major PFI construction companies (Balfour Beatty plc, Carillion plc, Costain plc and Kier Group plc) was 1.5% between 2003–09 (Company Annual Reports).

#### USE OF TAX HAVENS IN PFI EQUITY TRANSACTIONS

24. The equity in 91 PFI projects is owned by secondary market infrastructure funds located in tax havens (Table 8).

**Table 8**  
PPP INFRASTRUCTURE FUNDS LOCATED IN TAX HAVENS

<i>Company</i>	<i>Tax haven</i>	<i>No of PFI assets</i>	<i>PFI projects</i>
HSBC Infrastructure	Guernsey	33	Substantial stakes in hospitals, schools, police stations, Home Office Headquarters, London.
John Laing Infrastructure Fund	Guernsey	19	Range of schools, social housing, hospitals, courts, police stations and street lighting projects.
3i Infrastructure Fund (3i Groups owns 33.2%)	Jersey	18	Norfolk & Norwich University Hospital (26.0), Alpha Schools, Highland (50.0), Elgin Infrastructure Fund (joint venture with Robertson Group)
International Public Partnerships (formerly Babcock Brown Public Partnerships)	Guernsey	14	100% shareholding in schools and criminal justice PPP companies.
GCP Infrastructure Fund Ltd— Gravis Capital Partners	Jersey	7	4 investments in Grosvenor PFI Holdings and 3 in Investment in Leisure Infrastructure Investors Ltd
<b>Total</b>		<b>91</b>	

Source: ESSU PPP Equity Database, 2011

#### TRANSFER OF PFI EQUITY ASSETS TO CONTRACTOR'S PENSION FUNDS

25. At least five companies, Interserve, Amec, John Laing, Costain and Vinci, transferred PFI equity to their pension funds in lieu of cash payments or the transfer of other assets. The pension funds records ownership of the asset in its accounts and receives future dividends (Whitfield, 2011).

#### RECOMMENDATIONS

1. The standard PFI contract should be re-written to include a ceiling imposed on the level of profits that can be extracted from PFI equity together with a requirement that the public sector should have a 50% share in any profit above a specified level.
2. A new value for money methodology should be devised to take account of the profiteering in PFI equity transactions and the other flaws in the current evaluation methodology.
3. New transparency and disclosure requirements should be introduced as a matter of urgency requiring more expansive notification about equity sales.
4. The Treasury PFI database should be significantly extended to include historic and future PFI equity sales, be publicly available and regularly updated.
5. The National Audit Office and Treasury should research the longer-term effects of the growing secondary market.
6. Ultimately, the negative effects of the PFI equity secondary market can only be solved by the termination of the PFI programme combined with new regulatory controls on existing projects.

June 2011

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### **Written evidence submitted by Equility Capital Ltd**

The evidence presented herein shows that as much as £62 billion of tax-payers money has been wasted on PFI, due solely and exclusively to the flawed perception that we must keep infrastructure funding off-balance sheet.

We also demonstrate that the Capital Lease Infrastructure Program (CLIP) funding option will immediately introduce savings on cost-of-finance in the order of 50%+ (from current 12% to 15% to 6% or less) with no effect on operations and maintenance. Also, with the ability to produce surplus funds that can be re-directed into social infrastructure.

Before moving forward with this Paper, it is important to understand that Equility Capital works directly with an investment management company for a consortium of financial institutions. These are comprised principally of life companies, pension funds, large investment banks and sovereign wealth funds.

In short the CLIP process described herein is resourced with what can probably be regarded as one of the world's largest financial resources focused exclusively on infrastructure funding.

However, the investment business of the investors is their private concern. Therefore, Equility Capital has arranged that selected names of the financial institutions participating in this consortium will be given only to Ministers of buying departments and members of the Treasury Select Committee who arrange a conference call direct with the US-based investment manager.

#### **INTRODUCTION**

This Evidence Paper is presented by Equility Capital Ltd, an alternative capital brokerage firm established in 2009 in response to the new capital and financing structures that began to emerge in the wake of the global financial meltdown. We now work with a wide range of hedge funds, asset/investment/wealth managers who are introducing innovative financing structures into the market. These new structures fall under the general heading of "Alternative Capital".

Equility Capital is widely regarded as the leading global brand in this rapidly emerging market. Further information on our company is available at [www.equilitycapital.com](http://www.equilitycapital.com).

This evidence paper has been produced on the advice of Jesse Norman MP, a member of the Commons Treasury Select Committee, after a meeting held in his Hereford constituency office on 10 June.

#### **INFRASTRUCTURE FUNDING BACKGROUND**

As Eric Pickles, Secretary of State for Communities and Local Government, remarked soon after the coalition took office, the UK has relied on the private sector to provide its key infrastructure needs for hundreds of years. In more recent years this has translated into PFI and, even more recently DBFO. Both these structures are driven by the perceived need to assign all risk for the project to the private sector, in so doing keeping it off the national balance sheet.

The cost of this approach is already well known and is the driver behind the Committee's call for PFI Evidence Papers.

Equility Capital takes the position that the continuing requirement to remove all risk from the balance sheet is anachronistic when set against today's financing and underwriting options. While the rest of the world is confidently embracing new funding structures, and powering ahead with their infrastructure programmes, the UK remains trapped in the misplaced, inward looking (and obscenely expensive) belief that it must assign all risk to the private sector to reduce liability on the balance sheet.

This approach is obsolete. Using new financing structures and state of the art construction programme management techniques, now widely used around the rest of the world, the UK can have all the infrastructure it needs by employing lease-based funding programmes. Yes, it will appear on the balance sheet but, as the funding is lease based, so will the asset.

Sophisticated and proven risk-mitigation programmes and 21st century project management methods also remove risk by 99%, the remaining 1% being tectonic events that would destroy the entire, global political and economic firmament.

## CAPITAL LEASE INFRASTRUCTURE PROGRAMME (CLIP)

To starkly illustrate the obscene amount of money that has been wasted on PFI, and is due to continue to be wasted on DBFO, driven simply by the balance sheet/risk assignment fixation, is starkly presented in the following comparative figures for existing PFI programs, compared to costs that WOULD have been incurred had the Capital Lease Infrastructure Programme (CLIP) been used:

## COMPLETED PFI PROJECTS

Source: PartnershipsUK  
(May 2011)

<i>Region</i>	<i>No. of Projects</i>	<i>Value £000,000</i>	
East of England	47	2,838	
East Midlands	60	2,494	
London	139	28,907	
North East	47	1,992	
North West	81	4,659	
Northern Ireland	35	1,016	
South East	81	7,509	
South West	62	3,524	
Scotland	120	6,396	
Wales	42	1,016	
West Midlands	58	3,810	
Yorks & Humber	67	2,726	
	838	66,887	(Principal)
Monthly interest @ 12%/20 years		736	(8,832pa)
Monthly interest @ 6%/20 years		479	(5,742pa)
Monthly saving		248	(3,090pa)
Cost of funds saving over 20 years		61,800	

*£62 billion of waste to satisfy an accounting process*

This table shows that, had CLIP been the financing source for all current PFI projects, the saving to the country would by now be in the order of £61.8bn. A saving we have not achieved simply and exclusively because we have not been able to overcome the fixation on the balance sheet/risk assignment dynamic.

ALSO, and equally important, at the end of the lease period the asset reverts in its entirety to the borrower. That can be NHS, DfT, a local authority or any other government entity.

## CLIP BALANCE SHEET TREATMENT

It is proposed that CLIP is given a different balance sheet treatment to traditional PFI or DBFO social and economic infrastructure funding programmes.

CLIP relies on the credit rating of the borrower, AAA from all agencies for the UK, and from the funders' standpoint the risk will rest 100% with HM Government. This is simply a requirement of the investors in order for the project to secure the significantly lower cost of funds. They are required to invest in investment grade rated entities in order to provide maximum protection and long-term, predictable returns for their pensioners and policyholders.

However whilst the investors will rely on the UK's AAA rating, over the past five to 10 years, project management processes have advanced significantly and to the point where risk is now dispersed and diluted across the supply chain for the entire project. In short, risk at all stages of construction is assigned to any one of the growing range of insurance companies and underwriters who provide a huge diversity of insurance wraps and performance bonds.

The ACTUAL risk to HM Government is, in reality, limited to force majeure that would, in any event, undermine the entire global financial and political firmament. And even these 'Acts of God' can be covered with the insurance wraps that are now available. In order to address the balance sheet treatment of CLIP funding for UK infrastructure it is therefore essential to understand the REAL as opposed to PERCEIVED risk of applying the funding to the balance sheet.

The points therefore that are addressed in this proposal are:

1. Preserving our AAA rating.
2. Balance sheet process for CLIP funding.
3. Stabilizing overall infrastructure costs.

### 1. *Preserving our AAA rating*

Even though PFI and DBFO funded infrastructure projects are off-balance sheet, the credit rating agencies are fully aware of them and their impact on our economic stability. Actually having them off-balance sheet makes not the slightest difference to our rating.

Currently, in order to assign risk to the private sector through PFI/DBFO we are paying in the order of 12% to 15% when, in fact, contractors are off-setting risk to their own underwriters (and including the charge for that in their cost of funds).

We propose that CLIP funded infrastructure projects are actually posted to the balance sheet with an indicative annotation thus:

#### *All Risks Private Sector Underwritten (ARPSU)\**

Defined as (proposed):

All construction, performance and other risks relating to the financial stability or performance of this project has been underwritten by private sector insurers.

\*The above definition will, undoubtedly, become more detailed and specific should the Committee decide to adopt these proposals. They are shown here only for illustrative purposes.

On the opposite side of the balance sheet the assets to which these ARPSU costs refer can be shown.

In this way, exactly the same protections enjoyed by the private sector, at a cost to us of between 12% and 15% can be assigned to the taxpayer at a much reduced cost of (currently) 5.5% to 6%.

However, a key part of the process will be to advise the UK analysts at Moody's, S&P and Fitch that this new infrastructure accounting process is being adopted and why it is being done. This should be done not by a simple notification, but by presenting all aspects of this policy to them face-to-face. The agencies will respond positively if it is seen that steps are being taken to reduce the financing costs of our much needed infrastructure, with perceived risks mitigated by 99%.

### 2. *Balance sheet process for CLIP funding*

In order for this to be acceptable to the rating agencies and, indeed, to HM Government itself, the process for applying CLIP funding to the balance sheet needs to be rigorous and based on proven best project management practice.

Essentially this hinges on the following:

- Each contract in the supply chain is shown to be underwritten for financial, material, performance and all other factors.
- The insurance/underwriters must be acceptable to the project manager and the relevant government purchasing department. They will need to demonstrate financial stability (probably based on credit agency rating) with proven track record in providing the relevant insurance wraps to infrastructure projects.
- The project managers themselves are experienced and can demonstrate acceptable financial stability.

As noted above with our ARPSU proposal we realise that these are only headline, indicative requirements. However, Equility Capital has close relationships with a number of leading, global infrastructure project management firms. Working with them as well as directly with the fund manager, we are positioned to produce the full process for these CLIP funding proposals within a short time. An estimated three months.

It may be required that a small CLIP transaction processing team will be required at HM Treasury, in which case we can assign liaison staff working directly with the fund manager.

### 3. *Stabilizing overall infrastructure costs*

We fully appreciate that incurring any additional liability on the balance sheet, even within the proposals we have set forth here, might be seen as potentially hazardous. The third stage of our proposal is, therefore, that for every NEW project financed through CLIP, we select an existing PFI project (or a number of them) with an equivalent outstanding value for RE-FINANCE.

In this way a new project financed at, say, 6%, can be off-set against an existing (or number of) PFI project(s) with an equivalent principal value but with the cost of finance reduced from, say, 12% to 6%. In this way, we are stabilizing our infrastructure costs.

It must also be kept in mind that under the CLIP process, all revenues received (after lease and operating costs) are retained by the borrowing entity. That might be an NHS trust, bridge, railway or any other asset that is currently seeing those revenues being dispersed amongst contractors and financiers. These operating profits can be re-directed into social infrastructure.

Naturally unpicking PFI agreements, even though they may have opt-out clauses, will take significantly longer than arranging new CLIP funded projects. These can take anywhere between 45 and 120 days, against a re-financing that could take anywhere between six and 12 months.

For those PFI deals selected for re-financing, Equility Capital can assign a liaison to ensure that all the funder's requirements are met and coordinated right through to the point of closing.

June 2011

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### Written evidence submitted by Professor Allyson Pollock, Queen Mary, University of London

#### 1. INTRODUCTION

1.1 The following submission summarises previously published findings that are relevant to the scope of the present inquiry and to the conclusions reached by the National Audit Office (NAO) in its last report on the private finance initiative (PFI).<sup>97</sup> I address two of the Committee's questions, namely, what are the strengths and weaknesses of different public procurement methods, and how far can risk really be transferred from the public to the private sector?

1.2 I make two main claims. The first is that, notwithstanding a growing body of scholarly research over the last 14 years, neither the government nor the NAO has undertaken a properly designed systematic evaluation of PFI. Secondly, I argue that sufficient case study evidence is available to justify an explicit focus by the committee on the high costs of risk transfer and the effects of affordability problems on resource allocation and service planning.

#### 2. BACKGROUND

2.1 I and my colleagues have researched and published extensively on PFI since 1997. Our findings show successive governments' failure to collect data for systematic policy evaluation and monitoring<sup>98</sup> and also the detrimental effect of PFI's relatively high cash costs on NHS resource allocation and planning.<sup>99</sup>

2.2 We have also drawn attention to the consistent failure of the NAO and successive governments to evaluate risk transfer appraisal methods and risk transfer claims underpinning the policy or to evaluate rates of return charged by the private sector for assuming risks.<sup>100</sup>

2.3. In this connection, I note that in April 2011 the NAO said of the availability of data for policy evaluation: "There is no clear data to conclude whether the use of PFI has led to demonstrably better or worse value for money than other forms of procurement."<sup>101</sup> It said of risk transfer data and returns: "There is insufficient data on the returns made by equity investors for the risks they are bearing."

2.4. In fact, these data are available in full business cases, but generally shielded from parliamentary scrutiny by "commercial in confidence" rules. I cannot understand why the NAO has failed to obtain the data and contracts, not least when there is a growing body of scholarship in this area. I note, however, that the NAO has played a prominent role in promoting PFI abroad and suggest that the Treasury Committee extend its inquiry to include potential conflict of interest between NAO income generation and financial scrutiny.

#### 3. *What are the strengths and weaknesses of different public procurement methods?*

##### 3.1 Planning and resource allocation

3.1.1 In evidence to the House of Lords Economic Affairs Committee, Pollock, Hellowell, Price, and Liebe (2009) identified the main problems of PFI in the health sector as: off-balance sheet accounting, biased value for money ('economic') appraisal, high financing costs, erroneous time and cost overrun data, and distortion of resource allocation as a result of affordability problems with meeting annual PFDI charges.

3.1.2 Hellowell and Pollock (2010) critically examined the main fiscal and economic rationales for PFI and the impact of the policy on the long-term financial viability of NHS trusts. The study concluded that the PFI funding of capital investment is highly problematic and can have a negative impact on the finances of health systems because it distorts resource allocation mechanisms at national and local level.

3.2 In 1999, Pollock, Dunningan, Gaffney, Price and Shaoul showed the impairment of planning data associated with PFI. This research found that PFI hospitals were planned on the basis of financial, not clinical, needs and that the data used in support of private finance initiative planning did not conform to the Department of Health's standards and definitions. It was also found that PFI hospitals entailed major reductions in the clinical workforce, and service capacity—in direct contradiction of government policy.

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<sup>97</sup> National Audit Office. *Lessons from PFI and other projects*. London: The Stationery Office, 2011.

<sup>98</sup> See references 6 and 9.

<sup>99</sup> See references 1, 12, 16, 17–21, 23–26, 29–35, 38–42.

<sup>100</sup> See references 3, 4, 6, 9, 13, 14, 15, 22, 28.

<sup>101</sup> National Audit Office. *Lessons from PFI and other projects*. London: The Stationery Office, 2011, p 6.

### 3.3 Affordability

3.3.1 Our first findings on the adverse effects on services of PFI affordability problems were published in 1997 and subsequently in a series of case studies. Dunnigan and Pollock (2003) undertook a systematic assessment of the impact of PFI on hospital capacity in Scotland.

3.3.2 Pollock, Price and Liebe (2011) showed that the NHS is facing serious revenue pressures if it is to meet the target of £15–20bn efficiency savings by 2013–14. A major source of revenue pressure for trust budgets in England is the annual PFI charge, which is ring-fenced and indexed to inflation. Although PFI charges pre-empt between 0.4% and 18.6% of annual hospital trust income, PFI contractors are insulated from efficiency targets. This, coupled with serious deficiencies in contract monitoring, compliance, and contract enforcement at departmental level, means that there are real concerns over the value for money of the policy. Lack of control over PFI costs has serious implications for quality and levels of NHS care.

#### 4. *How far can risk really be transferred from the public to the private sector?*

4.1 Pollock and Price (2008) drew attention to failures by the NAO to audit risk transfer and rates of return. The study found that of the 622 PFI deals signed by October 2007, the NAO has examined the relationship between risk transfer and risk premiums in only three. They concluded that the government's justification for the policy was largely unevaluated and unscrutinised by Parliament, raising wider issues of public accountability for public expenditure.

4.2 In 2007 Pollock, Price and Player highlighted substantial flaws in Treasury claims about risk transfer under PFI. UK government procurement policy rests on Treasury claims that the PFI has reduced cost and time overruns. The five studies cited by the Treasury in support of this claim were reviewed and it was found that only one purports to compare PFI with traditional procurement. The results of this single study are uninterpretable because of selection bias, small sample size (only 11 out of 451 PFI projects are included), and fundamental flaws in the analysis. There was therefore no evidence to support the Treasury cost and time overrun claims of improved efficiency in PFI. We concluded that Treasury appraisal guidance, the Green Book that compares PFI with other methods of procurement, was not evidence based but biased to favour PFI.

4.3. In 1999, Gaffney, Pollock, Price and Shaoul showed that the use of land sales and capital charges to fund investment meant that local affordability, not national priorities, determined investment; that the high costs of private sector financing increased affordability problems at national and local level; and that the increased costs of the private finance initiative were being met from hospital closure programmes, reductions in services and capacity, subsidies from the Treasury, NHS block capital allocations, and trusts' operational budgets.

4.4. In 2002 and in various papers since, I have drawn attention to weaknesses and bias in economic appraisal methodology.

June 2011

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### Written evidence submitted by Professor David Heald

#### INTRODUCTION

My memorandum concentrates on those issues raised by the Committee's request for evidence on which I have specialist expertise. I make some brief comments about other matters within the remit of this Inquiry.

#### RESPONSES TO QUESTIONS

Committee Question 2A: *If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much?*

The answer is categorically "No".

I refer the Committee to the table showing the October 2007 classification of UK Private Finance Initiative (PFI) projects as on- or off-balance sheet for financial reporting. This was included in the memorandum of evidence I submitted to the Committee in the previous Parliament, in relation to the 2008 Budget Report (Heald, 2008, p Ev67).

At the request of the then Chairman, I submitted supplementary evidence on accounting for PFI after the oral evidence session on 14 December 2009 (Heald, 2010). That memorandum provides a concise summary of the conclusions of my academic research on PFI accounting (Heald and Georgiou, 2010, 2011).

It is inconceivable that such a pattern across functional departments could have emerged as a result of the objective characteristics of particular projects. Education (0% on-balance sheet) and Health (2%) contrasted markedly with Justice (93%) and Transport (88%) (Heald, 2008). This pattern arose because of (a) public expenditure control arrangements, and (b) auditor appointments. The then Comptroller and Auditor General (Sir John Bourn) drew Parliament's attention to departments indicating on their websites that PFI projects had to be off-balance sheet, notwithstanding the Treasury's declared policy that accounting treatment would not

influence project choice. The National Audit Office (NAO) took a more restrictive line than the appointed auditors of the Audit Commission. The fact that this could happen resulted from the availability of arbitrage between the Accounting Standards Board's FRS 5A (ASB, 1998) and the Treasury Technical Note 1 (Revised) (TTN1R, Treasury Taskforce, 1999). It is also noticeable that the Northern Ireland Audit Office followed the NAO approach whereas Audit Scotland and the Wales Audit Office did not (Heald and Georgiou, 2011).

The consequences were (a) inconsistent treatment across sectors and countries, and (b) probable loss of Value-for-Money (VFM) because accounting treatment became a dominant consideration in project choice (Heald, 2003).

It is important to note that this accounting arbitrage ended with the adoption of International Financial Reporting Standards (IFRS) from 2009–10. The adoption of the mirror image of IFRIC 12 (IASB, 2006), changing the criterion from risks and rewards to control, brought almost all PFI projects on-balance sheet for financial reporting. However, the Treasury (2009b) announced in June 2009 that Spending Review 2010 would be conducted on a national accounts basis, exploiting the lax criteria in the Eurostat (2004) rules. All that is required to keep PFI projects off the national accounts public sector balance sheet is the transfer of construction risk and availability risk to the private sector consortium (Heald and Georgiou, 2011).

Committee Question 2B: *How should PFI deals be accounted for?*

I have written extensively on this topic (Heald, 2010; Heald and Georgiou, 2010, 2011), so I will here concentrate on the major issues without providing full justification for my conclusions.

The crucial point to note is that there are two separate types of accounting for government activity: that for financial reporting (now IFRS, as modified by the Treasury's Financial Reporting Manual and approved by the Financial Reporting Advisory Board) and national accounts (ESA 95 being the governing regulation).

My view is that the PFI financial reporting problem—arbitrage being rife—has now been resolved in the United Kingdom. This took 10 years, and alertness is required to ensure that PFI schemes are not modified to escape from the remit of the mirror image of IFRIC 12 (IASB, 2006; Heald and Georgiou, 2011). The bringing of PFI on balance sheet to the public sector client has been attributed by the Treasury to the move from risks and rewards as the criterion under UK GAAP to that of control under IFRS. I am not convinced by this argument as most projects would have been On-balance sheet under UK GAAP if FRS 5A had been properly applied and not arbitrated by TTN1R. The switch to IFRS provided a convenient cover for a change that had long been necessary.

The new UK arbitrage is between IFRS-derived financial reporting (almost all PFI is on the client balance sheet) and budgetary treatment following national accounts. The June 2009 announcement that Spending Review 2010 would treat PFI on a national accounts basis (Treasury, 2009b) also ran counter to the objectives of the "Clear Line of Sight project" (Treasury, 2009a). Misleadingly, the Treasury has claimed that it must follow national accounts treatment for budgeting purposes: the United Kingdom has long used control aggregates which, though national accounts based, deviated from them in various ways (Heald, 1995). The important issue now is to ensure that there are clear reconciliations between various presentations.

In summary, my answer to the direct question is as follows:

- I support the existing financial reporting treatment.
- I believe that the budgeting treatment will create a new phase of project distortions, with (a) PFI being preferred to conventional procurement for "accounting" rather than VFM reasons, and (b) PFI schemes that satisfy the Eurostat rules for off-balance sheet treatment being preferred to those which do not.

Committee Question 3: *How far can risk really be transferred from the public to the private sector?*

Committee Question 4: *Are there particular kinds of risk which are particularly appropriate for transfer through PFI deals, or particular projects which are suited for PFI?*

Questions 3 and 4 should be taken together. A standard decomposition of risk in relation to PFI projects is as follows:

- construction risk;
- design risk;
- demand risk;
- third-party revenue risk;
- penalties for under-performance;
- penalties for non-availability;
- potential changes in relevant costs;
- obsolescence; and
- residual value risk.

Under PFI, construction risk can be transferred to the private sector and, in most UK PFIs, this has been done. This was not relevant to financial reporting treatment under FRS 5A because it is extinguished prior to accounting recognition by the public sector client. However, it is relevant to VFM calculations (Heald, 2003) if such risk transfer cannot be achieved under conventional procurement. Importantly, this opens up a wider question of why the UK public sector finds it difficult to transfer construction risk on conventionally-financed projects. This emphasises the importance of considering PFI, not in isolation, but within the context of overall public procurement policy.

In international discussions, terminology poses a serious obstacle to understanding. The United Kingdom regards PFI as a sub-set of a broader set of public-private interactions, labelled as “Public-Private Partnerships” (PPP). In most other countries the term PPP is used either for all asset-based long-term contractual service delegations (PFI in the United Kingdom) or only for those service concessions (such as motorways and tunnels) where there are third-party payers.

The critical issue is whether the public sector client can actually transfer risk to the private sector which operates through a Special Purpose Vehicle (SPV). Attempts to transfer risk inappropriately to the SPV will (a) be expensive, and (b) increase the probability that the SPV might default. Australian States have made extensive use of PPPs for tolled infrastructure, transferring some or all demand risk. Experience has shown that what is really important is that there are mechanisms through which a PPP project can be smoothly passed from a failing operator to a new operator, without cost to the public sector or inconvenience to users. In New South Wales, these transitions have been accomplished in relation to three transport infrastructure PPPs, showing that (some) demand risk had been transferred.<sup>102</sup>

In the above cases, the credibility of demand risk transfer was clearly related to (a) the existence of third-party payers, (b) features of contractual design, and (c) the facility being sufficiently free-standing. Without such features, demand risk transfer is likely to be (i) extremely expensive (transfer is not VFM), and (ii) ineffectual (the SPV lacks the capacity to sustain the risk when it materialises).

Those risks associated with the operational phase of the PPP are more conducive to transfer, subject always to the condition that the SPV must be able to withstand the materialisation of such risks, either from its own resources or through insurance or parental guarantees. In this category are to be found: penalties for under-performance; penalties for non-availability; and potential changes in relevant costs.

Typically, the physical asset may have an expected economic life of 60 years, in comparison with the PFI duration of 30 years, after which that asset reverts in good condition to the public sector client. It is for this reason that residual value risk is regarded as so important in relation to balance sheet treatment for financial reporting. Issues of design risk (the facility is not well-designed for purpose) or obsolescence risk (the facility becomes less functionally suitable because of changes in service delivery patterns) will also manifest themselves in effects on residual value at reversion date. Whether residual value risk can be transferred to the SPV will depend, *inter alia*, on whether the public sector client would have access to alternative facilities at the reversion date.

Residual value does not figure in the Eurostat (2004) rules regarding national accounts treatment. However, it figures importantly in financial reporting treatment under the “mirror-image of IFRIC 12” treatment required by the Treasury and which is proposed in the International Public Sector Accounting Standards Board’s Exposure Draft 43 (IPSASB, 2010). Tightening financial reporting treatment may lead to some reconfiguration of PFI projects so that they fail on the control tests of the mirror-image of IFRIC 12 (ie fall outside its scope) (Heald and Georgiou, 2011). If so, this would repeat the earlier experience of PFI projects being designed, possibly in ways damaging to VFM, to fail the risk and rewards test of FRS 5A.<sup>103</sup>

An overriding point is that it should not be an objective of PFI to transfer risk to the private sector but only to transfer those risks which the private sector is better equipped to handle, either in terms of managerial action that reduces the amount of risk or of being able to bear that risk in less costly ways. Attempting to transfer inappropriate types of risk will instead lead to excess costs and to potential default, with the materialising costs falling on the public sector. This echoes an important lesson from outsourcing in the petroleum industry: if the responsibility—legal and reputational—remains with the “principal”, the loss of operational knowledge and control may offset the apparent cost savings. Especially in an institutionally fragmented public sector, it is difficult to be an intelligent client and to sustain that through a 30-year PFI.

<sup>102</sup> Three New South Wales Government PPPs have run into financial difficulty. In each case the operator went into receivership (due to patronage not meeting initial expectations) and the receiver subsequently sold the business to a new operator:

— The Cross City Tunnel is a 2.1 km road tunnel under the City of Sydney. It opened in August 2005. The operator went into receivership in 2006 after the traffic volumes failed to meet initial expectations. The receiver sold the operation to a new operator in December 2006. The tunnel will transfer to the State at the end of the 30-year term of the PPP.

— The Lane Cove Tunnel is a 3.6 km road tunnel at Lane Cove, a Sydney suburb. It opened in March 2007. The operator went into receivership in January 2010 after traffic volumes failed to meet initial expectations. The receiver sold the operation to a new operator in May 2010. The tunnel will transfer to the State at the end of the 30-year term of the PPP.

— Four privately-operated railway stations opened on the new (State-operated) railway to Sydney Airport in May 2000. The operator went into receivership later that year due to passenger volumes failing to meet initial expectations. The receiver eventually sold the stations to a new operator in March 2007. The stations will transfer to the State at the end of the 30-year term of the PPP.

This information has been provided to the author by the New South Wales Treasury.

<sup>103</sup> It is not possible to be conclusive on this point. Alternatively, it could be argued that it was so easy to arbitrage FRS 5A by reference to TTN1R that project redesign was unnecessary.

Committee Question 5: *If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much?*

I have answered this Question at 2A and 2B above.

Committee Question 6: *In what circumstances are PFI deals suitable for delivery of services?*

The PFI should be regarded as one option in the armoury of public procurement. It should be neither ruled out *ex ante*, nor imposed through the operation of budgeting and authorisation rules, as was widely understood to have occurred with NHS and schools projects in much of the 2000s. The VFM of PFI schemes can only be effectively assessed if there is a mixed procurement model, when the Public Sector Comparator (PSC) is credible because it is fundable. Where it is known in advance that no public funding is available, whatever the numerical results of a Green Book (Treasury, 2003) project appraisal, it is predictable that the PFI project will almost always be pronounced best VFM. Moreover, in such circumstances, the lack of recent experience with conventional procurement means that the PSC is not credible, either to advocates or critics of PFI.

During an extended period of fiscal austerity, the “shortage of public capital” argument will again have influential advocates, such as PricewaterhouseCoopers (2011). In most circumstances this argument is invalid.<sup>104</sup> Although VFM judgements are difficult to make, depending on forecast events over long time horizons, decisions on the role of PFI should be driven by VFM considerations, not by the desire to evade budgetary restrictions. Governments learn how to present narratives: the official rationale for the policy being VFM while it is widely known that the driving factor is budgetary and accounting treatment. Not only is this damaging to transparency but it is also likely to damage achieved VFM.

#### FURTHER OBSERVATIONS

Whereas it is now clear how accounting treatment—both financial reporting and national accounts—does treat PFI projects, the satisfactory resolution in relation to financial reporting (almost all UK projects are rightly on-balance sheet) will not be matched by national accounts treatment. The international context of changes in national accounts means that the present lax arrangements will remain in place indefinitely. However, that does not prevent the United Kingdom from being fully transparent in its own budgetary presentations, including the publication of clear reconciliations.

Assessing VFM from PFI remains problematic, both at the *ex ante* project appraisal stage (for the reasons discussed above) and *ex post*. The long duration of PFI projects means that a definitive assessment is necessarily long-term, after which much else will have changed and there will be inevitable disputes about the relevance of findings about projects executed many years previously. Nevertheless, given the scale of UK PFI, it is imperative that there are systematic empirical studies of cohorts of projects across functional areas of government at key stages in their life: e.g. commissioning; early operation; mature operation; and reversion. Restrictions on resources and access to information mean that academics are unable to undertake such studies. This puts an enormous responsibility on public audit offices across the United Kingdom to undertake such studies and on the Parliaments and Assemblies to demonstrate interest in dispassionate work. It would be expecting too much for such studies to eliminate political disagreement about the desirability of the PFI but such work can aspire to provide a sounder factual basis for policy discussions.

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<sup>104</sup> Some countries, particularly in the developing world, may not have access to capital markets. In the case of non-tolled PFIs, the “shortage of public capital” argument is frequently used without regard to the fact that the PFI unitary charges will have to be met from future budgets.

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### **Further written evidence submitted by the Foundation Trust Network (FTN)**

#### ISSUES AROUND ACCESS TO CAPITAL FOR NHS FOUNDATION TRUSTS AND AN NHS BANKING FACILITY

##### INTRODUCTION

1. The Foundation Trust Network is the independent membership organisation for authorised and aspirant foundation trusts. We represent 212 public provider organisations in the acute, mental health, ambulance and community services.

2. We understand that the Committee received oral evidence on 14 June from the NHS Confederation and following that has requested a supplementary note on an NHS banking function. This is a critical issue for FTN members and we have been considering the role of a banking function for some time. Below we outline some of the emerging issues from our perspective, which we hope is helpful to the Committee’s deliberations and which we consider complements the NHS Confederation paper.

3. Our members have a particular concern for the access of public sector providers to capital and working capital in future. There is undoubtedly a need for banking functions for the NHS to support re-structuring, day to day risk management and longer term capital investment programmes. Adequate amounts of capital are unlikely to be available from the public purse alone.

##### BACKGROUND

4. The original form of the Health and Social Care Bill proposed significant changes to the environment for financial activities, including:

- All NHS Trusts to become Foundation Trusts (FTs) by 2014—even though this has now been “softened” and the deadline will be extended for some.
- More freedoms for FTs including removal of prudential borrowing limits and the Private Patient Income Cap; clarification on the responsibilities of FT Directors; and extended roles for FT governors (although this will not now be in force until 2016 as Monitor’s jurisdiction has been extended to this date);
- A new sector regulator with the duty to set prices;
- Proposals for a new asset steward / investment management function to oversee the £23 billion of PDC in provider organisations to be known as the NHS Investment Agency (NHSIA).

5. For those organisations working towards FT status, access to capital on the pipeline will be critical.

6. There were some changes to the Bill following the pause that are less helpful and where uncertainty remains. These changes are to the original proposals covering continuity of services and a special administration / failure regime which were meant to be developed under the purview of the regulator.

7. Whilst no policy has finally been decided, it now appears that the failure regime will not be independent and that the Secretary of State will have step in or veto rights within it. Additionally, the system for protecting patient services and who pays for such protection remains an unanswered question, but is much more likely to be controlled by the NHS Commissioning Board. Taken together with greater powers of challenge for Health and Wellbeing Boards with Overview and Scrutiny Committees remaining intact, it will be even more difficult for providers to successfully reconfigure services in order to avoid failure.

8. It had been planned that the NHSIA will take over the functions of the existing Foundation Trust Funding Facility. It is not yet clear how much the NHSIA role and scope will change as a consequence of the recent

re-think—for example whether, and how far, the NHSIA will have responsibility for dealing with failure and pre-failure, but we anticipate it to have some duties that act as the investment banker on behalf of the public purse.

9. Foundation Trusts are currently classified as Central Government by the ONS. This classification means that all expenditure by Foundation Trusts scores against Departmental spending limits whether financed by Government or from commercial sources.

#### THE FOUNDATION TRUST REQUIREMENT FOR CAPITAL

10. Below we outline what we perceive the need for access to various forms to capital to be, cover how it is supplied at the moment and look at the options of how it might be supplied in future.

#### UNSECURED WORKING CAPITAL

11. Originally it was believed that the DH would provide working capital for foundation trusts, but this was not the case and trusts now seek this from commercial banks. The regulator, Monitor, has required foundation trusts to have an arrangement in place which they need to maintain financial ratings even when they do not immediately need the cash. In recent years the banks have doubled, and even trebled their charges, costing the FT community—we believe—over £20 million per annum. In recent months there have been examples of FTs actually needing the cash, and finding the facilities withdrawn. Working capital will be increasingly necessary to manage the service reconfigurations required to face the QIPP financial challenge, so lack of access is a problem that should be solved rapidly.

#### UNSECURED CAPITAL EXPENDITURE FINANCE

12. The capital budget has been under spent for several years suggesting there has not been a supply problem to date, but as public capital will be more restricted in future this may not continue to be the case.

13. The FTFF has committed over £1 billion to date. The commercial banks have not lent to foundation trusts unsecured for anything beyond a year. Up to date the FTFF has lent at cost without adding a risk premium in general or differentiating between borrowers in particular.

14. Bank credit committees dislike the uncertainties about insolvency, are uncomfortable with the way risk is managed across the system and, have particular concerns about the financial health of the commissioners. In the past the commercial sector has been unwilling to lend without specific use of the Deed of Guarantee from the Secretary of State.

15. If price is a problem for the commercial sector, then the logical solution would be to allow the price to rise to the point at which banks are prepared to lend. Whilst some might consider this to be a sound medium term objective, currently it would seem to be politically unpalatable to raise the cost of finance to FTs in order to benefit private sector lenders. In addition no public provider would be enthusiastic about lobbying for a cost increase. This would only be tenable if there is an allowance for full cost recovery in independent price setting. Given the fiscal challenges to the system this seems increasingly unlikely. In addition foundation trusts are unlikely to make the kinds of surpluses that can finance large scale capital investment.

#### UNSECURED SECURITISATION/SYNDICATION/POOLING

16. It is in the tax payers' interest to keep the cost of lending as low as possible. As commercial banks are currently reluctant to lend to individual organisations, it might be possible that a portfolio of risks already processed by the FTFF might be attractive to lenders wishing to explore the market. There are precedents in other parts of the public sector such as Housing Associations and Student loan books. In general a spread of risk should attract a better price than an individual risk.

#### LONGER TERM/PERMANENT CAPITAL

17. The existing stock of Public Dividend Capital (PDC) is significant (some £23 billion) but the policy is that no new PDC should be issued. For foundation trusts with existing PDC the future management should be a relatively passive exercise. For unsuccessful trusts and those trying to acquire them the problem may be that the nominal PDC may be greater than the economic value of the trust. Managing the revaluation of the investment is likely to be highly complex and fraught. Any entity invited to take on existing PDC as the result of a merger or acquisition would insist on undertaking a due diligence exercise to establish any diminution of value before its board accepts such responsibility.

#### RESTRUCTURING

18. The original Bill provided for DH and Monitor to borrow in order to lend. There was no pre funded solution beyond the idea of some sort of risk pooling. The problem of such pools is that successful organisations see themselves paying for the failures of their weaker competitors and regard this as wrong. The system needs a pot to solve problems. It would need to be transparent and accountable but it needs to be available. As we saw in the banking crisis, where the government is looking for the private sector to help solve problems,

government support may even make the pricing more competitive than for unsupported, but better managed organisations. There is the potential that we see a “too big to fail” effect.

#### THE BALANCE BETWEEN PUBLIC AND PRIVATE CAPITAL

19. The attraction of the private sector as a supplier of capital should remain a medium term objective whilst recognising that experience so far suggests it will be expensive. However, if banks are not prepared to take risk without at least implicit government support, what are they contributing that government itself cannot provide more cheaply? The ultimate solution might be to look a risk sharing between public and private sectors.

20. If government is to provide a temporary solution itself through making banking services/ capital available, there is a need to question whether or not this should be further complicated by creating a bank which has to manage its liabilities as well as its assets. This might work best if the structure is a bank with the government as sole depositor, but this would require more public money than Government seems willing and able to contribute.

21. It should be noted that the funding of trusts that are in difficulties (but not yet in administration) is a different skill set and should be separated from the business as usual in any organisations. Foundation trusts will be nervous that if an NHS Bank did not have convincing operational freedom, it would provide a conduit through which government ministers can intervene in ways that would undermine the independence of foundation trusts.

#### INTER-LOCKING POLICY PROBLEMS TO BE RESOLVED

22. There are inter-linked issues that need to be addressed in order to solve the issue of longer term access to commercially provided capital at affordable cost for the FT sector in the context of restricted public capital. These are:

- Will the proposed failure regime have enough independence not to close out access to private capital and what will be the pecking order of creditors in the regime?
- What should the pre-failure regime look like and which agency might manage a pre-failure regime and what implications would this have for the FT governance lines of accountability currently proposed in the NHS Health and Social Care Bill to take effect after 2016?
- How will the government structure public dividend capital between debt and equity and is there a realistic prospect of debt being paid off and equity refinanced from other than government sources? If so what are the timescales for achieving this?
- How far will the NHS tariff price setter take capital demands into account in the price and how far will the financial structures of foundation trusts need to change to accommodate this?
- How can the Treasury limitation of the Departmental Expenditure Limit total be overcome?

#### CONCLUSION

23. As set out at the head of this submission, there is undoubtedly a need for banking functions for the NHS to support re-structuring, day to day risk management and longer term capital investment programmes. Adequate amounts of capital are unlikely to be available from the public purse alone. Unless the inter-locking policy considerations outlined above can be successfully reconciled, it is unlikely that this can be provided commercially at reasonable cost. This will leave public providers unable to properly manage their risks.

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