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Private Finance 2

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The Treasury Committee

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1 Introduction

The Private Finance Initiative

1. In November 1992 the then Chancellor of the Exchequer, Norman Lamont, made an announcement in the Autumn Statement about "ways to increase the scope for private financing of capital projects".[1] This was the beginning of what was to become known as the Private Finance Initiative (PFI), through which groups of private investors manage the design, building, finance and operation of public infrastructure. By the time the Labour government came to power in 1997 a total of 68 PFI projects, worth around £4 billion, had been signed. In May 1997, the new government commissioned Sir Malcolm Bates to conduct a review of the Private Finance Initiative. The aim of the review was to "identify obstacles" in the way of PFI projects and establish how the process could be streamlined.[2] One of the recommendations of the review was to abolish the Private Finance Panel (see paragraph 3). By November 1999, a further £5 billion worth of PFI projects had been signed.[3] The current coalition government, formed in May 2010, remained committed to the Private Finance Initiative as a way of delivering investment in infrastructure.[4] In total, 61 new PFI projects were in the procurement stage as of March 2011, with a total estimated investment value of £7 billion. By March 2013, over 700 PFI projects were operating under contract, with a private sector investment value of around £55 billion.[5]

2. In a typical PFI project, the private sector party is constituted as a Special Purpose Vehicle (SPV). The financing of the initial capital investment (i.e. the capital required to pay transaction costs, buy land and build the infrastructure) is provided by a combination of share capital and loan stock from the owners of the SPV, together with senior debt[6] from banks or bond-holders. The return on both equity and debt capital is sourced from the periodic "unitary charge", which is paid by the public authority from the point at which the contracted facility is available for use. The unitary charge may be reduced (to a limited degree) in certain circumstances: e.g. if there is a delay in construction, if the contracted facility is not fully operational, or if services fail to meet contracted standards. A condition for acceptance as a PFI project originally was the transfer of project risks from the public to the private sector.

3. PFI was a departure from what were known as the 'Ryrie Rules' which had governed and restricted the use of private finance in the 1980s.[7] In particular, PFI widened the circumstances where private finance could be used and allowed private finance which would be additional to, rather than a substitute for, public finance.[8] In Autumn 1993, the

1 HC Deb (1992–93), 12 November 1992, col 998 [Commons Chamber]

2 Treasury Committee, Fourth Report of Session 1999–00, *The Private Finance Initiative,* HC 147, Ev 18

3 Treasury Committee, Fourth Report of Session 1999–00, *The Private Finance Initiative,* HC 147, Ev 17

4 HM Treasury, *Public Private Partnership – Technical Update*, 2010, p 1

5 HM Treasury, *Private Finance Initiative Projects: 2013 Summary Data*, December 2013, para 1.5, p 3

6 Debt which has a higher repayment priority compared to other types of unsecured debt in the event of liquidation. If a company goes bankrupt, senior debt holders are repaid before holders of unsecured debt.

7 David Heald and Alasdair McLeod, Constitutional Law, The Laws of Scotland: Stair Memorial Encyclopaedia: Public Expenditure, 2002, para 502

8 HC Deb (1992–93), 12 November 1992, col 998 [Commons Chamber]

then Chancellor Kenneth Clarke announced the creation of a Private Finance Panel (PFP) whose role included identifying "new areas of public sector activity where the private sector could get involved", encouraging "greater participation in the initiative by both public and private sectors" and seeking "solutions to any problems that might impede progress". In 1994, he told the CBI conference that "private sector finance would be the main source of growth" in public investment projects and that the Treasury would not approve capital projects unless private finance options had been explored.[9] In 1997, the new Labour government announced an end to the requirement to consider private finance for all capital projects and abolished the PFI Panel in favour of a taskforce within the Treasury:

> In light of the reduced requirement to promote the concepts of PFI throughout the public and private sectors, there is no ongoing requirement for a Panel of senior private sector members. Their work over the 4 years of giving credibility to the Initiative has been valuable and should be publicly acknowledged.[10]

This taskforce was later replaced by the organisation Partnerships UK which itself became a Public Private Partnership in 2001.[11]

4. The overall aim of PFI was "to achieve better value for money for the taxpayer by ensuring that infrastructure projects were delivered to time and to cost, and that assets were well maintained", by "harnessing the private sector's efficiency, management and commercial expertise". It was intended to bring "greater discipline to the procurement of public infrastructure" and creating, "through the transfer of appropriate risks to the private sector, a clear focus on the whole of life costs of projects and an innovative approach to service delivery".[12]

5. The case for attempting reform of public procurement was strong at the time PFI was launched, given the chequered record of conventional public procurements in the 1970s and 1980s. For example, the construction of the Dungeness B power station took 13 years longer than planned and cost well over twice the original estimate. The Advanced Passenger Train was pushed into service before technical issues had been resolved, resulting in the project being cancelled.[13]

6. Despite the positive intent, some aspects of PFI did not work effectively in practice.[14] As early as the late 1990s, concerns were beginning to be raised by the National Audit Office and others over the economy, effectiveness and efficiency of PFI deals.[15] Concerns grew as projects progressed and the use of PFI expanded. In 2011, the Treasury Committee published a Report, *Private Finance Initiative,* which set out many of the defects with PFI

9 *The Private Finance Initiative (PFI)*, Research paper 01/117, House of Commons Library, 18 December 2001, p 15

10 HM Treasury, *First review of the Private Finance Initiative by Sir Malcolm Bates*, 1997, p 4

11 *The Private Finance Initiative (PFI)*, Research paper 01/117, House of Commons Library, 18 December 2001, p 16; BBC, New Government Approach to PFI, 1997

12 HM Treasury, *A new approach to public private partnerships*, December 2012, box and para 1.1, pp 15–16

13 Walter C. Patterson, *Going Critical – An Unofficial History of British Nuclear Power*, 1985; Calleam Consulting, *Why projects fail, British Rail – Advanced Passenger Train*, 6 October 2012

14 HM Treasury, *A new approach to public private partnerships*, December 2012, p 15

15 Gaffney, D., A. Pollock, M. Dunnigan, D. Price and J. Shaoul (1999b), *NHS Capital Expenditure and the Private Finance Initiative:Expansion or Contraction?*, British Medical Journal,10 July1999; Comptroller and Auditor General, HC 584 (1999–2000), *The Refinancing of the Fazakerley PFI Prison Contract*, 29 June 2000

that had become evident and which raised serious concerns about the value for money that PFI represented for the taxpayer.[16]

7. There has been an absence of clear evidence that PFI projects offer sufficient savings and benefits to justify their higher cost as compared to traditional procured projects and, as the Government acknowledges, PFI has "led to sub-optimal value for money in some projects".[17] The quality of some services was also lower under PFI.[18] As the Treasury Committee has previously highlighted, the accounting and budgetary frameworks in place meant that there were incentives, unrelated to value for money, for the Government to use PFI.[19] This "undermined a genuine appraisal of the optimal delivery route" and, as a result, PFI was used on projects where its application was unsuitable.[20]

8. The procurement process for PFI was slow and expensive and the contracts were insufficiently flexible. In some cases, inappropriate risks were given to the private sector to manage, resulting in higher prices and inefficiency. There was also a lack of transparency about the future liabilities created by PFI projects and the perception that some equity investors made windfall gains.[21] The catalogue of problems with PFI resulted in the approach becoming "tarnished by its waste, inflexibility and lack of transparency" and led to widespread criticism.[22] For example:

> The balance of the existing empirical evidence available suggests very strongly that private finance in the UK has contained, on average, an excess cost to the public sector, a premium that does not appear to be related to the risks borne by investors. [...]
>
> Even before the financial crisis [...] the evidence suggests that PFI has not provided clear advantages in terms of more efficient construction, maintenance or support services. To date, the advantage of private finance in improving the delivery of public infrastructure projects (which could, theoretically, off set the higher cost of finance), has not been demonstrated, indeed, the available evidence, which should not be regarded as conclusive, suggests that, overall, PFI is associated with higher cost delivery.[23]

9. Although the Government had always been able to obtain cheaper funding than private providers of project finance, debt finance became scarce and expensive following the financial crisis and the difference between direct government funding and the cost of this

16 Treasury Committee, Seventeenth Report of Session 2010–12, *Private Finance Initiative,* HC 1146

17 Treasury Committee, Seventeenth Report of Session 2010–12, *Private Finance Initiative,* HC 1146, para 46, pp 24–25; HM Treasury, *A new approach to public private partnerships*, December 2012, p 15

18 Treasury Committee, Seventeenth Report of Session 2010–12, *Private Finance Initiative,* HC 1146, para 44, pp 23–24

19 Treasury Committee, Seventeenth Report of Session 2010–12, *Private Finance Initiative,* HC 1146, p 3

20 HM Treasury, *A new approach to public private partnerships*, December 2012, p 6

21 HM Treasury, *A new approach to public private partnerships*, December 2012, p 15; Treasury Committee, Seventeenth Report of Session 2010–12, *Private Finance Initiative,* HC 1146, para 38, p 21

22 HM Treasury, *A new approach to public private partnerships*, December 2012, p 3, Foreword

23 *International Handbook on Public-Private Partnerships*, Edited by Graeme A. Hodge, Carsten Greve and Anthony E Boardman, Chapter 14, *The UK's Private Finance Initiative: history, evaluation, prospects*, by Mark Hellowell

finance increased significantly. This substantial increase in private finance costs meant that, following the crisis, the PFI financing method became extremely inefficient.

10. It is, however, important to consider the performance of PFI in context. Although much criticism has been levelled at PFI, the reputation of conventional public sector procurement is far from untarnished. The National Audit Office (NAO) and the Committee of Public Accounts (PAC) have consistently identified failings in projects under both the PFI and conventional procurement routes (Box 1). This is not, perhaps, surprising given that the NAO has "consistently identified cases of problem government projects involving a lack of public sector commercial skills and experience"[24]. Both routes depend on such skills. In its 2011 report, *Lessons from PFI and other projects*, the NAO concluded that "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" and that "many lessons learned on PFI apply to other forms of procurement".[25] The NAO has stated, however, that while private finance is "not suitable at any price or in every circumstance" and "when it is used for the wrong reasons or is managed badly, it does not deliver projects well", when it is "used for the right reasons and managed effectively" it "can work well" and "can deliver benefits".[26] It is also important to note that many of the problems the UK has encountered in procuring public capital goods under both the PFI and conventional procurement approaches are not unique, with similar problems arising from the use of private finance by other countries.[27]

24 Comptroller and Auditor General, HC 962 (2008–09), *Commercial skills for complex government projects,* 6 November 2009, para 2, p 4

25 Comptroller and Auditor General, HC 920 (2010–12), *Lessons from PFI and other projects*, 28 April 2011, para 11 & 1.8, p 6 & 15

26 National Audit Office, Paper for the Lord Economic Affairs Committee, *Private Finance Projects*, October 2009, p 6

27 For example the Australian GP Super Clinics Scheme and the State Route 125 — South Bay Expressway in California.

Box 1: Examples of project failings under the PFI and conventional procurement routes

PFI
Procurement of the M25 private finance contract – Delays in preparing and executing the project added 18 months to the original timetable. Exposing the project to risk for longer than was expected resulted in the Highways Agency encountering the credit crisis which added £660 million to the contract price.
Multi-role tanker aircraft – The Department's ability to get the best deal it could was undermined by: • selection of a PFI solution without a sound evaluation of alternative procurement routes; • timescales more than doubled; • during the procurement the discount factor for assessing the Public Sector Comparator changed but the Treasury granted FSTA an exemption. If the revised rate had been applied the PFI solution would not have represented value for money against a Comparator using an A330 aircraft; and • the lack of a mature fallback plan and the fact that any alternative would have required difficult decisions to find additional capital funding left decision-makers with limited alternatives to going ahead with the deal even when problems arose.
Conventional
Ministry of Defence Major Projects Report 2012 – • Forecast costs of the 16 major projects in the report had increased by £468 million in 2011–12 and were expected to cost £6.6 billion more than originally expected; and • Delivery of the 13 projects for which time performance could be measured, had slipped by 139 months meaning that they were expected to be delivered 468 months later than originally expected.
Delivery of armoured vehicle capability – Despite spending over £1.1 billion since 1998, the Department's acquisition process was undermined by a combination of over-ambitious requirements and unstable financial planning. As a result it faced significant shortfalls against its plans to equip the Armed Forces and was likely to continue to do so until at least 2025.
National Programme for IT in the NHS – • The NHS underestimated the scale and complexity of this major IT-enabled programme and was getting far fewer systems than planned despite the Department paying contractors almost the same amount of money.

Sources: Comptroller and Auditor General, HC566 (2010–11) , Procurement of the M25 private finance contract, 19 November 2010; Comptroller and Auditor General, HC 433 (2009–10), Delivering multi-role tanker aircraft capability, 30 March 2010; Comptroller and Auditor General, HC684-I (2012–13), The Major Projects Report 2012, 10 January 2013; Comptroller and Auditor General, HC1029 (2010–12) The cost-effective delivery of an armoured vehicle capability, 20 May 2011; Comptroller and Auditor General, HC888 (2010–12), The National Programme for IT in the NHS: an update on the delivery of detailed care records systems, 18 May 2011

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11. Although the former official Opposition voiced some criticism of PFI,[28] the current Coalition Government, formed in May 2010, has said that it remains committed to private finance as a way of delivering investment in infrastructure.[29] In its response to our 2011 Report, the Government told us that it recognised concerns with the existing PFI model

28 For example as reported in *The Great Debate: Will Hutton vs George Osborne,* The Observer, Sunday 15 November 2009.

29 HM Treasury, *Public Private Partnerships – Technical Update*, 2010, p 1; HM Treasury, *A new approach to public private partnerships*, December 2012

and that it would consider further measures to reform PFI and improve the way in which private finance was used to deliver public infrastructure. In December 2012, the Government published a document entitled *A new approach to public private partnerships* which introduced Private Finance 2 (PF2) as the Government's new approach. Box 2 sets out the most significant reforms included under PF2.[30]

Box 2: Key reforms under PF2

Financing	• The Government will look to take on a co-investor role by taking a minority share in the project equity; • projects will be structured with a greater proportion of equity (i.e. a lower gearing) with the aim of facilitating access to the capital markets or other sources of long-term debt finance; and • funding competitions will be introduced for a proportion of the private sector equity to attract long-term investors into projects prior to financial close.
Budgetary control	• The Government will introduce a control total for all commitments arising from off-balance sheet PF2 contracts signed.
Risk transfer	• There will be greater management of risks by the public sector, including the risk of additional capital expenditure arising from an unforeseeable general change in law, utilities costs, site contamination and insurance.
Flexibility	• Soft services such as cleaning and catering will be removed from projects.
Process	• The tendering phase of PF2 projects will not be allowed to take longer than 18 months unless an exemption is agreed by the Chief Secretary to the Treasury.
Transparency	• The private sector will be required to provide equity return information for publication; and • the Government will publish an annual report detailing project and financial information on all projects where Government holds a public sector equity stake.

Source: Adapted from HM Treasury, A new approach to public private partnerships, December 2012, p 13

12. This Report is not an exhaustive examination of PF2, the full details of which are still being worked out. We have instead examined key elements of the proposals to determine whether they are likely to address the principal concerns the Committee has previously raised with regard to PFI.

Our inquiry

13. The Committee held oral evidence sessions with institutional investors, accounting and commercial experts, senior Treasury officials and the Commercial Secretary, Lord Deighton of Carshalton. The Committee has also drawn on evidence from its previous hearings where relevant. We are grateful to all those who gave written or oral evidence to the inquiry. We also thank Dr Mark Hellowell, Lecturer at the University of Edinburgh, who acted as a specialist adviser to the Committee during the inquiry.[31]

30 HM Treasury, *A new approach to public private partnerships*, December 2012, p 13

31 Mark Hellowell declared no interests

2 Accounting and budgetary incentives

Incentives to use PFI

14. In our 2011 Report, the Committee highlighted the fact that the accounting treatment for PFI debt meant that nearly all PFI debt was being included in the financial accounts of Government departments for financial reporting purposes but that it was recorded off balance sheet for National Accounts and statistical purposes. As a result, most PFI debt was invisible to the calculation of Public Sector Net Debt (PSND) and not included in the headline debt and deficit statistics. The Committee concluded that there was therefore an incentive to use PFI in preference to other procurement options, as it resulted in lower headline Government borrowing and debt figures in comparison to other forms of capital investment.[32]

15. The Committee also noted that PFI deals had a smaller (but much longer lasting) impact on the current budget of an organisation, whereas conventionally procured capital projects resulted in a significant one-off hit to the capital budget. This meant that if departments or public bodies did not have a capital budget large enough to allow for desired capital investment, there was a substantial incentive to use PFI as it was not included within Departmental Expenditure Limits. In the long term, the PFI arrangement would build up large commitments against future years' current budgets that had not yet been allocated or agreed. The Committee raised the concern that this incentive might have encouraged poor investment decisions and allowed organisations and Government the possibility of procuring capital assets without due consideration for their long-term budgetary obligations. We concluded that there were therefore incentives in play which could act to encourage the use of PFI for reasons other than value for money. We stressed, on value for money grounds, that it was essential that any incentives unrelated to value for money were removed.[33]

16. The Committee also reported that while International Financial Reporting Standards (IFRS) require that most PFI projects be scored in an organisation's financial accounts, the capital investment related to PFI projects rarely scored in individual government Departmental Expenditure Limits. This is because Departmental budgets follow the definitions used in the European System of Accounts (ESA), rather than those set out in IFRS. We said that this was not only confusing, but also created incentives to use PFI, rather than direct capital investment by departments. The Committee recommended that the Treasury consider aligning the treatment of PFIs in Departmental budgets with the treatment in financial accounts so that most PFIs should score within those budgets in the same way as direct capital expenditure.[34]

32 Treasury Committee, Seventeenth Report of Session 2010–12, *Private Finance Initiative,* HC 1146, para 17, p 12

33 Treasury Committee, Seventeenth Report of Session 2010–12, *Private Finance Initiative,* HC 1146, para 22–23, pp 13–14

34 Treasury Committee, Seventeenth Report of Session 2010–12, *Private Finance Initiative,* HC 1146, para 25, p 14

Abolition of PFI credits

17. Under the previous Government, departments wishing to support a programme of local government PFI projects were given an allocation of 'PFI credits' at a Spending Review. This ring-fenced funding gave additional spending power to central departments wishing to deliver PFI projects through local authorities.[35] *A new approach to public private partnerships* states that the availability of this funding, solely for PFI, "provided a budgetary incentive to pursue PFI and, thereby, undermined a genuine appraisal of the optimal delivery route":[36]

> Despite a clear focus in government's business case guidance on the need to give due consideration to all reasonable options for delivering a project, the existence of separate, detailed appraisal guidance for PFI has led to a tendency for appraisers to undertake in-depth appraisal of PFI while giving insufficient weight to the potentially viable alternatives. In addition, the existence of PFI credits—ring-fenced funding available to support PFI but not other forms of delivery— exacerbated this, as there was a clear budgetary incentive for procuring authorities to pursue PFI.[37]

18. The Government abolished PFI credits in autumn 2010 with the intention of creating "a level playing field for all forms of public procurement, thus seeking to ensure that procuring authorities consider all reasonable options for meeting their requirements".[38] As the Committee has previously highlighted, however, PFI credits appear to have survived, albeit in a rebadged form, as part of the Government's National Infrastructure plan 2011:

> [the Government] allocated £2 billion in Waste Infrastructure Credits (formerly known as PFI Credits) to 32 waste treatment and management projects, providing publicly funded infrastructure investments using private finance.[39]

19. In his written evidence to this inquiry, Dr Mark Hellowell, Lecturer at the University of Edinburgh and Specialist Adviser to the Committee, said that the abolition of PFI credits had not had a significant effect in reducing the budgetary incentives for local Government projects:

> [...] the removal of PFI credits (which, it should be noted, were only ever in place for PFI projects undertaken by local authorities) is not a comprehensive solution. It remains the case that for non-central government authorities (local authorities, NHS/Foundation Trusts), the incentive to pursue PFI/PF2 is often strong due to constraints on departmental capital budgets.[40]

35 HM Treasury, *A new approach to public private partnerships*, December 2012, Box 1.E, p 25

36 HM Treasury, *A new approach to public private partnerships*, December 2012, p 6

37 HM Treasury, *A new approach to public private partnerships*, December 2012, para 7.25, p 71

38 HM Treasury, *A new approach to public private partnerships*, December 2012, para 7.25, p 71

39 HM Treasury, *National Infrastructure Plan 2011*, November 2011, para 3.147, p 81

40 Ev w12

PF2 proposals

Accounting treatment

20. In *A new approach to public private partnerships*, the Government has acknowledged that accounting and budgetary incentives were weaknesses of the PFI regime and that they resulted in flawed decisions being made:

> It is also evident that, too often, PFI has been used on projects where its application has been unsuitable and has, therefore, failed to deliver value for money. [...]Weaknesses in the budgetary and value for money framework meant that procurement decisions of government departments were sometimes skewed. This lead to PFI being used in sectors and projects where there was insufficient long term certainty on the future requirements of services; or where fast-paced technological changes made it difficult to establish requirements for the long term.[41]

21. Lord Deighton outlined how he believed the Government's proposals for PF2 would address these problems:

> In terms of how PF2 addresses that, firstly I can just give my own experience, and if you look at what has been happening, the flow of PF2 transactions has clearly slowed down considerably, which reflects that people are not just trying to pull through projects for which there isn't balance sheet room. The approach I have found in all of the Departments looking at projects is absolutely focused on value for money. It hasn't been focused on, "We cannot do it on our balance sheet because we do not have approval, therefore let us find another way of getting around it." That is just not the way the process works. In terms of transparency, you are right, the changes to the PF2 do not include putting it fully on the Government's balance sheet. What we are doing is from 2010, we had the liabilities laid out in the whole Government accounts, the contingent liability, and the undertaking that has been given is for the PF2 total—and of course we have nothing yet—that the spending round, which finishes at the end of next month, will lay out the basis upon which a control total for PF2 will be recorded. So we have moved some of the way but [...] it will not be on the balance sheet.[42]

22. The UK is required to prepare its National Accounts under internationally agreed guidance and rules set out principally in the European System of Accounts 1995 (ESA 95) and the accompanying Manual on Government Deficit and Debt (MGDD). These rules apply to all countries in the European Union. In the UK the Office for National Statistics (ONS) is responsible for the application and interpretation of these rules.

23. Preparing the National Accounts in accordance with ESA 95 has the consequence that the capital costs of some PFI deals are not included on the public sector balance sheet. This is for the reason that, under these rules, assets and liabilities are only included on the balance sheet if the public sector bears the majority of the financial risk. This differs from the Whole of Government Accounts (WGA) approach whereby assets and liabilities are

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41 HM Treasury, *A new approach to public private partnerships*, December 2012, p 6

42 Q144

included on the balance sheets in the accounts of whichever entity is deemed to have effective control. PSND excludes most PFI liabilities because it is calculated using the National Accounts balance sheet. In its July 2013 *Fiscal Sustainability Report* the OBR quantified the impact of excluding PFI liabilities:

> the total capital liabilities in WGA arising from Private Finance Initiative contracts were £36 billion, up from £32 billion a year earlier. Only £5 billion of these were on the public sector balance sheet in the National Accounts and therefore included in PSND [...]. If all investment undertaken through PFI had been undertaken through conventional debt finance, PSND would be around 2.1 per cent of GDP higher than currently measured.[43]

24. Professor David Heald, Professor of Accountancy at the University of Aberdeen Business School, told the Committee that while the exclusion of PFI projects from the national accounts meant that there had been a budgetary incentive to choose the PFI route, he thought the changes under PF2 might result in more PF2 projects coming onto the balance sheet for national accounts purposes:

> The proposals in PF2 very clearly involve less risk transfer than in conventional PFI. That will have implications not for the financial reporting accounting, not for the Government accounts or the whole of Government accounts, but it might well have implications for national accounts treatments. [...]
>
> If the spending reviews are conducted on national accounts basis, and the off balance sheet PFI is not included in the budgetary numbers, there very clearly is a budgetary incentive to adopt that route.
>
> [...] taking out soft services, larger capital contributions, Government equity contributions. I suspect that in national accounts terms that is more likely to bring future projects on balance sheet.[44]

Dr Hellowell disagreed with this view, however:

> Most PF2 investments will continue to be accounted for in the private sector under ESA, and will therefore be off-balance sheet for the purposes of compiling UK debt and deficit statistics. Given the salience of these statistics in the current fiscal context, the attractiveness of this for government is evident.[45]

25. In its *National Accounts Classifications, Forward Workplan, September 2013*, the ONS stated that it has not yet classified PF2 contracts but that it assessed the impact of the classification of PF2 contracts on the fiscal aggregates as “medium” and on the National Accounts as “small”. The ONS added that it “will be reviewing how these new, different contractual arrangements fit against the guidance in the manuals”, and that it expects to reach a conclusion by December 2013.[46] However, in its *National Accounts Classifications,*

43 Office for Budget Responsibility, *Fiscal Sustainability Report 2013*, July 2013, para 14, p 5

44 Qq79–83

45 Ev w12

46 Office for National Statistics, *National Accounts Classifications, Forward Workplan*, September 2013, 30 September 2013, section J, p 6

Forward Workplan, December 2013, PF2 contracts remain unclassified. The ONS's expected completion date for this classification is now March 2014.[47]

26. In his evidence to the Committee on the *HM Treasury annual Report and Accounts 2012–13*, Sir Nicholas Macpherson, the Permanent Secretary to the Treasury, told us that:

> Left to my own devices, I would very much like it all to be on balance sheet. Then, people could take decisions on the basis of what is the right thing, rather than being influenced by accounting. In theory, you should not be taking into account the balance-sheet treatment but, at the margin, people have done.[48]

PF2 control total

27. As part of the reforms set out in *A new approach to public private partnerships*, the Government announced that it will introduce "a control total for the commitments arising from off balance sheet PF2 contracts signed" in order to "increase transparency and control over the liabilities created by future PF2 projects".[49]

28. In oral evidence to the Committee during our *Autumn Statement 2012* inquiry, Dr Hellowell told us that he was sceptical that a control total would have a significant impact in mitigating the accounting incentives to use private finance:

> I think it moderates the way that those incentives operate, but it does not remove the incentives. There is still an incentive to use private finance in order to leverage increase capital budgets for departments. There is still an incentive to use off balance-sheet financing in order to make the level of national indebtedness look a little bit better than it really is, and so those kind of budgetary or fiscal incentives still remain.

He added, however, that:

> I do think though that it makes sense from a budgeting perspective to say if we are going to use these off-balance-sheet mechanisms, we want to have a good sense of how much of future current expenditure we are willing to earmark for this kind of thing.[50]

29. The Government set out further details of the control total in the *Spending Round 2013*:

> The control total will include the existing stock of PFI contracts as well as new PF2 contracts signed, and cover payments for the ongoing maintenance of the assets, the provision of services and repayment of, and interest on, debt used to finance the project. The coverage of the control total will include all PFI and PF2 contracts funded by central government. The control total will limit payments under PFI and

47 Office for National Statistics, *National Accounts Classifications, Forward Workplan*, December 2013, 30 December 2013, section 6, p 6

48 Oral evidence taken before the Treasury Committee on 3 September 2013, HC (2013–14) 625, Q50 [Sir Nicholas Macpherson]

49 HM Treasury, *A new approach to public private partnerships*, December 2012, para 5.9, p 57

50 Oral evidence taken before the Treasury Committee on 12 December 2012, HC (2012–13) 818–II, Q238

PF2 contracts in nominal terms in each future Parliament and will be set for the five years from 2015–16 at £70 billion. Performance will be assessed on an annual basis at Budget.[51]

30. Geoffrey Spence, Chief Executive of Infrastructure UK,[52] told us that:

For the first time what we are proposing to do is to have a mechanism to control what happens in terms of off balance sheet liabilities, so I think that is a major step forward [...] I think the second thing about it is that what it does give in terms of assessing projects coming forward is a greater focus on the whole of life cost beyond a spending review period. [...] one of the other reasons that we are introducing this control total, [...] is to ensure that there is far more of a whole of life assessment as to potential cost that goes beyond a short-term spending review period.[53]

31. At a seminar shortly after the announcement of the £70 billion control total, Geoffrey Spence said that the cap on PF2 spending would leave "headroom" of around £1 billion for new PFI projects in each of the five years of the control total.[54] This can be compared with the 15 projects, with a combined capital value of £1.6 billion, which reached financial close in the year to March 2013.[55]

32. In his evidence to the Committee's inquiry into the 2012 Autumn Statement, Dr Hellowell concluded that, overall, the PF2 reforms would have little effect in removing the incentives that existed under PFI:

I think in terms of the off-balance sheet question, that is fairly straightforward. The move from PFI to PFI2 or PF2 doesn't really do anything substantially different in terms of the accounting treatment, and therefore we still have the budgetary incentive and the fiscal incentive to pursue private financing almost regardless of the sort of value for money merits of PFI.

[...] There is still an incentive to use private finance in order to leverage increase capital budgets for departments. There is still an incentive to use off-balance-sheet financing in order to make the level of national indebtedness look a little bit better than it really is, and so those kind of budgetary or fiscal incentives still remain.[56]

33. **In its previous Report, the Committee concluded that the accounting treatment of PFI debt was encouraging the use of private finance for reasons other than value for money. The production of National Accounts according to European System of Accounts (ESA) leaves PFI debt off balance sheet. The Government's headline debt statistic, Public Sector Net Debt (PSND), which is calculated using the National Accounts balance sheet, therefore excludes PFI debt. This acts as an incentive to pursue**

51 HM Treasury, *Investing in Britain's Future*, June 2013, paras 10.6–10.7, p 67

52 Infrastructure UK is a unit within HM Treasury that works on the UK's long-term infrastructure priorities and secures private sector investment.

53 Q153

54 Partnership Bulletin, *PF2 'a £1bn per year market'*, 12 July 2013

55 HM Treasury, *Private Finance Initiative Projects: 2013 Summary Data*, para 1.5, p 3. Financial close is the stage in a financial agreement where conditions have been finalised and contracts have been signed.

56 Oral evidence taken before the Treasury Committee on 12 December 2012, HC (2012–13) 818–II, Qq237–238

PFI as it does not add to the headline measure of national indebtedness. Departmental capital budgets also follow the definitions used by the ESA. When a department does not have a capital budget large enough to finance an investment project under conventional procurement, PFI can be used to leverage its capital budget to proceed with the investment.

34. One of the PF2 innovations is the introduction of a control total. This will limit the payments under PFI and PF2 contracts to £70 billion over the five years from 2015–16 onwards, allowing about £1 billion of new PF2 projects a year. However, an aggregate control total would not remove the budgetary incentive for individual Departments to choose PF2 over traditional procurements: until the £70 billion upper limit is reached, it would remain. Indeed, the control total will create an incentive for departments to bring forward investment decisions under PF2 as soon as possible in order to include the projects within the £70 billion cap. This is likely to reduce the quality of decision making within government on investment projects, with less consideration given as to whether PF2 offers the best value for money. The Committee remains concerned that the control total will fail to address the budgetary incentives to use private finance.

3 Value for money

Public sector minority equity stake

35. A significant change under PF2 is that the Government will seek to invest directly in the project company. This will take the form of a minority share of the project equity. The Government believes that this will "strengthen significantly the partnership between the public and private sectors", by enabling:

- greater alignment of interests between the public and private sectors, and a more collaborative approach to improving project performance and managing risk;
- better partnership working, with the public sector having greater visibility of project information and more involvement in strategic decision making;
- more transparency, including in relation to the financial performance of the project company, through its project company board membership; and
- value for money to be improved as, subject to the appropriate management of project risk, the public sector will share in the ongoing investment returns, reducing the overall cost of projects to the public sector.[57]

36. The Government intends to invest between 25 per cent and 49 per cent of the equity funding for each PF2 project. Mr Spence explained the rationale for this range:

> I think the 49 per cent is an important barrier, because I think for both the private sector and the public sector, we want the private sector to retain control over these entities, subject to various safeguards that we will have in the shareholders' group of the sort you would expect. So I think the 49 per cent is a barrier. In terms of the minimum amount you would want, in company law there are various shareholding levels that provide blocking majorities for certain decisions, and if you like, that is the minimum. That sets the framework.[58]

37. In terms of how the Government would determine where in that range was appropriate for a specific project, he told us:

> [it] is a very pragmatic matter of looking at each procurement to establish in terms of the dynamics of that procurement what is the right level. Is it the size of the project that may encourage you to have a smaller percentage, simply because you want the other shareholders to have a larger amount of capital at risk? So it is those sort of dynamics that we would want to consider.[59]

38. Lord Deighton told the Committee that the principal motivation for taking an equity share in PF2 projects was to establish a "true partnership" with the private sector:

57 HM Treasury, *A new approach to public private partnerships*, December 2012, p 7

58 Qq126–133

59 Q133

> […] when you are on the same side of the table at the board meetings, receiving a portion of the same returns, it is a much better relationship in order to both negotiate these transactions initially, but probably more importantly to run them over the very long term that most of them take place. So it works well for both sides, so we are not left with a sense that it is all about extracting profit if you are one side and on the other side you are sort of left at the mercy of a transaction that was done, in many cases, years ago. So for me, the heart of it all is really about trying to establish a true partnership approach to these transactions for the benefit of both sides.[60]

Professor Heald was more sceptical:

> I don't know whether it would actually align interests. There is a danger of rolling out a very standardised model—for example, the discussion about what kind of maintenance would be part of the contract and soft services being necessarily outside. […] there is a centralising tone to the PF2 document, pulling things back to Whitehall, and one can see conflicts within the public sector, between the local public sector client and central Government.[61]

Richard Abadie, Global Head of Infrastructure at PricewaterhouseCoopers, told us that aligning interests through the contract would have been preferable to the taxpayer taking an equity stake:

> It is an indictment on the model that we have deployed that we have not been able to—as the public sector and through procurement—achieve that outcome through the actual contract. That would be the preference, rather than participating in the risk of capital.[62]

39. The public sector equity investment will be made on the same terms as those agreed by the private sector for a particular project. The price for the private sector equity will be set either through funding competitions for a portion of the private sector equity prior to financial close or, where an equity funding competition is not held, the price will be matched to that of the successful bidder. The funding for the public sector equity investment will come from the procuring government body. The returns made from investment, in the form of dividends, interest payments on shareholder loans or gains in the eventuality of any sale of the public sector equity stake, will be returned to the same body net of the Treasury's costs for managing the investment.[63]

40. We asked Mr Abadie whether he thought that the Government taking minority equity stakes would improve value for money for taxpayers:

> Not particularly. [...] If you looked at it on a standalone basis — i.e. you were in the world of 10 per cent equity and 90 per cent debt; so where we used to be before PF2 —Government taking, say, half of that equity would do something that I think adds

60 Q125

61 Q91

62 Q90

63 HM Treasury, *A new approach to public private partnerships*, December 2012, paras 2.10–2.11 & box 2.C, pp 32–33

value and that should make the deals cheaper. Whether cheaper is better value for money is a separate discussion. [...] if Government took half the equity and the return was paid back effectively to the taxpayer, you would argue that the net cost of PFI, being the payment that goes to private sector less the dividends that come back to Government, would ultimately make the deal cheaper. If your point, which is not how it is made out, is, let's get the cheapest potential source of capital—on average the lowest weighted average cost of capital—it achieves that outcome, and you tick a particular box or objective or policy initiative. When it comes to value for money, you heard today there is substantial appetite in the private sector to take equity. […] There is so much equity flowing into infrastructure on a global basis that we do not have a shortage of equity. The latest estimate is about US$150 billion. My question around that is: what is Government's policy intervention around equity? If it is to reduce the overall cost, as I say, that is not a problem at all. That is an understood and logical policy objective.[64]

41. The public sector equity investment will be managed by a central unit located in the Treasury, separate from the procuring government body. The Treasury has appointed Margaret Bonsall, a former partner in Linklaters with experience of non-executive posts, to help the set up the unit. Geoffrey Spence told the Committee:

We will have, in the short term, say five to 10 of these positions. […] Basically, we don't think we need very many people. In fact, we don't think we probably need more than three people to sit on the relevant boards. They will work for the Treasury in the sense that they are civil servants, but with the right skills, looking at this from a commercial point of view, and also engaging with the private sector partners.[65]

42. On 10 July 2013, the Treasury launched a consultation on the terms of the public sector equity participation in PF2 projects. The shareholder consultation was to last for six weeks and form the basis of legal documentation that public bodies will issue alongside PF2 contracts.[66]

43. On 16 October 2013, following the conclusion of the consultation period, the Government published the final Standard PF2 Equity documents, comprising a Shareholders' Agreement, Articles of Association and Loan Note Instrument.

Cost of finance

44. As set out in our previous Report, private finance has always been more expensive than government borrowing, and since the financial crisis the difference between the costs has widened.[67] A key objective of the Government's review of PFI has been to "create a new approach to public private partnerships that is sustainable for the longer-term".[68] Given the reduction in the availability of long-term bank debt following the financial crisis, the

64 Q89

65 Qq136–137

66 HM Treasury, Press Notice, *New PF2: Government sets out investment strategy for public infrastructure*, 10 July 2013

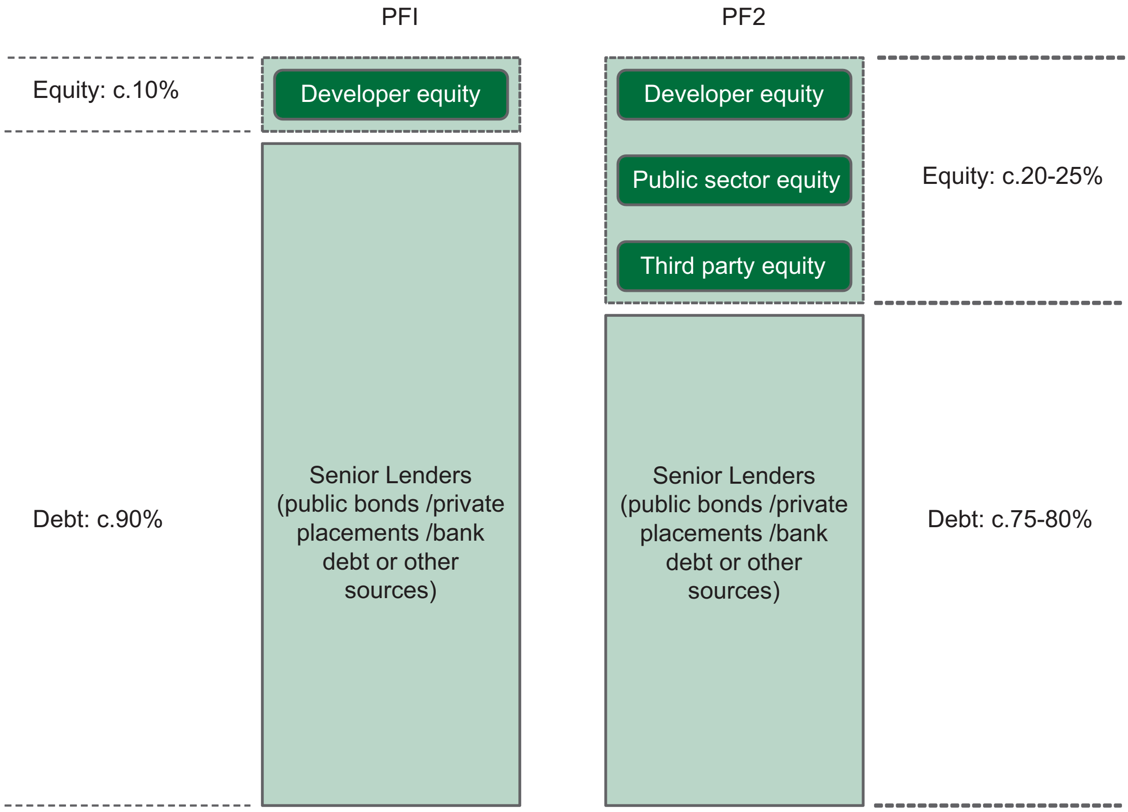
67 Treasury Committee, Seventeenth Report of Session 2010–12, *Private Finance Initiative,* HC 1146, p 3

68 HM Treasury, *A new approach to public private partnerships*, December 2012, para 2.8, p 31

Government has attempted to structure the PF2 financing structure in such a way that it facilitates access to the capital markets or other sources of long-term debt finance. The proposed financing structure for PF2 (Figure 1) therefore involves a greater proportion of equity (20 per cent–25 per cent) than under PFI (about 10 per cent). The Government's rationale for this is that a greater proportion of equity (i.e. a lower gearing) in the capital structure will provide "a credit enhancement to the underlying debt rating of the project", making the debt more attractive to a wider range of long term-debt providers.[69] Lord Deighton told us:

> The broad conclusion I have drawn about the evolution of the cost advantages or disadvantages of PF2 are that bank finance is less available and much more expensive, therefore we need a structure that can accommodate institutional lending. To do that, we need a structure with more equity in the capital, so let us say moving from a 10 per cent to 20 per cent equity component. I think with that greater degree of equity, we are able to come up with structures from a ratings point of view that can attract what I would describe as the "sweet spot" for the institutional market [...].[70]

Figure 1: Comparison of PFI and PF2 financing structure



Source: adapted from HM Treasury, A new approach to public private partnerships, December 2012, Chart 8.B, 80

69 HM Treasury, *A new approach to public private partnerships*, December 2012, para 2.8, p 31

70 Q113

Equity cost

45. As the Government acknowledges, equity finance is more expensive than debt finance owing, in part, to the higher risk it carries. As a result, including a larger proportion of equity in the structure may, at a project level, increase the weighted average cost of capital (WACC) if the credit enhancement effect does not decrease the price of debt proportionately or equity returns do not fall as far as anticipated.[71] Richard Abadie told the Committee that he thought the higher equity proportion would lead to a cost increase:

> I estimate that the overall cost could go up by up to 10 per cent. Only for the sake of argument, if the weighted average cost of capital is 8 per cent, it could go up to 9 per cent or 8.8 per cent. I would caveat that, though. If the pension funds and life insurance companies that we saw at the table earlier today are able to invest their debt at a lower price than banks are currently lending at, that difference would come down. It is quite an easy calculation, but my estimate is that the pension funds and insurance companies putting debt into projects, as opposed to equity, would have to have their debt in the projects 20 per cent cheaper than the current banks to break even. It is an approximation, so effectively they would have to come in with much cheaper capital on the debt side than the current banking model.[72]

Table 1 sets out an illustrative example by Mr Abadie of what the cost increase from increased equity proportions in PF2 might look like:

Table 1: Illustrative example from Mr Abadie of the potential impact of PF2 on cost of capital

Old [PFI]			New [PF2]		
% of Capital	Cost		% of Capital	Cost	
Equity 10%	x 12%	= 1.2 %	Equity [25%]	x 12%	= 3.0 %
Debt 90%	x 6%	= 5.4%	Debt [75%]	x 6%	= 4.5%
Pre tax WACC		**6.6%**	**Pre tax WACC**		**7.5%**

Source: Ev w1

Dr Hellowell suggested that the cost of the equity finance would be higher, however, meaning that both the overall cost of capital, and the increase from PFI to PF2, might be even greater (Table 2):

Table 2: Illustrative example from Dr Hellowell of the potential impact of PF2 on cost of capital

Old [PFI]			New [PF2]		
% of Capital	Cost		% of Capital	Cost	
Equity 10%	x 15%	= 1.5 %	Equity [25%]	x 15%	= 3.75 %
Debt 90%	x 6.25%	= 5.63%	Debt [75%]	x 6.25%	= 4.69%
Pre tax WACC		**7.13%**	**Pre tax WACC**		**8.44%**

Source: Ev w8

46. Lord Deighton accepted the view that, all else being equal, the increased equity proportion would act to make PF2 more costly than PFI. He explained, however, that the

71 HM Treasury, *A new approach to public private partnerships*, December 2012, para 2.9, p 31

72 Q107

higher equity proportion would enable the Government to obtain cheaper debt finance from institutional investors and so he thought that, overall, “the cost of capital for the PF2 structure will deliver a lower cost of capital today than an equivalent PFI structure would deliver today”:[73]

> I think with that greater degree of equity, we are able to come up with structures from a ratings point of view that can attract what I would describe as the “sweet spot” for the institutional market, which would be in the range of single A-type ratings. I think the cost saving on the 80% of the debt component at that higher rating, which brings in the institutional market, more than outweighs the extra return you have to give on the additional equity capital. So on balance, the weighted average cost of capital in the current markets is better served by the structure that we have developed for PF2.[74]

Dr Hellowell agreed that, in the longer term, “it is possible that, as equity substitutes for debt, it will be perceived by investors as less risky with the result that expected returns will eventually fall”,[75] but told us that in the short term he did not think this likely:

> [...] PF2 is almost certainly, at least in the short term, going to increase the WACC, the weighted average cost of capital, because [...] of the higher equity component, [...].
>
> I think in the longer term, we might see some moderation of both equity returns and interest rates on debt. In the short term, I think that is very unlikely to emerge.[76]

Glenn Fox, Chief Investment Officer at Hadrian’s Wall Capital, told the Committee, that the finance cost would, ultimately, be dependent on what investors were prepared to offer:

> In terms of the price of debt and whether a more leveraged or less leveraged structure is going to be the cheapest alternative, well, that is very much in the hands of institutional investors themselves to determine whether or not they are offering an efficient price for a more highly rated piece of debt. The evidence we see in bidding for projects today is that, if we structure a project to the right kind of credit rating, investors will give us a price that provides a potentially compelling proposition against other financial structures.[77]

Public sector returns

47. The Government argues that since the public sector will earn a return from its minority equity investment, assuming appropriate management of project risk, the overall cost to the public sector will be lower under PF2 than would be the case if the public sector did not invest.[78] Geoffrey Spence went further, telling us that:

73 Qq113,114,122

74 Q113

75 Ev w8

76 Oral evidence taken before the Treasury Committee on 12 December 2012, HC (2012–13) 818–II, Qq239–241

77 Q56

78 HM Treasury, *A new approach to public private partnerships*, December 2012, para 2.9, p 31

> […] the potential extra cost of having higher equity is mitigated significantly, if not wholly, by the fact that that shareholding benefit in terms of dividends or any other payments that come from that shareholding will go back to the authority that has paid for the service. It will go through Treasury, but the commitment that the Treasury has made is that will go back directly to the procurement authority, so their net cost will be lower than their gross cost to the tune of the equity return.[79]

Lord Deighton provided the Committee with a further example of how the cost of capital might change under PF2, illustrating this potential effect (Table 3).

Table 3: Illustrative comparison from Lord Deighton of financing costs for PF2 and PFI including the potential effect of public sector equity returns

Standard bank financed PFI structure (indicative example)				PF2 (indicative example)			
	Cost	Proportion	Weighted cost		Cost	Proportion	Weighted cost
Senior Debt	6.25%	90%	5.63%	Senior Debt	5%	80%	4.00%
Equity	13%	10%	1.30%	Equity	13%	20%	2.60%
							6.60%
				Public sector equity return	13%	6%	-0.78%
Net cost			**6.93%**	**Net cost**			**5.82%**
Assumptions: *Swap Rate 3%* *Bank debt pricing starting at 3.0% rising to 3.5% p.a.* *Equity IRR 13%* *Capital Structure 90:10*				*Assumptions:* *Gilt Rate 3%* *Senior debt rating of AA-* *bonds pricing at G+200bps* *Capital Structure 80:20* *Public Sector Equity Share of 30%* *Equity IRR 13%*			

Source: Ev w3

48. Dr Hellowell's analysis supports the idea that public sector returns would potentially help to mitigate the higher cost of the additional equity (Table 4). He raised a number of concerns, however, as to whether this would be achieved in practice and also highlighted that, as the public investment would tie up capital which could not be used on other projects, it would effectively carry an implicit opportunity cost:

> From an economic perspective, [Table 4] overstates the benefit attributable to the public sector equity stake, for three reasons. First, there is an opportunity cost to the equity investment equal to the benefits accruing to an alternative allocation, for example using the money to buy financial securities or to pay off public sector debt. Second, the investment is subject to project risks, and the actual return may be higher or lower than that projected at the time of financial close. Third, although there may be some advantages to having a public official on an SPV board, for example in reducing the asymmetry of information between the public and private sectors in terms of the performance of the project, it is unclear how officials will balance their fiduciary duties owed to the SPV against their broader public interest responsibilities. If the consequence is that the incentive structure designed to

79 Q125

stimulate effective project delivery is compromised, the resulting costs will offset the benefits of a lower effective cost of capital.[80]

Table 4: Illustration from Dr Hellowell of the potential effect of public sector equity returns on the cost of cost of capital for PF2

	Proportion	Cost	Weighted Cost
Private equity	25%	15%	3.75%
Debt	75%	6.25%	4.69%
		Pre-tax WAC	**8.44%**
Public equity (25% stake)	6.25%	15%	-0.94%
		Net WACC	**7.5%**
Public equity (49% stake)	12.25%	15%	-1.84%
		Net WACC	**6.6%**

Source: Ev w10

49. **There was agreement among our witnesses that increasing the equity proportion under PF2 is likely to increase the cost of capital compared to conventional PFI. The Government claims, however, that a higher proportion of equity will offset the increased cost of finance, in whole or in part, for two reasons. First, a higher proportion of equity will reduce the risk borne by lenders and should therefore help to attract long-term institutional investors such as pension funds. Given the reduction in availability and increased cost of long-term bank debt following the financial crisis, this alternative source of funding will, the Government argues, lower the cost of finance. Second, the cost of the higher equity share will be offset by the returns on the public sector minority investment. However, there is a risk that these returns may not be realised in practice. For example, any return on the minority investment is subject to appropriate management of project risks. Failure to manage these risks will result in a lower return. This means that the Government's equity share is exposed to the same risks as that of any other private sector equity holder—there is no guaranteed return on its investment.**

50. **The Committee would also be concerned if the Treasury did not consider the opportunity cost of the equity investments when assessing the value for money of PF2 projects. Investing a minority stake in the private finance project under PF2 will mean that the money cannot be allocated elsewhere across government. There is an opportunity cost if the alternative allocation would yield a better return for the taxpayer: for example, paying off public sector debt. In such a case PF2 would represent lower value for money. The Treasury must take account of the estimated opportunity cost of the public sector equity when assessing whether the PF2 procurement approach represents the best value for money for a project.**

80 Ev w10

Risk transfer

51. As noted in our previous Report, the transfer of project risks from the public to the private sector was a fundamental principle of PFI. This transfer comes at a cost premium, however, and is only worthwhile if the private sector is better able to understand, control and minimise the cost of the risk. If the risk transfer is too expensive, it can result in poor value for money even if a project delivered in time and within budget. The Committee concluded that:

> The price of finance is significantly higher with a PFI. The financial cost of repaying the capital investment of PFI investors is therefore considerably greater than the equivalent repayment of direct government investment. We have not seen evidence to suggest that this inefficient method of financing has been offset by the perceived benefits of PFI from increased risk transfer.[81]

52. In addition to PF2 being more expensive than PFI, at least in the short term, Dr Heald told us that the proposed reforms would also result in less risk transfer to the private sector under PF2:

> In the PF2 document, the Treasury seems to be quite ambiguous about whether it really did get the construction risk transfer and really did get better performance, in terms of time and construction costs. [...]The proposals in PF2 very clearly involve less risk transfer than in conventional PFI. [...][82]

Dr Hellowell supported this view in his written evidence to the Committee and raised the concern that:

> [...] the short-term impact [of the contractual reforms represented by the rebrand from PFI to PF2] is likely to be an increase in the cost of capital for projects, for a lower level of risk transfer to the private sector. *A priori*, this raises clear questions about the value for money impact of these reforms.[83]

53. **In its previous Report, the Committee concluded that there was insufficient evidence that the risk transfer under PFI had, in aggregate, justified the higher cost of capital. In other words, greater efficiencies through better management of projects by the private sector had not offset the higher finance costs. Witnesses told us that PF2 will involve less risk transfer than PFI. Witnesses also said that PF2 would increase the cost of capital still further. If they are right, the value for money of PF2 contracts for the taxpayer will—unless PF2 delivers savings in other areas, such as construction—be even lower than that of PFI.**

Comparison of procurement options

54. Under PFI, all projects had to complete a Value for Money (VFM) assessment of the PFI option compared to a conventional procurement option funded directly by central

81 Treasury Committee, Seventeenth Report of Session 2010–12, *Private Finance Initiative,* HC 1146, para 71, p 35

82 Q79

83 Ev w13

government. This was known as the PSC (Public Sector Comparator). In our previous report, we expressed concerns that the system for appraising value for money was biased to favour PFI and that there was an incentive for both HM Treasury and public bodies to present PFI as the best value for money option as it was often the only avenue for investment in the face of limited departmental capital budgets.[84] In his evidence to this inquiry, David Heald told us that in relation to PFI, the procedures in the Treasury's guidance for how to assess value for money, known as the Green Book, "get corrupted to get the answer that is actually required."[85]

55. In light of these concerns, the Committee asked Lord Deighton what criteria the Treasury would use to establish value for money for PF2 projects and who would be responsible for ensuring that those criteria are applied to individual projects:

> Of course each project and sector will tend to have a slightly different approach. If we look at the schools programme, because that is one that is currently about to go through the PF2 model, the focus has been clear that the two risks we are determining or evaluating whether they are better off managed in the private sector are the construction risk and then subsequently the maintenance risk over the whole life cycle of the asset, and those are the ones that we manage there. The process [...] goes through a series of reviews at departmental and Treasury level to assure those value for money tests are fulfilled.[86]

Geoffrey Spence added:

> Departments of course do a value for money assessment that then at different stages has to be approved by the Treasury if it is above a delegated limit for expenditure, and that is the process that we use. We are giving further thought as to how we assess value for money before PF2, but it is worth just remembering that we have changed direction on Crossrail rolling stock, because we did not think that the solution that we had, which would have been a PF2 solution, was the best one. We have adopted a slightly different approach to schools than the market expected, because we did not think it was the right one. So I would say that shows that, certainly over the last six months, the centres in Government have been far sharper in helping people come to the right conclusion as to what to do next and they are not approaching this on the basis that there is only one alternative, which is PF2, because there isn't: there are many alternatives.[87]

Mr Spence also told us that part of the rationale for introducing a control total for PF2 projects was to ensure "there is far more of a whole of life assessment as to potential cost that goes beyond a short-term spending review period".[88]

84 Treasury Committee, Seventeenth Report of Session 2010–12, *Private Finance Initiative,* HC 1146, paras 62, 65, p 30, 33

85 Q87

86 Q148

87 Q149

88 Q153

NAO review of the VFM assessment process

56. In our previous Report, we recommended that the National Audit Office (NAO) should perform an independent analysis of the VFM assessment process and model for PFI. This should include an audit of all of the assumptions within the model, and a report on whether or not these were reasonable.[89]

57. The NAO responded to this recommendation in its *Review of the VFM Assessment Process for PFI,* provided to the Committee in October 2013. The NAO's review looked at the two elements that make up the VFM assessment process:

- The quantitative assessment—consisting of a standardised financial model which provides a comparison of costs and timings between using PFI and a conventional procurement alternative;
- The qualitative assessment—a series of questions aimed to assess the viability, desirability and achievability of the PFI project.

58. In *A new approach to public private partnerships,* the Government has announced that it is withdrawing the standardised Value for Money Assessment Quantitative Assessment Tool:

> The Value for Money Assessment Quantitative Assessment Tool will be withdrawn from 5 December 2012. Procuring authorities should continue to undertake appropriate quantitative assessment, in accordance with the principles set out in the Green Book, supported by in depth consideration of the qualitative factors that influence the choice of contracting route. Further advice about how to apply the Green Book principles when selecting a contracting option for a project, and the relationship between the economic and commercial cases of a business case, will be provided in the updated value for money guidance.[90]

59. The document stated that "the updated and extended guidance will be published for consultation in spring 2013." However, at the time of writing this Report, the updated guidance and associated consultation remain in development within Government.

60. Despite the tool's withdrawal, the NAO's analysis of the quantitative element helps in identifying any limitations which the Treasury needs to address in its updated appraisal guidance.

61. The NAO's analysis found that the model supporting the quantitative assessment was biased in favour of PFI in two key areas. First, the review states that the difference in the timing of cash flows between projects funded by private finance and conventional procurement affected the comparison:

> The model reflected when cash payments would be made by the public authority in question. This meant that the PFI cash flows reflected the payment schedule of unitary charges that were due to be paid by the public authority to the contractor,

89 Treasury Committee, Seventeenth Report of Session 2010–12, *Private Finance Initiative,* HC 1146, para 89, p 41

90 HM Treasury, *A new approach to public private partnerships*, December 2012, paras 7.29–7.31, p 72

> while the payments for the conventional procurement route were concentrated in the early years of the contract. As a result, the present value cost of construction under PFI was significantly reduced relative to that of conventional procurement in the model.[91]

62. The second area related to the discount rate used within the quantitative model. In line with The Green Book, the model uses the Social Time Preference Rate which has been 6.05% nominal over the last decade. The NAO review states:

> The application of this discount rate to the PFI costs that were spread over time meant that the additional cost of private finance in the model was only measured to the extent that its implicit interest rate was above 6.09 per cent [...] in 2012-13 the average cost of public borrowing was 2.09 per cent. Because the model both charged the majority of the conventional procurement costs upfront and used the standard discount rate that is well above the cost of public borrowing, the model understated the additional cost of using private finance compared to government borrowing.[92]

63. The Treasury disagree with the approach adopted by the NAO. To address the cash flow timing issue raised by the NAO, the Treasury provided the following response:

> The opportunity cost of alternative spending is the Government's approach to measuring the public value of all spending proposals. At the individual project level the appraisal informs individual spending decisions and applies only to decisions about resource allocation within a predetermined budget; the decisions are on whether to spend, or not, on a particular proposal.[93]

64. In response to the NAO's view on the discount rate adopted, the Treasury states:

> [...] the standard approach uses a single, common discount rate – the Social Time Preference Rate. This is used simply as a means to adjust alternative options with different patterns of future costs and benefits to allow for social time preferences and so facilitating their comparison. The discount rate used attempts to reflect pure preferences for benefit now over benefits postponed until the future, an element of unidentified background risk.[94]

65. **All potential PFI projects are appraised in line with the Government's central appraisal process set out in the Green Book. The timing of cash flows and the discount rate follow this standardised approach. The appropriateness of the Green Book falls outside the scope of this report, but the Committee may seek to address this area in a future inquiry.**

66. The NAO's review also pointed out that within the quantitative model, material adjustments were being made to the public sector comparator which were not supported by sufficient evidence. One such adjustment mentioned in the NAO report relates to

91 National Audit Office, *Review of the VFM Assessment Process for PFI*, October 2013, para 3.12, p 22

92 National Audit Office, *Review of the VFM Assessment Process for PFI*, October 2013, para 3.15–3.16, p 23

93 National Audit Office, *Review of the VFM Assessment Process for PFI*, October 2013, para 10, p 7

94 National Audit Office, *Review of the VFM Assessment Process for PFI*, October 2013, para 12, p 8

optimism bias which is an adjustment made to the public sector comparator to reflect the tendency for government led projects to overrun in both time and cost after the projects are approved. The NAO report states:

> Guidance from the Treasury in 2004 stated that departments should collate databases of projects' performance so they could measure the tendency of non-PFI projects to overrun on cost and time. However, none of the departments involved in these six projects systematically compiles the necessary performance data [...]
>
> In the absence of data on project performance to cost and time, project teams and their consultants [...] conducted workshops at which they estimated the likelihood that costs would rise above levels envisaged at the early stages of the project. To do so, they drew on their experience and understanding of the project [...] but it lacked an empirical basis and created uncertainty about a key variable of the model.[95]

67. In addition, the NAO review found that tax adjustments made to the model were not being supported by empirical evidence. Tax adjustments, known as the shadow price of tax, were made to the quantitative model to ensure that only the net costs were being reflected. Where taxes would be collected under PFI but not under conventional procurement, the amount of tax would be added to the public sector comparator. The NAO report states that:

> HM Treasury commissioned financial advisers to develop generic benchmarks for this shadow price of tax, to make it simpler for project teams to estimate. All projects we looked at added either six or eight per cent of the resource costs to the public sector comparator to reflect the corporation tax expected to be paid by the private sector under a PFI project. [...]HM Treasury has not been able to verify whether these generic benchmarks reflected actual tax receipts across the programme.[96]

68. A 'residual value' assumption also lacked an empirical basis. The NAO review explained that this residual value adjustment reflects the varying quality of repair and maintenance between the public sector comparator and the PFI option. The assumption is based on the view that higher maintenance costs for the PFI option throughout the life of the project would result in fewer costly dilapidations of assets at the end of the project. Therefore whenever the repair costs for the PFI option were above the equivalent costs for the public sector comparator, the difference would be added to the cost of the public sector comparator. According to the NAO review, this adjustment "reflects the cost of bringing the asset up to the PFI standard of repair at the end of the project". The NAO found that the residual value adjustment was often material to the comparison:

> In the one instance [...] the repair costs were three times the original cost of construction once cumulative inflation over the lifetime of the contract was taken into account. [97]

95 National Audit Office, *Review of the VFM Assessment Process for PFI*, October 2013, para 3.31–3.32, p 29

96 National Audit Office, *Review of the VFM Assessment Process for PFI*, October 2013, para 3.35, p 30

97 National Audit Office, *Review of the VFM Assessment Process for PFI*, October 2013, para 3.38, p 31

The NAO review again found that these adjustments were not supported by an evidence base:

> [...] departments have not collected the evidence to show how much of this additional cost of maintenance actually prevents costly dilapidations of the assets rather than simply being cosmetic or otherwise unnecessary.[98]

69. The second component of the VFM process, the qualitative assessment, was also reviewed within the NAO report. The NAO found that the qualitative assessment was "a useful checklist" when considering whether PFI was an appropriate option; however, they found that the responses to the questions lacked supporting evidence:

> Almost all of the assertions in the qualitative assessments we reviewed lacked a reference to any supporting evidence. [...] We rarely saw a response that referred to a specific example of a previous project. Instead, when references were made they tended to be generic to PFI, sometimes drawing on HM Treasury guidance.[99]

The NAO added that:

> The qualitative assessment, unlike the quantitative assessment, does not require project teams to compare PFI to the public sector comparator. Instead, all questions in the qualitative assessment are focussed on whether or not PFI will meet the intended outcomes of the project and is a suitable delivery methodology. [...] it does not enable project teams to assess whether or not PFI is value for money either in comparison to a public sector comparator or to any other alternative procurement route.[100]

70. **The NAO report highlights that both the quantitative and qualitative elements of PFI assessment have lacked reference to supporting evidence. Failure to base assumptions on empirical evidence will reduce the value of the VFM comparison.**

71. **The Government withdrew the Value for Money Assessment Quantitative Assessment Tool for comparing private finance and conventional procurement options in December 2012. The Treasury is still in the process of developing its updated and extended value for money guidance for PF2. In the meantime, procuring authorities are still required to use the qualitative assessment when appraising whether projects should be funded by private finance.**

72. **The Committee recognises that the qualitative element of the process is important, but believes that it should only be considered a supportive tool and in conjunction with a quantitative component. It is the quantitative assessment that provides the best basis for direct comparisons between PFI and government borrowing. The Committee recommends that the new value for money guidance for PF2 should consist of both quantitative and qualitative components.**

98 National Audit Office, *Review of the VFM Assessment Process for PFI*, October 2013, para 3.38, p 31

99 National Audit Office, *Review of the VFM Assessment Process for PFI*, October 2013, para 3.48, p 33

100 National Audit Office, *Review of the VFM Assessment Process for PFI*, October 2013, para 3.46 & 3.49, p 33

73. **The Treasury should seek to ensure that under the new value for money guidance for PF2, quantitative assumptions, particularly for the optimism bias and the tax adjustments, are supported by robust evidence which can be subject to scrutiny. The Treasury should also ensure that Department's responses to the questions posed in the qualitative assessment are also accompanied by evidence.**

74. **Decisions are nevertheless being taken, without such a quantitative assessment tool, on whether or not to use PF2 for infrastructure projects such as the Priority Schools Building Programme. The absence of robust updated guidance for assessing whether PF2 offers the best value for money for a particular project is highly unsatisfactory. The Treasury must consider carefully whether it should permit PF2 projects to proceed in the absence of such guidance, and should set a date for issuing new guidance.**

Transparency

75. In our previous Report we concluded that far more transparency was required in PFI. We recommended that HM Treasury should:

- collate and compare data to ensure that it gets a good price on any deals already being negotiated;
- benchmark operational costs of PFI projects with market prices outside PFI;
- compare the equity returns of investors with other investments with a similar risk profile. It should publish as much of this information as is commercially possible; and
- consider whether this should extend to publishing data and costings on existing contracts, where commercially possible, in addition to what was already published.[101]

76. The Government acknowledged this concern in *A new approach to public private partnerships* where it stated that:

> Improving the external transparency of PF2 arrangements is essential to ensure that the taxpayer is confident it is getting value for money from these arrangements; and the private sector has the relevant information it needs to enable efficient business planning and service delivery.[102]

It has therefore introduced a number of measures in PF2 in an attempt to provide transparency:

> increasing the amount of project information made available to taxpayers to give confidence that value for money is being achieved; and, at the same time, being more open with industry about the Government's project approval processes so that companies can plan ahead with greater certainty. Specifically:
>
> - publishing an annual report detailing full project and financial information on all projects where Government is a shareholder;

101 Treasury Committee, Seventeenth Report of Session 2010–12, *Private Finance Initiative,* HC 1146, para 107, p 48

102 HM Treasury, *A new approach to public private partnerships*, December 2012, para 5.2, p 56

- requiring the private sector to provide actual and forecast equity return information for publication;
- increasing transparency and control over the liabilities created by future PF2 projects by introducing a control total for commitments arising from off balance sheet PF2 contracts signed. [...];
- introducing a business case approval tracker on the Treasury website providing a status update on the progress of projects through the public sector approval processes; and
- publishing readily accessible and easily understood information on current PFI and future PF2 projects, and on the infrastructure and construction pipeline.[103]

The Treasury's draft document *Standardisation of PF2 Contracts* sets out that the equity return information that the private sector will be required to provide will be in the form of:

> a calculation of the equity internal rate of return [...] for the Project and for each of the Shareholders to be prepared using the Senior Credit Agreement Financial Model and calculated on a cash basis to include all Distributions and any other payments made to Shareholders in respect of fees.[104]

The Internal Rate of Return (IRR) is one measure by which investors can measure and compare the profitability of investments. It is, however, widely recognised that the IRR is not always the most objective measure to use when comparing investment options, as the Treasury's own Green Book guidance acknowledges:

> [...] the 'internal rate of return' (IRR) should be avoided as the decision criterion. Whilst it is very similar to NPV as a criterion, there are some circumstances in which it will provide different, and incorrect, answers. For instance, IRR can rank projects that are mutually exclusive differently from NPV.[105]

77. **The Committee welcomes the Government's commitment to publish an annual report providing detailed financial information on all projects where the Government is a shareholder. We also support the requirement for private sector investors to provide actual and forecast equity return information to the Treasury for publication. The Treasury must clearly define the basis of the calculation of such information to ensure consistency over time and comparability between projects, and to minimise the risk of manipulation of the figures. The Treasury must demonstrate that the requirements will be sufficient to capture the returns of equity investors involved in subsequent refinancing or sales of equity.**

103 HM Treasury, *A new approach to public private partnerships*, December 2012, p 55

104 HM Treasury, *Standardisation of PF2 Contracts*, December 2012, para 31.2.1(h)(iv), p 299

105 HM Treasury, *The Green Book – Appraisal and Evaluation in Central Government*, 2003 (amended July 2011), para 6.9, p 39

Service agreements

78. Another issue that the Committee highlighted in its 2011 Report was that PFI contracts were inherently inflexible. Specifications for a 30 year contract had to be agreed in detail at the start of a project. The PFI financing structure also required negotiation with the equity and debt holders before any substantial changes were made during the life of a contract. Debt and equity holders had little to gain from changing profitable contracts, so would be unlikely to agree to changes unless they significantly enhanced profitability. We received little evidence of the benefits of these arrangements, but much evidence about the drawbacks. The inflexibility of PFI meant that any emergent problems or new demands on an asset could not be efficiently resolved.[106]

79. Under the plans for PF2, design, construction and responsibility for maintenance and renewal will still be combined in a single contract. The Government believes that this will ensure that the contractor continues to be incentivised to consider future operational costs as decisions are made during the project's design and reconstruction. The Government acknowledges, however, that "flexibility has been a significant problem for PFI projects in the past" and has set out measures to address this:

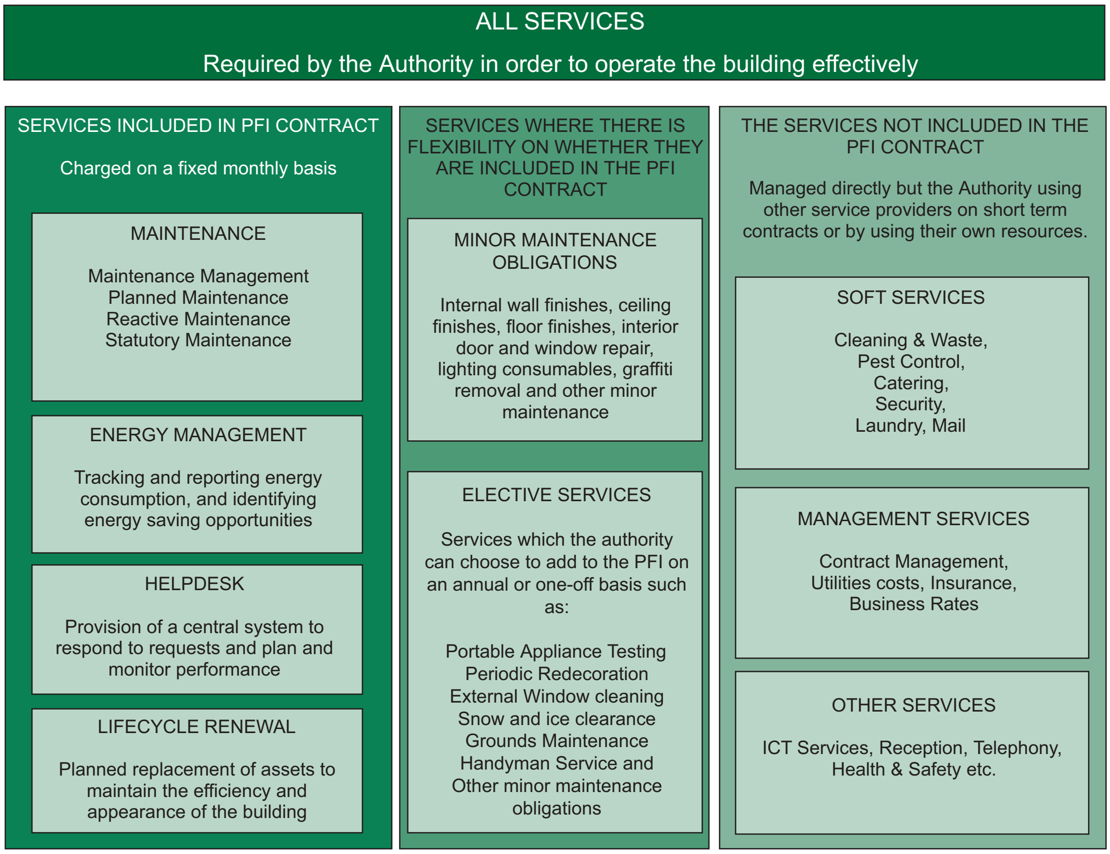
> To improve the flexibility of service provision the range of services included in the PF2 model will be reduced. 'Soft services', such as cleaning and catering, will be excluded from the contract, other than in exceptional circumstances. These services will be provided separately via shorter term contracts or directly by the authority, which will provide the public sector with the flexibility to alter service specifications over time.
>
> Procuring authorities will also have discretion over the inclusion of certain minor maintenance activities at the project outset. There will be additional flexibility to add or remove certain 'elective services', such as external window cleaning, once a contract is in operation. These elective services will be at a pre-agreed price, and can be added or removed from the project without the need to re-run the financial model.
>
> In order to provide greater flexibility at contract expiry, authorities will be able to adapt their requirements for the 'handback' condition of the asset to ensure it meets their expected future needs.[107]

Figure 2 summarises the services that will, may and will not be included in the principal contract for PF2 projects.

106 Treasury Committee, Seventeenth Report of Session 2010–12, *Private Finance Initiative,* HC 1146, para 56, p 29

107 HM Treasury, *A new approach to public private partnerships*, December 2012, para 4.5, pp 9–10 & pp 48–49

Figure 2: responsibility for service provision in PF2



Source: HM Treasury, A new approach to public private partnerships, December 2012, table 4.A, p 49

80. While stripping the 'soft services' out of the principal PF2 contract may increase flexibility it will mean that, for a given project, the asset and its services may be delivered by multiple service providers under a number of projects. We asked Lord Deighton whether he believed this measure would reduce costs or instead add complexity and cost. He responded:

> That is an important question, which I think does get into the heart of some of the things that we are trying to improve. One way of answering the question is to look at the work that has been done on the existing portfolio of [PFI] transactions in order to reduce their ongoing lifetime costs. The team at the Treasury has been working at this for a year or so now and I think the rolling target of savings now is about £1.65 billion and there is a target to accumulate another about £1.4 billion of savings from the existing portfolio. So that is really doing the work on the existing portfolio, which you are now discussing, should be applied in how we approach the new transactions differently. So I think that is proof that there is some value in doing this differently, and in the schools programme, for example, I think you are absolutely right.
>
> [...] I think it is more efficient to break up these bundles of services into their different kinds and to place them with people who can provide them in the most flexible, cost-efficient way. I agree with you, there is an element of management or

> overhead or complexity in order to accomplish that, but I do not think it is so incredibly complicated, and I think the opportunity is demonstrated by what we have done with the existing portfolio.[108]

81. The Treasury recognises, however, that there may be circumstances where splitting soft services into separate contracts may not represent the best approach:

> 4.8 The only exception to this [exclusion of soft facilities management services] will be where there are significant integration and interface benefits from procuring all services as a single contract. If procuring authorities consider that the inclusion of soft services is integral to the delivery of a project, a clear value for money case will need to be demonstrated and approved by the Treasury.[109]

82. Noble Francis, economics director at the Construction Products Association, has been quoted as having concerns over how the changes to the service agreements under PF2 will affect investors willingness to invest:

> If the Government is no longer tied to long-term service contracts, then there is a serious issue regarding who will invest given that the return on PFI for the private investor/contractor is in the long term over the course of the service contract.[110]

Lord Deighton told us, however:

> Like all these things, it is a question of balance. In terms of some of the sort of heavier maintenance and facilities management, I think in many—if not most—cases that works very naturally as part of the construction, because they go together very well. In terms of the softer services/elements, [...] I think it works very well to separate those out, particularly as the provision can change over time, you can work very hard at the efficiency. I think certain kinds of services do go better bundled, others are definitely more efficiently delivered on a separate basis under a separate contract from a separate provider. I think in every component of these transactions, clearly the return that we provide to the investor, the constructor, whoever it is, needs to be sufficient to bring them to the table. That is the balance that we are trying to establish the whole time, absolutely.[111]

83. **The Committee supports the principle of building greater flexibility into Private Finance contracts. The Treasury should seek to ensure that any benefits from the splitting out of 'soft services' from PF2 contracts are not negated by any increased complexity, and potentially cost, that coordinating and managing multiple contracts may bring.**

108 Qq155–156

109 HM Treasury, *A new approach to public private partnerships*, December 2012, para 4.7–4.8, pp 49–50

110 Financial Times, *Osborne to unveil PFI revamp*, 5 December 2012

111 Qq157–158

4 Securing private investment

84. The Government has made attracting private investment a key part of its National Infrastructure Plan, stating that it “will now also use all the tools at its disposal to facilitate the private investment that will finance the majority of the UK’s infrastructure”.[112] Private Finance 2 is one element of this wider approach and so as part of this inquiry we examined the steps the Government is taking to attract private investment.

85. As the Government has set out in *A new approach to public private partnerships*, prior to the financial crisis, there was an active bond market for UK and international private finance projects. Since then, however, PFI projects have been largely dependent on the bank loan market as the provider of long-term debt finance. However, the Eurozone sovereign debt crisis, combined with a downturn in the global economy and new bank regulatory requirements, mean that long-term borrowing for infrastructure projects has become more expensive and the availability of long-term bank debt has decreased. Where long-term bank finance is still available, margins demanded by the banks are often at levels which threaten the value for money of projects.[113]

86. As a result, the Government is looking to attract investment in PF2 projects from institutional investors with “longer-term investment horizons”, such as pension funds, and, in particular, is looking for them to invest in the project at an earlier stage. This class of investor has, however, been reluctant to invest directly in projects historically. The Government believes that:

> In part, this is because they have not developed the in-house skills and resources to manage these investments, but also because they have been averse to the time, risk and cost of bidding for projects.[114]

87. The Government has therefore included a mechanism under PF2 which it hopes will provide an attractive investment opportunity for these investors:

> Where appropriate, it will require an equity funding competition after the preferred bidder stage for a proportion of the equity requirement. The timing of such a competition, when project documentation and commercial and financial arrangements are substantially complete, will keep the costs of participation in the competition down and so meet concerns expressed by long-term equity providers. It is also expected that widening access to different types of investor could be expected increase competitive tension, with downward pressure on equity pricing in the longer-term.[115]

Lord Deighton told us that:

112 HM Treasury, *National Infrastructure Plan 2011*, November 2011, p 5

113 HM Treasury, *A new approach to public private partnerships*, December 2012, pp 10–11

114 HM Treasury, *A new approach to public private partnerships*, December 2012, para 2.23, p 34

115 HM Treasury, *A new approach to public private partnerships*, December 2012, para 2.24, p 34

> [...] my view on the market generally is our approach is to ensure that we access the global capital markets for the private money we need. Whether it comes from pension funds, life companies, sovereign wealth companies is less of an issue as long as we get there in total, so we are doing everything we can in each sector to encourage them along.[116]

Willingness to invest

88. In March 2013, we took oral evidence from a range of institutional investors in order to get their perspective on the Government's PF2 plans. All of the witnesses told us that their institutions were, in principle, prepared to invest in private finance projects. Robert Hingley, Director of Investment Affairs at the Association of British Insurers, told us:

> There is essentially a strong interest among our members to invest in this asset class. There is a widespread understanding that the quality of revenue from these projects is high, it is uncorrelated to the corporate cycle. If problems do occur the recovery rates tend to be good, and the default rates tend to be pretty low. So, in principle, there is a strong interest in investing as an asset class. It also fits the liability structure, particularly, of annuities and some of the longer term life funds very well.
>
> [...]
>
> Some of the larger members have indicated that, potentially, this asset class could be attractive for up to 15 per cent to 20 per cent of relevant portfolios for annuities and life funds, and I cannot give you exactly what that proportion would be. [...] That is an enormous capital pool.[117]

Joanne Segars, Chief Executive of the National Association of Pension Funds, said:

> From a pension fund perspective, very much like the insurer's perspective, infrastructure should be a good match for pension funds. It should be able to deliver long-term, low-risk, inflation-linked returns, which is what pension funds want. In particular, what pension funds are after is lower leverage. That way, we can get the inflation linking—very high levels of leverage tend to squeeze out the inflation linking that my members need to match their inflation-linked liabilities. So we have certainly welcomed the drive in the PF2 initiative and in the Autumn Statement to have lower levels of leverage. We think that that will make this particular sector more attractive to pension funds as investors, and will enable us to get the inflation linkage that we are after much more in terms of return. So I think, in principle, yes, this is a sector that could be attractive to pension funds.[118]

Perry Noble, Infrastructure Partner at Hermes GPE, told us:

> The Hermes Infrastructure Fund acts on behalf of various investors but, in particular, the long-term institutional investors that I think you are here to speak

116 Q162

117 Qq1, 29–30

118 Q15

> about. To answer the question perhaps a little less lengthily: yes, in principle, but the devil is in the detail. That is: yes, in principle, there is certainly an appetite to invest, and, yes, in principle, without a Government guarantee.[119]

89. Although investors told us they were keen to invest in the infrastructure sector in principle, they also highlighted that there are potential barriers to institutional investment. We explore some of these potential barriers below.

Potential influences on investment

Deal flow

90. Perry Noble told the committee that "there are some very positive initiatives contained within [*A new approach to public private partnerships*] that will help institutional investors invest with more enthusiasm in the asset category". He agreed, however, with the Committee's suggestion that, based solely on that document, there was insufficient detail for investors to determine whether or not to invest in PF2 projects.[120] Robert Hingley told us that "deal flow" would be crucial to providing the necessary detail institutional investors require if they were to invest in PF2:

> There are technical risks […] about the structuring of individual deals. To some extent, those will be more easily solved once there is a flow of projects to finance. Solving things in the abstract is harder than in the specific.
>
> In terms of what investors want, […] you can boil it down almost to two things. The first is regulatory certainty, and I have made the Solvency II point. The second is, as much as anything else, it is deal flow. What the insurers would like is a significant "plain vanilla asset class", as they refer to it, so lots of comparability between instruments for different projects and the deal flow […].[121]

Mr Noble agreed:

> When you are writing a cheque for someone else's money, and someone else's pension, we look at it very much on a deal by deal, project by project-specific basis. So it will depend on the nature of the project. There has not been real visibility yet, at least from my institution's perspective, on specific projects with a guarantee structure in place which we could analyse and get our mind around. So, it is deal flow.[122]

Glenn Fox of Hadrian's Wall Capital told us that, provided there was a sufficient flow of deals, he was confident that there would be a demand for PF2 projects from institutional investors:

> In terms of general institution investor demand, the market has reached a tipping point. [...]We are now at a point in the market where there are a wide variety of fund

119 Q7

120 Q66

121 Qq31, 55

122 Q58

managers out there actively raising infrastructure debt funds, and it has almost become the flavour of the moment, given the limited alternative opportunities there are to invest in relatively safe assets that offer a reasonable yield above gilts. From that point of view I am very confident that the Treasury will see long-term institutional demand for projects, provided there is a sufficient pipeline, of course, which is another matter.[123]

Pension Investment Platform

91. Pension funds are a key constituent of the institutional investors that the Government is trying to encourage to invest in infrastructure projects. But, although, as Joanne Segars told us, "from a pension fund perspective […] infrastructure should be a good match for pension funds", they have previously struggled to invest directly in the sector. She explained that this had:

> partly been to do with the way in which the market has been structured. So pension funds have objected to the very high levels of leverage that they find in current deals and current funds. That does squeeze out the inflation linking that I have said that pension funds are really seeking. Pension funds have also objected to some of the high fees that are present in the infrastructure market, […] those three things are among the factors that have dissuaded pension funds from investing in this asset class. The other is internal expertise within some of the funds.[124]

92. In response to this, The Government, the National Association of Pension Funds (NAPF) and the Pensions Protection Fund (PPF) signed a memorandum of understanding to create the Pension Infrastructure Platform (PIP).[125] The PIP forms part of the Government's plans to encourage up to £20 billion of private sector finance for UK infrastructure over the next decade.[126] Joanne Segars explained how the PIP will help pension funds to invest in the infrastructure sector:

> What we are trying to do through the Pensions Infrastructure Platform is to develop something that has low leverage, a low fee base, and also gives us the inflation link; so it is those three things coming together. […]
>
> I think by coming together, by developing something that is for pension funds by pension funds, with dedicated expertise and with a dedicated manager, we can start to overcome those barriers. It would therefore become a much more attractive asset class to pension funds, and in a sense put pension funds much more in the driving seat to be able to demand what they want much more from the market.[127]

123 Q56

124 Q48

125 HM Treasury, Press Notice, *Government welcomes first injection into Pensions Infrastructure Platform*, 18 October 2012

126 Qq47, 161

127 Q48

Joanne Segars told us that a proportion of the £2 billion the PIP aims to build will be used to get involved in the construction phase of infrastructure projects, including those under PF2:

> What we are looking at is to get inflation-linked returns, so RPI plus between 2 per cent and 5 per cent. That gives you a range of potential assets in which you might invest, somewhere towards the lower end of the risk spectrum, so in the sort of PF2 space. What [...] we want to be able to do is to get involved in the construction phase but without taking on the construction risk, just like the insurers. That is not where our expertise lies. Partly through the Government guarantee scheme, partly through other channels, we think that some of that construction risk might be able to be managed, might be able to be wrapped by others. From our perspective, what we are after are those inflation-linked cash returns. [...][128]

93. Ms Segars suggested that there was more the Government could do to encourage pension fund investment:

> In terms of what the Government can do, that is about some of the policy changes that will help shape and make infrastructure an attractive asset class to long-term investors, not just pension funds but insurers and others as well. That is about the focus on lower leverage. It is about getting some of the policy issues right around Solvency II and those sorts of things. It is about looking at the leverage that comes through from the regulated utilities to tackle some of those issues. We have had a very good, constructive dialogue with Infrastructure UK, with the Treasury, as we have been working through and developing the PIP. It is independent from Government, and I think it is important that that point does not always come across. By developing something that is for pension funds by pension funds, we can start to attract more pension funds into this asset class.[129]

Securing investment through PF2

94. At the launch of PF2 in December 2012, the Government set out that it wanted "to ensure that all suitable projects take advantage of the benefits of PF2" and that the Treasury would "work with departments to assess which future projects are eligible for PF2." Three projects were identified as candidates:

> The first confirmed programme to which PF2 will be applied is the £1.75 billion privately financed element of the Priority Schools Building Programme (PSBP). The Treasury and the Department for Education have been working together closely in the development of PF2.
>
> In addition, the Treasury is working with the Ministry of Defence as they finalise their basing strategy and infrastructure investment plans for a more cost effective estate that meets 'Future Force 2020' requirements, to explore how much of this investment—including construction and maintenance activity—can be delivered through PF2.

128 Q35

129 Q45

> In the health sector the Sandwell and West Birmingham Hospitals NHS Trust project is working with the Department of Health to assess the suitability of PF2 to deliver significant new investment, enabling consolidation of services from multiple sites and reorganisation of activity between hospital and community settings.[130]

95. Since the launch, the uptake of PF2 by these programmes has been less than expected, however. In March 2013, the *Financial Times* quoted "Whitehall officials" as saying that the £1.8 billion required for new bases and infrastructure would "come from inside government", rather than from private finance:

> "The money will all come from our own budgets," said the official. "We have decided not to take up the Private Finance Initiative to fund this, which was something we originally looked at. We will use the defence infrastructure organisation budget instead."[131]

96. The projects set out in the PF2 launch document have not been the only ones for which private finance has been selected but subsequently rejected. In March 2013, the Secretary of State for Transport also announced that it would also be abandoning a private finance approach for the purchase of the trains for Crossrail:

> I would like to inform the House about a change in the financing approach for the Crossrail rolling stock and associated depot facilities contract. The Mayor of London and Transport for London have proposed using the flexibility in the original procurement to move from the current financing model, involving a substantial element of private sector funding, to one that is entirely funded by the public sector.
>
> [...] Any delay in the rolling stock order would place this delivery timetable in jeopardy. By removing the private financing requirement and moving to a wholly publicly funded procurement the contract negotiations will be simplified and as a result Transport for London believes this will provide greater certainty that the contract can be awarded in time.[132]

Lord Deighton said to the Committee that this decision had been made as a result of timing rather than cost:

> The analysis from a value for money perspective, if I recall, was pretty balanced and so certainly my perspective is that the principal thing with many of these big infrastructure projects at the moment is to make sure that we deliver and keeping the project on schedule was the priority. So that is why the people involved overall went with the recommendation of a direct procurement route.[133]

In May 2013, the Education Funding Agency and Department for Education announced that only "46 schools in 5 batches will be rebuilt under the Government's new approach to public private partnerships, known as PF2" with a "total funding requirement of

130 HM Treasury, *A new approach to public private partnerships*, December 2012, para 7.32–7.35, pp 72–73

131 The Financial Times, *Army prepares for German drawdown*, 5 March 2013

132 HC Deb, 1 March 2013, col 50WS [Commons written ministerial statement]

133 Q110

approximately £700 million”.[134] In addition to the reduction in the proportion of the project to be delivered under PF2, it was also announced that the funding for this PF2 element “is set to be raised using an innovative new ‘aggregator’ model” which “will be able to access both the bank debt and capital markets in order to secure the best deals for the taxpayer”.[135] In his written evidence to the Committee, Lord Deighton told us that he welcomed this innovation and told us that this was an example of “alternative solutions” that might emerge "as the institutional investor market develops”.[136] Since giving evidence to the Committee, Lord Deighton has been quoted by the *Financial Times* as playing down the idea that PF2 has been a failure:

> we’re in a different environment now and PF2 is just a smaller weapon in our armoury [...] government really does take value for money very seriously so it doesn’t use that technique any more, to get stuff done that we wouldn’t invest public money in.[137]

97. **Even if a value for money case could be demonstrated for the PF2 approach, institutional investors would need to enter the market in sufficient numbers to create the kind of competition that could lead to the cheaper equity pricing that the Government is seeking. Investors have indicated that this is only likely to happen if there is a clear pipeline of PF2 projects and a flow of deals. Such a deal flow has yet to materialise, and some of the projects that the Government initially planned to procure using PF2 have either scaled back their use of the approach or have abandoned it altogether.**

98. **It is unclear how the new aggregator model which the Government intends to use to fund the privately financed element of the Priority Schools Building Programme will operate. We are concerned that, if this involves grouping schools into batches, the advantages of involving private investors at the individual project level may be lost and the approach will be driven by accounting and budgetary incentives rather than value for money. The Treasury should set out, in detail, how this model will operate and how it believes the approach will offer value for money compared with direct capital investment.**

134 GOV.UK, Press Notice, *Private finance to fund rebuilding of 46 schools under the next steps of the Priority School Building Programme*, 10 May 2013

135 GOV.UK, Press Notice, *Private finance to fund rebuilding of 46 schools under the next steps of the Priority School Building Programme*, 10 May 2013

136 Ev w2

137 The Financial Times, *After Olympics, Deighton enters the infrastructure challenge*, 30 July 2013

Conclusions and recommendations

Accounting and budgetary incentives

1. In its previous Report, the Committee concluded that the accounting treatment of PFI debt was encouraging the use of private finance for reasons other than value for money. The production of National Accounts according to European System of Accounts (ESA) leaves PFI debt off balance sheet. The Government's headline debt statistic, Public Sector Net Debt (PSND), which is calculated using the National Accounts balance sheet, therefore excludes PFI debt. This acts as an incentive to pursue PFI as it does not add to the headline measure of national indebtedness. Departmental capital budgets also follow the definitions used by the ESA. When a department does not have a capital budget large enough to finance an investment project under conventional procurement, PFI can be used to leverage its capital budget to proceed with the investment. (Paragraph 33)

2. One of the PF2 innovations is the introduction of a control total. This will limit the payments under PFI and PF2 contracts to £70 billion over the five years from 2015–16 onwards, allowing about £1 billion of new PF2 projects a year. However, an aggregate control total would not remove the budgetary incentive for individual Departments to choose PF2 over traditional procurements: until the £70 billion upper limit is reached, it would remain. Indeed, the control total will create an incentive for departments to bring forward investment decisions under PF2 as soon as possible in order to include the projects within the £70 billion cap. This is likely to reduce the quality of decision making within government on investment projects, with less consideration given as to whether PF2 offers the best value for money. The Committee remains concerned that the control total will fail to address the budgetary incentives to use private finance. (Paragraph 34)

Value for money

3. There was agreement among our witnesses that increasing the equity proportion under PF2 is likely to increase the cost of capital compared to conventional PFI. The Government claims, however, that a higher proportion of equity will offset the increased cost of finance, in whole or in part, for two reasons. First, a higher proportion of equity will reduce the risk borne by lenders and should therefore help to attract long-term institutional investors such as pension funds. Given the reduction in availability and increased cost of long-term bank debt following the financial crisis, this alternative source of funding will, the Government argues, lower the cost of finance. Second, the cost of the higher equity share will be offset by the returns on the public sector minority investment. However, there is a risk that these returns may not be realised in practice. For example, any return on the minority investment is subject to appropriate management of project risks. Failure to manage these risks will result in a lower return. This means that the Government's equity share is exposed to the same risks as that of any other private sector equity holder—there is no guaranteed return on its investment. (Paragraph 49)

4. The Committee would also be concerned if the Treasury did not consider the opportunity cost of the equity investments when assessing the value for money of PF2 projects. Investing a minority stake in the private finance project under PF2 will mean that the money cannot be allocated elsewhere across government. There is an opportunity cost if the alternative allocation would yield a better return for the taxpayer: for example, paying off public sector debt. In such a case PF2 would represent lower value for money. **The Treasury must take account of the estimated opportunity cost of the public sector equity when assessing whether the PF2 procurement approach represents the best value for money for a project.** (Paragraph 50)

5. All potential PFI projects are appraised in line with the Government's central appraisal process set out in the Green Book. The timing of cash flows and the discount rate follow this standardised approach. The appropriateness of the Green Book falls outside the scope of this report, but the Committee may seek to address this area in a future inquiry. (Paragraph 65)

6. The NAO report highlights that both the quantitative and qualitative elements of PFI assessment have lacked reference to supporting evidence. Failure to base assumptions on empirical evidence will reduce the value of the VFM comparison. (Paragraph 70)

7. The Government withdrew the Value for Money Assessment Quantitative Assessment Tool for comparing private finance and conventional procurement options in December 2012. The Treasury is still in the process of developing its updated and extended value for money guidance for PF2. In the meantime, procuring authorities are still required to use the qualitative assessment when appraising whether projects should be funded by private finance. (Paragraph 71)

8. The Committee recognises that the qualitative element of the process is important, but believes that it should only be considered a supportive tool and in conjunction with a quantitative component. It is the quantitative assessment that provides the best basis for direct comparisons between PFI and government borrowing. **The Committee recommends that the new value for money guidance for PF2 should consist of both quantitative and qualitative components.** (Paragraph 72)

9. **The Treasury should seek to ensure that under the new value for money guidance for PF2, quantitative assumptions, particularly for the optimism bias and the tax adjustments, are supported by robust evidence which can be subject to scrutiny. The Treasury should also ensure that Department's responses to the questions posed in the qualitative assessment are also accompanied by evidence.** (Paragraph 73)

10. Decisions are nevertheless being taken, without such a quantitative assessment tool, on whether or not to use PF2 for infrastructure projects such as the Priority Schools Building Programme. The absence of robust updated guidance for assessing whether PF2 offers the best value for money for a particular project is highly unsatisfactory. **The Treasury must consider carefully whether it should permit PF2 projects to proceed in the absence of such guidance, and should set a date for issuing new guidance.** (Paragraph 74)

11. The Committee welcomes the Government's commitment to publish an annual report providing detailed financial information on all projects where the Government is a shareholder. We also support the requirement for private sector investors to provide actual and forecast equity return information to the Treasury for publication. The Treasury must clearly define the basis of the calculation of such information to ensure consistency over time and comparability between projects, and to minimise the risk of manipulation of the figures. The Treasury must demonstrate that the requirements will be sufficient to capture the returns of equity investors involved in subsequent refinancing or sales of equity. (Paragraph 77)

12. The Committee supports the principle of building greater flexibility into Private Finance contracts. The Treasury should seek to ensure that any benefits from the splitting out of 'soft services' from PF2 contracts are not negated by any increased complexity, and potentially cost, that coordinating and managing multiple contracts may bring. (Paragraph 83)

Securing private investment

13. Even if a value for money case could be demonstrated for the PF2 approach, institutional investors would need to enter the market in sufficient numbers to create the kind of competition that could lead to the cheaper equity pricing that the Government is seeking. Investors have indicated that this is only likely to happen if there is a clear pipeline of PF2 projects and a flow of deals. Such a deal flow has yet to materialise, and some of the projects that the Government initially planned to procure using PF2 have either scaled back their use of the approach or have abandoned it altogether. (Paragraph 97)

14. It is unclear how the new aggregator model which the Government intends to use to fund the privately financed element of the Priority Schools Building Programme will operate. We are concerned that, if this involves grouping schools into batches, the advantages of involving private investors at the individual project level may be lost and the approach will be driven by accounting and budgetary incentives rather than value for money. The Treasury should set out, in detail, how this model will operate and how it believes the approach will offer value for money compared with direct capital investment. (Paragraph 98)

Formal Minutes

Wednesday 12 March 2014

Members present:

Mr Andrew Tyrie, in the Chair

Mark Garnier	Mr Brooks Newmark
Andrea Leadsom	Jesse Norman
Mr Andrew Love	Teresa Pearce
John Mann	David Ruffley
Mr George Mudie	John Thurso

Draft Report (*Private Finance 2*), proposed by the Chair, brought up and read.

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

Paragraphs 1 to 98 read and agreed to.

Resolved, That the Report be the Tenth Report of the Committee to the House.

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

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

[Adjourned till Tuesday 18 March at 9.45am

Witnesses

List of written evidence

(published in Volume II on the Committee’s website www.parliament.uk/treascom)

List of Reports from the Committee during the current Parliament

Session 2010–12

First Report	June 2010 Budget	HC 350
Second Report	Appointment of Dr Martin Weale to the Monetary Policy Committee of the Bank of England	HC 475
Third Report	Appointment of Robert Chote as Chair of the Office for Budget Responsibility	HC 476
Fourth Report	Office for Budget Responsibility	HC 385
Fifth Report	Appointments to the Budget Responsibility Committee	HC 545
Sixth Report	Spending Review 2010	HC 544
Seventh Report	Financial Regulation: a preliminary consideration of the Government's proposals	HC 430
Eighth Report	Principles of tax policy	HC 753
Ninth Report	Competition and Choice in Retail Banking	HC 612
Tenth Report	Budget 2011	HC 897
Eleventh Report	Finance (No.3) Bill	HC 497
Twelfth Report	Appointment of Dr Ben Broadbent to the Monetary Policy Committee of the Bank of England	HC 1051
Thirteenth Report	Appointment of Dr Donald Kohn to the interim Financial Policy Committee	HC 1052
Fourteenth Report	Appointments of Michael Cohrs and Alastair Clark to the interim Financial Policy Committee	HC 1125
Fifteenth Report	Retail Distribution Review	HC 857
Sixteenth Report	Administration and effectiveness of HM Revenue and Customs	HC 731
Seventeenth Report	Private Finance Initiative	HC 1146
Eighteenth Report	The future of cheques	HC 1147
Nineteenth Report	Independent Commission on Banking	HC 1069
Twentieth Report	Retail Distribution Review: Government and FSA Responses	HC 1533
Twenty-first Report	Accountability of the Bank of England	HC 874
Twenty-second Report	Appointment of Robert Jenkins to the interim Financial Policy Committee	HC 1575
Twenty-third Report	The future of cheques: Government and Payments Council Responses	HC 1645
Twenty-fourth Report	Appointments to the Office of Tax Simplification	HC 1637
Twenty-fifth Report	Private Finance Initiative: Government, OBR and NAO Responses	HC 1725
Twenty-sixth Report	Financial Conduct Authority	HC 1574
Twenty-seventh Report	Accountability of the Bank of England: Response from the Court of the Bank	HC 1769
Twenty-eighth Report	Financial Conduct Authority: Report on the Governments Response	HC 1857
Twenty-ninth Report	Closing the tax gap: HMRC's record at ensuring tax compliance	HC 1371
Thirtieth Report	Budget 2012	HC 1910

Session 2012–13

First Report	Financial Services Bill	HC 161
Second Report	Fixing LIBOR: some preliminary findings	HC 481
Third Report	Access to cash machines for basic bank account holders	HC 544
Fourth Report	Appointment of Mr Ian McCafferty to the Monetary Policy Committee	HC 590
Fifth Report	The FSA’s report into the failure of RBS	HC 640
Sixth Report	Appointment of John Griffith-Jones as Chair-designate of the Financial Conduct Authority	HC 721
Seventh Report	Autumn Statement 2012	HC 818
Eighth Report	Appointment of Dr Mark Carney as Governor of the Bank of England	HC 944
Ninth Report	Budget 2013	HC 1063

Session 2013–14

First Report	Appointments of Dame Clara Furse, Richard Sharp, and Martin Taylor to the Financial Policy Committee	HC 224
Second Report	Appointments of Dr Donald Kohn and Andrew Haldane to the Financial Policy Committee	HC 259
Third Report	Spending Round 2013	HC 575
Fourth Report	Re-appointment of Professor Stephen Nickell to the Budget Responsibility Committee	HC 688
Fifth Report	Appointment of Sir Jon Cunliffe as Deputy Governor of the Bank of England	HC 689
Sixth Report	Re-appointment of Dr Martin Weale to the Monetary Policy Committee	HC 313
Seventh Report	Money Advice Service	HC 457
Eighth Report	OBR Fiscal Sustainability Report 2013	HC 958
Ninth Report	Autumn Statement 2013	HC 826
Tenth Report	Private Finance 2	HC 97
Eleventh Report	Appointment of Spencer Dale to the Financial Policy Committee	HC 1236
Twelfth Report	Appointment of Andy Haldane to the Monetary Policy Committee	HC1235
Thirteenth Report	Budget 2014	HC 1189

Oral evidence

Taken before the Treasury Committee

on Tuesday 5 March 2013

Members present:

Mr Andrew Tyrie (Chair)

Mark Garnier
Stewart Hosie
Mr Andrew Love
Mr Pat McFadden
Mr George Mudie
Mr Brooks Newmark
Jesse Norman
Teresa Pearce
John Thurso

Examination of Witnesses

Witnesses: **Joanne Segars** Chief Executive, National Association of Pension Funds, **Robert Hingley**, Director of Investment Affairs, Association of British Insurers, **Glenn Fox**, Chief Investment Officer, Hadrian's Wall Capital and **Perry Noble** Infrastructure Partner, Hermes GPE, gave evidence.

Q1 Chair: Thank you very much for coming to give evidence this morning. PFI has had a bumpy life so far, and it now appears to be in the process of being transmogrified; how much, is something that we want to explore. Thank you very much all of you, and I will go left to right or perhaps right to left. Why don't I go right to left for a change? I go left to right too often. Can I ask each of you whether you will invest in any of this stuff without a Government guarantee?
Robert Hingley: I am "right", am I?
Chair: Yes, Mr Hingley.
Robert Hingley: I represent the Association of British Insurers. There is essentially a strong interest among our members to invest in this asset class. There is a widespread understanding that the quality of revenue from these projects is high, it is uncorrelated to the corporate cycle. If problems do occur the recovery rates tend to be good, and the default rates tend to be pretty low. So, in principle, there is a strong interest in investing as an asset class. It also fits the liability structure, particularly, of annuities and some of the longer term life funds very well. Our members are looking for assets with a tenure of up to 30 years, so the asset class fits that very well. What they need for Solvency II—which is a particular problem for the life insurance industry—is essentially paper that is rated A minus or better.
To talk about PF2 specifically, one of the things that is helpful in that context, or the most helpful change, I think, is the increased equity proportion. So 10% to 20% will generally enhance credit quality. But the key thing—and this is where the Government guarantee may still be relevant—is if it becomes BBB, then the capital charge for holding that paper, particularly in an annuity fund, becomes greater. There are limits to the extent to which you can hold BBB paper. It has to be no more than 33% of the total if you were to qualify for the matching adjustment, which is an important issue.

Q2 Chair: You are saying that part of it has to be guaranteed or it has to be packaged in the form where the average risk value pushes it at least to AA minus, did you say?
Robert Hingley: To A minus, so one grade.
Chair: A minus.
Robert Hingley: It needs to be investment grade and one grade up. If that can be achieved without the Government guarantee, that should be fine, but at present I think the general expectation is that some form of Government guarantee is likely to be needed.

Q3 Chair: For part of it or for all of it? Clearly Government guarantee takes you way above one peg above investment grade.
Robert Hingley: Then it should be for part of it. Government guarantee is one means of credit enhancement, and monoline insurers used to provide guarantees in the past for part of it. I think that is the role that Government would still be expected to take on.

Q4 Chair: So the answer to my question was, "Yes"?
Robert Hingley: Yes, partially.

Q5 Chair: This is not a flier without risk transfer?
Robert Hingley: Sorry, I did not hear.
Chair: Without risk transfer to the Government?
Robert Hingley: Sorry, I still did not hear you.
Chair: With part of the risk being transferred to the Government?
Robert Hingley: Yes.

Q6 Chair: Appearing one way or another on the UK's balance sheet somehow, which is an accounting issue?
Robert Hingley: Yes.

Q7 Chair: So a very helpful, if somewhat lengthy, introduction. I am going to carry on moving from my right to left. Mr Noble, who can tell us something about Hermes.
Perry Noble: Yes, Hermes. I am here with an infrastructure investor hat on. The Hermes Infrastructure Fund acts on behalf of various investors but, in particular, the long-term institutional investors that I think you are here to speak about. To answer the question perhaps a little less lengthily: yes, in

principle, but the devil is in the detail. That is: yes, in principle, there is certainly an appetite to invest, and, yes, in principle, without a Government guarantee.

Q8 Chair: So it is a different answer from Mr Hingley.
Perry Noble: A different perspective.

Q9 Chair: You are happy to go ahead without a Government guarantee?
Perry Noble: In principle. But the devil is in the detail, which is all around the risk transfer and the way in which some of these proposals that are being discussed will be implemented.

Q10 Chair: Well, either the risk is transferred or it is not.
Perry Noble: It is the intelligent transfer of a risk.

Q11 Chair: At the point at which risk gets transferred, there is a guarantee.
Perry Noble: I don't think it is a "one size fits all" solution.

Q12 Chair: You cannot have these projects two-thirds built and then just sitting there, can you?
Perry Noble: I think it is correct to say that our biggest concern with the current construct will be in relation to the construction risk and how that risk is managed.

Q13 Chair: I am trying to get to the heart because I am trying to unpick the words "in principle". It seems to me you are saying there needs to be a Government guarantee to cover the construction risk.
Perry Noble: I am reluctant to say that.
Chair: Although you have come here, you are very reluctant to say it.
Perry Noble: I am reluctant to say that because I think there are other ways in which you could approach this in order to achieve an outcome without the Government guarantee. But I am looking at it very much from an investor perspective rather than from an institutional pension fund perspective, as an investment professional.

Q14 Chair: What are these other ways?
Perry Noble: It depends a lot on the role of the public sector equity, the extent to which sponsors are involved, the capital structure, the debt structure, the nature of the construction risk that you are talking about. We would look at this very much more in relation to counterparty risk, refinancing risk and external factors. Many of these things are driven by the extent to which this type of product is affected by macro and external factors. Yes, a Government guarantee is one way of approaching that but it is not necessarily the most efficient way of approaching it from the pure project perspective.

Q15 Chair: Joanne Segars?
Joanne Segars: Thank you. From a pension fund perspective, very much like the insurer's perspective, infrastructure should be a good match for pension funds. It should be able to deliver long-term, low-risk, inflation-linked returns, which is what pension funds want. In particular, what pension funds are after is lower leverage. That way, we can get the inflation linking—very high levels of leverage tend to squeeze out the inflation linking that my members need to match their inflation-linked liabilities. So we have certainly welcomed the drive in the PF2 initiative and in the Autumn Statement to have lower levels of leverage. We think that that will make this particular sector more attractive to pension funds as investors, and will enable us to get the inflation linkage that we are after much more in terms of return. So I think, in principle, yes, this is a sector that could be attractive to pension funds.

Q16 Chair: We are sure it is interesting. All of us are convinced it is interesting.
Joanne Segars: Interesting as an investment.

Q17 Chair: I know I am being fairly generous on time here for your answers, but what I want to know is, will the people you represent do these without risk transfer, without a guarantee?
Joanne Segars: As a Pensions Infrastructure Platform, we are currently looking at the specific investment criteria that we may invest in. We are creating the fund at the moment; the fund doesn't actually exist, unlike Perry's fund. But we think that, yes, in principle, this again could be interesting. We are certainly also talking to the Treasury about the construction guarantee.

Q18 Chair: You say "interesting"; I am trying to pin down what this means. This could be done without a guarantee?
Joanne Segars: We also want to look with the Government at the role that the guarantee scheme could play, yes.

Q19 Chair: So was that a "yes" or a "no" to my question?
Joanne Segars: It was a "We are likely to want to invest in this sector." The presence of guarantees might make that more likely.

Q20 Chair: Well, we are slowly groping our way towards some sort of answer. Mr Fox.
Glenn Fox: Chairman, I can be more definitive. I represent an infrastructure debt fund, which has been set up specifically to provide credit enhancement to attract capital markets investors into PFI-type projects. Yes, absolutely, we are bidding to invest in projects today without the need for a Government guarantee. Our view is that for the vast majority of projects in the PFI sector—perhaps not in other sectors, but in the PFI sector—Government guarantees are not necessary in order for those projects to be financed.

Q21 Jesse Norman: Can I be perfectly clear as to what is happening? We have two sets of long-term pension investors. We have one infrastructure risk-taking investor and we have one monoline insurance provider, as was.
Glenn Fox: As was.

Jesse Norman: As was, thank you.
Perry Noble: Just to be clear, our clients are primarily long-term investors. We are not a short-term fund but we are an investor. We write cheques.

Q22 Jesse Norman: To crystallise this, for example, you guys would take construction risk?
Perry Noble: In principle, yes.

Q23 Jesse Norman: We are back to "in principle". You would insure construction risk?
Glenn Fox: We don't insure. Our new business model is about providing long-term credit debt.

Q24 Jesse Norman: So, you will provide credit debt?
Glenn Fox: We provide cash and we will take construction risk.

Q25 Jesse Norman: I am assuming that the NAPF and the ABI would not take construction risk.
Robert Hingley: The same sort of answer as Joanne gave—that we are looking at ways with our members of being able to take construction risk. Construction risk has historically been unattractive to insurance companies. A sixth of an inch between pensions is quite important, but it is something they have historically been unwilling to do; but we are looking at ways of trying to take that up.

Q26 Jesse Norman: When are you going to have a view?
Robert Hingley: When are we going to have a view? Well, we are working with our members.

Q27 Jesse Norman: Does that mean this year, next year?
Robert Hingley: This year.

Q28 Jesse Norman: Good. Then potentially substantial amounts of member capital could flow?
Robert Hingley: Absolutely, yes.

Q29 Jesse Norman: What kind of numbers, do you think?
Robert Hingley: Some of the larger members have indicated that, potentially, this asset class could be attractive for up to 15% to 20% of relevant portfolios for annuities and life funds, and I cannot give you exactly what that proportion would be.

Q30 Jesse Norman: That is an enormous capital pool.
Robert Hingley: That is potentially an enormous capital pool, yes.

Q31 Jesse Norman: What likelihood do you think there would be of investment out of that capital pool?
Robert Hingley: I think high. There are sets of risks. There are technical risks—that I think both Perry and Joanne have alluded to—about the structuring of individual deals. To some extent, those will be more easily solved once there is a flow of projects to finance. Solving things in the abstract is harder than in the specific. As Perry said, the devil is in the detail. There is a particular issue that the insurance industry has to address, which is currently unique to the insurance industry, concerning the capital treatment under Solvency II.

Q32 Jesse Norman: Thanks. Joanne, a similar kind of answer?
Joanne Segars: Yes, a similar kind of answer. As you know, we are building this Pensions Infrastructure Platform that will be a £2 billion fund for pension funds by pension—
Jesse Norman: £2 billion?
Joanne Segars: £2 billion.

Q33 Jesse Norman: It is not enormous.
Joanne Segars: It is twice what pension funds are currently investing in infrastructure as an asset class. A £2 billion fund is a pretty large infrastructure fund in the scheme of things—an individual infrastructure fund.

Q34 Jesse Norman: This will take risk-bearing investment, like construction risk as well as long-term debt or equity involvement?
Joanne Segars: What we want to do is to get involved at the construction phase because that is where the pipeline is coming from.

Q35 Jesse Norman: The £2 billion will be focused on that kind of investment?
Joanne Segars: A proportion of it will. What we are looking at is to get inflation-linked returns, so RPI plus between 2% and 5%. That gives you a range of potential assets in which you might invest, somewhere towards the lower end of the risk spectrum, so in the sort of PF2 space. What we are interested in—sorry to use that word again—what we want to be able to do is to get involved in the construction phase but without taking on the construction risk, just like the insurers. That is not where our expertise lies. Partly through the Government guarantee scheme, partly through other channels, we think that some of that construction risk might be able to be managed, might be able to be wrapped by others. From our perspective, what we are after are those inflation-linked cash returns.
To pick up on the Solvency II issue, at the moment it is an issue for insurers. It could also be an issue for pension funds as well, with a review of the Pensions Funds Directive in the EU. Again, if that comes to pass, I think that will dissuade pension funds from investing in this sector.

Q36 Jesse Norman: That is helpful. Again, to the two long-term investors—if I may put it that way; or three, if you like—how much actual investment have you done alongside public authorities, or have your members done?
Joanne Segars: The PIP doesn't exist at the moment. Certainly individual pension funds—

Q37 Jesse Norman: So pension funds have done virtually no investment alongside?
Joanne Segars: No, that is not necessarily true. According to NAPF's most recent survey, about 1.2%

of pension funds' assets in total are invested in infrastructure. At the moment it is a very small asset class but one that pension funds are keen to see grow. The problem that pension funds face at the moment is that the market isn't structured in their interests.

Q38 Jesse Norman: I want to ask a slightly different question, which is not just what your appetite for infrastructure investment is but what your experience of working alongside public equity investors is?
Joanne Segars: That will vary from pension fund to pension fund.
Jesse Norman: But I am guessing it is quite small.
Joanne Segars: It is relatively quite limited. Perry, you will have more to say.
Perry Noble: Yes, alongside public equity investors.

Q39 Jesse Norman: The truth of the matter then is that your members don't have much of a feel for what it will be like to be sitting alongside a relevant public investor, and the kinds of tensions that might arise within the investor groups.
Perry Noble: It would be a very unusual construct.

Q40 Jesse Norman: Yes, and presumably there could be significant differences of view about this.
Perry Noble: That is difficult. One of the big concerns we will have is how you achieve the alignment—which I think everybody is looking to achieve—particularly where, from what I have read, it looks more like that alignment is with the sponsor equity in the first phase. There is a view that in some way the public sector equity will be recycled. That alignment with us, when we are long-term hold investors, is a very difficult tension to manage and we would need to understand how that would be dealt with.

Q41 Jesse Norman: A final question then, which is: if you are looking at those kinds of parallel investments—and again, this is for the investors, if you don't mind, the current investors—how much experience do you have in terms of driving out returns as investors? Because often, as you know, in these PFI deals a lot of the fat is sitting in the construction contracts, and what you need is more upward pressure from the equity investors saying, essentially, "Where is my cash?" I take it you do not have much experience of doing that within a public sector-type deal, but you might have some within private sector infrastructure investments.
Robert Hingley: If I can answer for the insurance companies. First, to answer a question you asked a moment ago about the level of current investment in infrastructure, there is some. I don't have exact figures but it is quite low, so your point about experience is correct. As a general proposition, the investors that we would represent would be interested in the debt securities rather than the equity part of it. They would be looking simply at the credit rating and the security of the returns, rather than an active involvement in driving the deal.

Q42 Jesse Norman: They will be opting out from extracting value from the deals once they have been started up?
Robert Hingley: I think that that is the role of the equity holder rather than the debt holders.

Q43 Jesse Norman: Obviously; and from your point of view?
Perry Noble: We are a long-term investor. We are there to hold.
Jesse Norman: Because Hermes is going to be in that game.
Perry Noble: We are there to hold our investment, so it is all about the integrity and the robustness of the project.

Q44 Jesse Norman: It is so striking how little corporate governance gets applied from within the equity holders on the current deals.
Perry Noble: We would have a very big focus on corporate governance.
Jesse Norman: Good. That is very helpful. Anything else you wanted to add?
Joanne Segars: No.
Jesse Norman: I am sorry not to have involved you. Thank you, Mr Chairman.

Q45 Teresa Pearce: Joanne, on the pension investment plans being developed by your organisation, not many pension schemes are large enough to invest in an infrastructure project, so you are going to have to have smaller pension funds pooling together. How do you see that being done? What would the Government need to do to make that possible?
Joanne Segars: You are right that even some of the very largest pension funds do not have the in-house expertise to get involved directly in investing in infrastructure, and that is what sits behind the development of the Pensions Infrastructure Platform: the recognition that infrastructure should be, if it can be correctly shaped, a good investment class for pension funds. It should be a buy and hold. It should be a long-term investment. By joining together as a group of pension funds to develop a fund—a Pensions Infrastructure Platform, for pension funds by pension funds—and putting pension funds in the driving seat to try and get the sort of characteristics from this asset class that pension funds want, we think that we will be able to ensure that there is a much more significant investment by pension funds in this asset class.
We currently have 10 founding investors. They are among the largest pension funds in the UK, some from the public sector, some of the local authority funds, and some corporate funds. We have raised—if we can structure the Pensions Infrastructure Platform properly—£1 billion of capital from them, and we will go out later this year to smaller pension funds to invite them to join the Pensions Infrastructure Platform.
In terms of what the Government can do, that is about some of the policy changes that will help shape and make infrastructure an attractive asset class to long-term investors, not just pension funds but insurers and others as well. That is about the focus on lower leverage. It is about getting some of the policy issues right around Solvency II and those sorts of things. It is about looking at the leverage that comes through

from the regulated utilities to tackle some of those issues.

We have had a very good, constructive dialogue with Infrastructure UK, with the Treasury, as we have been working through and developing the PIP. It is independent from Government, and I think it is important that that point does not always come across. By developing something that is for pension funds by pension funds, we can start to attract more pension funds into this asset class.

Q46 Teresa Pearce: Trustees are required to understand the risks of their investment, and this is a pretty new area for lots of, particularly smaller, pension funds. Given everything else that is happening in pensions at the moment—we have the Pensions Bill, we have auto-enrolment, we have so many changes—do you think they will be able to grasp this or do you think this will just be for big players?

Joanne Segars: I have talked to an awful lot of my members about infrastructure over the last 18 months. Some of them have said, "Our trustees aren't quite at the point where they can come in as a founding investor to your fund, but we are having discussions right now with our trustees and we hope to join the PIP at a later stage". There are others who recognise that they need the sort of characteristics that the PIP and the infrastructure will be able to give them, so I think those discussions are happening.

You will know from your work on the other Select Committee that obviously, as pension funds are looking to de-risk, and as pension funds are closing in increasing numbers—and there is that focus on de-risking, but also on getting inflation-linked returns to match inflation-linked liabilities—then this sort of family of asset class will become more attractive to other trustees. Also, as pension funds see other pension funds getting comfortable with the asset class, I think more pension funds will be getting comfortable with the idea.

Q47 Teresa Pearce: One last point. You have already mentioned that the target size of the PIP is £2 billion, yet the Government said they are looking for £20 billion. Is that the wrong decimal point or are they over-optimistic?

Joanne Segars: That was a Treasury figure that was announced at the Budget in 2011. Treasury subsequently clarified that that was a long-term ambition; I think they were talking about something over 10 years, from a range of institutional investors and not just pension funds. We have never said that it will be £20 billion. As I said to Mr Norman, £2 billion would be about twice what pension funds are currently investing in infrastructure and, in and of itself, will make the PIP a rather large infrastructure fund.

Q48 Mr McFadden: To carry on on the same theme, to Joanne. Teresa Pearce mentioned the trustees' responsibilities for assessing risk. This kind of thing ought to be attractive to Governments, because it means somebody else pays in the short term when they are worried about their public borrowing. It ought to be attractive to pension funds because of the long-term returns that you are talking about. Historically, what have been the other obstacles—apart from this question of assessing risk—that have stopped pension funds investing in this kind of area in the past?

Joanne Segars: There have been a number. It has partly been to do with the way in which the market has been structured. So pension funds have objected to the very high levels of leverage that they find in current deals and current funds. That does squeeze out the inflation linking that I have said that pension funds are really seeking. Pension funds have also objected to some of the high fees that are present in the infrastructure market, and what we are trying to do through the Pensions Infrastructure Platform is to develop something that has low leverage, a low fee base, and also gives us the inflation link; so it is those three things coming together. The absence of those three things are among the factors that have dissuaded pension funds from investing in this asset class.

The other is internal expertise within some of the funds. So I think by coming together, by developing something that is for pension funds by pension funds, with dedicated expertise and with a dedicated manager, we can start to overcome those barriers. It would therefore become a much more attractive asset class to pension funds, and in a sense put pension funds much more in the driving seat to be able to demand what they want much more from the market.

Q49 Mr McFadden: So that has been the historic problem or the things that have been in the way. Looking at this current design and set-up, you have said there is about £1 billion at the moment. This new PIP has about £2 billion, and the Government is clearly ambitious for more for reasons I think we understand. In simple terms, you have been involved in a lot of discussions with the Treasury, and so on, trying to design a new system that will make this more attractive to pension funds. What are the current obstacles that are still standing in your way? In a sense, we provide an opportunity as a sort of message mechanism to the Treasury. If you could name, say, three things that you want changed to open the door to put this on a different scale, what would they be?

Joanne Segars: It is around the Solvency II implications that might come through the review of the Pensions Funds Directive, which will effectively rate infrastructure as a risky investment, whereas we are looking to put this in our de-risking asset class, so there is one policy issue. There are policy issues around the leverage attaching to regulated utilities, which tend to be rather high and which could dissuade pension funds from entering that particular asset class. That is about tackling the regulators and the regulated utilities. Also, we want to see a bit more about how the guarantee scheme could be made to work, so we might be able to use that to wrap some of the construction risks that I talked about earlier. There are some other more technical issues, which no doubt Perry knows more about, on the unbundling of electricity and power supply issues. As I say, they are the core issues. If we could tackle those—and we have made this quite clear to Government in our Budget submissions, and elsewhere—they would start to attract pension funds in. But I would say the real focus is on how we might tackle some of the high leverage that comes through some of the regulated utilities.

Q50 Mr McFadden: Finally, can I ask you about some of the other comment around this area? Paul Morrell, the Government's Chief Construction Adviser, told the *FT*, and I am quoting here, "There won't be a barrel-load of funding coming in from pension funds for Greenfield infrastructure". "The Construction Products Association, said Ministers had failed to produce a model 'with relatively safe payback' for private groups to invest". You seem a little bit more optimistic than those comments would indicate. Why do you think there is other commentary around that says this problem has not yet been cracked; that the changes announced have not been enough to unlock the greater scale of pension fund or other long-term investment the Government wants to see?

Joanne Segars: I am more optimistic, as you have rightly spotted. Perhaps it is a failure to recognise that, for pension funds to invest in this new asset class it is not just a snap of the fingers and it gets done; there are due processes. There is significant governance that sits around decisions—and rightly so—that pension fund trustees have to make. As Ms Pearce has said, to get very comfortable with the asset class they have to understand the risk and it is absolutely right that they do. Developing a new fund, which is a brand new initiative bringing together these different pension funds to work together to develop a very bespoke solution—is something that hasn't been done in the UK before specifically for pension funds; it has been done elsewhere, in Canada and Australia, but not in the UK—is a question of timing. So I would suggest to those perhaps more cynical people that they be a bit more patient.

Q51 Mr McFadden: Are some of the trustees saying to you, "Look, why should we bother with this? At the moment we basically choose between a range of investments. We can choose to invest so much in equities, so much in bonds, so much in this. Now you are asking us to try and get our heads around environmental risk, construction risk, supply chain risk and all these other things. This isn't really our job". Do people say that?

Joanne Segars: No, they don't. If you look at the path of pension fund investment over the last 10 years, it is one of increasing diversification. The era of, "We invest in equities. We invest in bonds" is long past. So it is about increasing diversification. It is also about looking for where you can get return for that de-risking portion. Frankly, you cannot get that in the gilt market at the moment. So it is about looking at where else you can get those sorts of returns.

Infrastructure is one that is being increasingly recognised by trustees and, if you like, we are reflecting the needs of our members. We are reflecting what they are asking us to do. It is not the NAPF driving this. It is our members saying to us, "We want to get involved in this; let's work together to do it".

Mr McFadden: Thank you.

Chair: I am going to bring in Andy Love. While I am doing so, I am going to invite the others—who have not had such a good run as Joanne Segars on those quite important points—to reflect on whether they want to chip in. So, Andy Love, and then anybody except Joanne Segars.

Q52 Mr Love: I am sorry to disappoint, Chairman, but I am going to follow on with Joanne Segars. I do apologise. I want to come back to this point about building the expertise to invest in infrastructure. I wonder, first, how long you think that might take; the Government was talking about £20 billion over 10 years, and you are talking about £2 billion. Is that over a 10-year period? The other part is: is a fund of £2 billion sufficient to have the expertise within it that will be necessary to evaluate all of the different types of projects that you are likely to want to invest in?

Joanne Segars: Let me deal with each part of that question. On the £2 billion, we aim to launch the fund later this year. So that is £2 billion this year, invested clearly over a time frame. In terms of whether £2 billion is enough to have its own internal expertise, as I said, £2 billion would make this a rather large infrastructure and one of the larger infrastructure funds in the UK. So, compared to the Government's needs and wants on infrastructure, yes, it is relatively small, but compared to what is going on in the wider infrastructure market it is quite a large fund. Of course, we are investing in this to get the right returns for pension fund members, and that is what has to motivate us. Going back to the earlier questions, it has to motivate the trustees who are deciding to invest in this, not whether the National Infrastructure Plan gets bids. That is not the primary driver. The primary driver is clearly seeking returns for the trustees.

So, yes, I do think that with the right management—and we are currently working at the moment to develop the right manager proposition, and that is work that is live at this very moment—we will be able to have the right expertise. As I mentioned earlier, as more pension funds see more pension funds investing in this asset class, that will hopefully build success in this area.

Q53 Mr Love: Let me ask a slightly different question, and others might want to respond to this. Of course the amount of leverage the Government has suggested is 75:25. But this is driven by the marketplace. How confident are you with the Government suggesting that it will actually turn out to be that, because I assume that this is a critical issue for all of you?

Perry Noble: There is a long history of PFI, unfortunately, and—

Mr Love: Some have been good.

Perry Noble: Some of it has been interesting. In my experience of public sector procurement, it is very price driven and that leads you to lowest costs. If you look at the price components of a typical PFI project, there is a very significant element that is capital related, which drives you to a capital structure that maximises the cheapest source of capital, which historically has been senior debt. I am not quite sure how that fits, so that is the first thing. I think for all of us—certainly for us—the leverage in the capital structure is a very significant indication of the overall risk in the project. Without a doubt we have a big interest in seeing leverage being more prudently managed. But if you look at the tax break on debt, and if you look at the price necessities around public sector procurement and the way in which the public sector goes around procuring assets, there is a massive tension there between the two, so I personally cannot see yet how those two tensions will be managed.

Q54 Mr Love: That needs to happen for you to invest.
Perry Noble: It will be capital structure, counterparty risk, inflation risk. We talk about construction risk, but most of the construction risk is more about counterparty risk, both in terms of credit and in capability of the players around the table. Those three are the things that would be most focused on. In a world where longer term debt finance is less available than it once was—probably for good reason—refinancing risk is going to be an increasing issue for long-term investors, where there may be capital market solutions that will come into play.

Q55 Chair: Thank you. I am going to come to Mr Hingley and then Mr Fox.
Robert Hingley: Perhaps I can pick up both those questions. In terms of what investors want, I would echo virtually everything that Joanne has said but I think you can boil it down almost to two things. The first is regulatory certainty, and I have made the Solvency II point. The second is, as much as anything else, it is deal flow. What the insurers would like is a significant "plain vanilla asset class", as they refer to it, so lots of comparability between instruments for different projects and the deal flow, I think—

Q56 Chair: An asset-backed security perhaps?
Robert Hingley: Possibly, yes.
Chair: Sorry to have broken the flow there.
Perry Noble: Good financiers.
Robert Hingley: But on the question of getting the requisite expertise and dealing with a lot of these technical issues, the market is good at solving that. It is a little bit like getting the bicycle pedalling properly—once there is a continuing flow of deals, I think investors and banks are good at solving those problems. I would boil down the request to those two things.
It also follows that, once you have a real record of deals out in the market, then you will start to see very clearly what levels of leverage are sustainable and, in particular, what levels of leverage are potentially sustainable, or that credit ratings can be sustainable without the Government guarantee. You might expect that once there is a longer track record, then the need—this is where we started—for the Government guarantee to support these transactions partially may start to diminish.
Glenn Fox: In terms of general institution investor demand, the market has reached a tipping point. I spent three and a half years of my life trying to raise an infrastructure debt fund. It took two and a half years to raise that money, and realistically it has taken another nine months to get to the point where we can see real opportunities to invest capital. We are now at a point in the market where there are a wide variety of fund managers out there actively raising infrastructure debt funds, and it has almost become the flavour of the moment, given the limited alternative opportunities there are to invest in relatively safe assets that offer a reasonable yield above gilts. From that point of view I am very confident that the Treasury will see long-term institutional demand for projects, provided there is a sufficient pipeline, of course, which is another matter.
In terms of the price of debt and whether a more leveraged or less leveraged structure is going to be the cheapest alternative, well, that is very much in the hands of institutional investors themselves to determine whether or not they are offering an efficient price for a more highly rated piece of debt. The evidence we see in bidding for projects today is that, if we structure a project to the right kind of credit rating, investors will give us a price that provides a potentially compelling proposition against other financial structures.

Q57 Mr Newmark: I will start off with Perry because he has been quiet for a while. I want to talk about the UK Guarantees Programme. Has the programme enabled institutional investors such as you to invest in infrastructure projects?
Perry Noble: Not as at today. We have not seen projects coming to us with that Government wrapper yet but, in principle, as we have heard already, we would be open to investing.

Q58 Mr Newmark: Is the issue for you, though, the guarantee or is it the availability of equity?
Perry Noble: No. I am afraid it is the detail in the individual project. We have to look at this. For all of the desire to standardise everything, which I understand—and I have been here before in terms of standardisation of PFI contracts—when you are writing a cheque for someone else's money, and someone else's pension, we look at it very much on a deal by deal, project by project-specific basis. So it will depend on the nature of the project. There has not been real visibility yet, at least from my institution's perspective, on specific projects with a guarantee structure in place which we could analyse and get our mind around. So, it is deal flow.

Q59 Mr Newmark: So, it is deal flow or is it the fact that you will ultimately have some sort of protection from the Government which is going to enable you to make that decision? Obviously you have the devil in the detail in the various issues that you have raised, but as a backstop, what is lowering your risk, or whatever: the fact that the Government is there and the cost of risk is being pushed down the order?
Perry Noble: We would invest in a Government guaranteed scheme, without any question whatsoever, if the scheme otherwise meets our investment options.
Chair: That is a slam dunk, isn't it?

Q60 Mr Newmark: What you are saying is that if ultimately—Mr Chairman, if I can just finish—the real risk is shifted to the Government, in other words the taxpayer, it is a slam dunk. You get what Glenn was talking about: people starting to crowd into the market with their tongues hanging out because it is a no brainer.

Perry Noble: It will have a market consequence, clearly, and it will also potentially—

Q61 Mr Newmark: So you are doing it—I was in private equity before—because the equity is there and we make a decision that the risk reward ratio is there. The risk reward ratio is being tilted in your favour because there is the backstop of the taxpayer if things go wrong.

Perry Noble: As I say, it depends on the integrity of the project. We are not a private equity fund. We are a long-term investor, and we have a different risk profile and a different return expectation to a private equity fund. It depends on the nature of the project, it really does. It is a project by project analysis.

Robert Hingley: And the nature of the guarantee.

Perry Noble: And what is being guaranteed.

Q62 Mr Newmark: Sorry, Robert, you wanted to say something.

Robert Hingley: I was simply saying that it is question of the nature of the guarantee. Your question seemed to predicate a total guarantee. I am not sure that is expected, but it is about looking at forms of credit enhancement, which is perhaps most easily provided by the Government, to make sure that the capital structure stacks up with the right credit ratings.

Perry Noble: Historically, the obsession with risk transfer, the theology around risk transfer, has led to risk being transferred for disproportionately the wrong price, which has created opportunities for secondary trading and so on. The fact that there is a recognition of that, and a more balanced approach to risk transfer, I believe should ultimately lead into a much better, stronger value for money proposition for Government.

Q63 Mr Newmark: I want to understand Glenn's comment a little bit more. Is my analysis correct: that this is leading to lots of people raising funds with their tongues hanging out because, ultimately, people out there who are willing to put money to work see this quasi-backstop—which I view as a real backstop—of the Government and the taxpayer as encouraging people to come into the market?

Glenn Fox: I would point to three different things. One, which is outside the scope of PF2, is quantitative easing. Quantitative easing has driven down the investor returns to the point—

Mr Newmark: Are you trying to press my heart button here?

Glenn Fox: It has driven down returns in the market, to an extent that investors are very keen to look at any alternative source of yield. That is a big part of the backdrop to institutional investors being keen to invest in the sector. Then there are two separate roles of Government, which can potentially make projects more or less attractive to private sector investors. The first is that all privately financed projects of the sort we are talking about ultimately have a public sector counterparty. It is that public sector counterparty that is going to be paying the cheques, provided the project is delivered to the specification that underlines the base credit quality of these projects and makes them attractive to investors in principle. Then there are other members of the panel who have rightly said that it is the nature of the Treasury guarantee that may make a project more or less attractive.

If the Treasury were in the business of guaranteeing all of the debt of a project from beginning to end, then you would find that none of the people at this table would be selling that as an attractive proposition to their investors because that would mean a much lower yield on the investment, and we are all looking for yield.

Q64 Mr Newmark: I understand that. What I am also looking for is making sure we don't have roads and bridges going nowhere, and we have sensible infrastructure projects. So, number one, obviously it is good to get infrastructure projects going because that creates jobs, but there has to be the return on capital employed—the return on investment aspect. People dipping their hands in their pocket, as I view it, and putting some equity on the table provides a sanity check in that regard. What you are saying, and what I am hearing out there is that discipline of me dipping my hand in my pocket, putting real money on the table, which provides that sanity check, is slightly being obviated because the Government guarantee is there, and is therefore making it easy for you to make a decision to actually put money to work.

Glenn Fox: That would be a strong criticism if the Treasury were offering to guarantee the debt of a project in full throughout its life. I don't think that is what the Treasury is aiming to do. The Treasury is aiming to create a market for infrastructure debt at better pricing than it has been seeing in the bank debt market, and it considers that, in some cases, Treasury guarantees of a limited part of the debt may be necessary to get the best price.

Q65 Mr Newmark: It is helping the decision making then because it is reducing the overall cost of capital, and because there is the overall reduction in the cost of capital, because debt is cheaper than it would otherwise be, more investors are likely to come in then. That is really what you are saying.

Glenn Fox: In general, I would say that, for the vast majority of PFI-type projects, there will not be Government guarantees because there will be no need for them in order to raise competitive funding. There will be projects that have more complex construction requirements or a very large size, where a Treasury guarantee can help to reduce the overall cost of financing to a level that the Treasury considers value for money.

Mr Newmark: Thank you.

Q66 Chair: That is very, very helpful, thank you. Let's take that one step further and go to the PF2 launch document, which I am sure you have all read carefully. You do not have enough detail, do you, to know, because the devil is in the detail, whether enough risk is being transferred to reduce the cost of

capital overall to make this worth while? Is that a correct summary?
Perry Noble: Correct, based on that document, yes.
Chair: If it is not, please say so. Mr Fox.
Mr Love: Just nod.
Glenn Fox: Yes, it is a general policy document, so of course.

Q67 Chair: Yes. It has some phrases that are seeking to give us comfort, but they are not doing much more than that.
Glenn Fox: No, I think there are some very positive initiatives contained within that document that will help institutional investors invest with more enthusiasm in the asset category.

Q68 Mark Garnier: I would like to follow up on a couple of those points that have already been picked up on, so if I might just jump around a few points. Mr Fox, you talked about quantitative easing driving down your yield, so you have to scratch around elsewhere to get yield. Also it is having the effect of pushing down your risk-free rate. Do you think that, because of quantitative easing, we are getting a situation where people are taking on risk for too cheap a price because of having to scratch around to find that yield? Is risk properly being valued as a result of QE? Anybody else can jump in.
Glenn Fox: As investors, we all have to justify the investments we are making to the people who have given us the money. We can only ever look at the price of risk on a relative basis, and therefore—

Q69 Mark Garnier: You can look at it on a relative historic basis as well as a current relative basis. If you go back over the last 20 years, you were getting paid a lot more for risk in the past than you are now.
Glenn Fox: Yes.

Q70 Mark Garnier: Do you think that now the price of risk or the risk-free rate is too cheap and, therefore, what you are getting back for your risk is not enough?
Glenn Fox: All I can say is that the risk that we are able to offer to investors in our fund is regarded by the investors in our fund as an adequate return for the risk they are taking.

Q71 Mark Garnier: Mr Noble, would you come in? You can come in on to our side of the fence.
Perry Noble: It is a truism, of course, to say that it is a relative assessment, which of course it is. It would be fair to say that the current environment creates the possibility that risk is being mispriced. That is clearly the case, but, having lived through this now for 20-odd years, there is always something in the current environment that seems to encourage risk to be mispriced for one reason or another. The idea of lending to the UK Government at the current rates, from a personal risk assessment perspective, is quite a stretch. You cannot ignore the importance of that, because everything is driven off what the price of a gilt is and yield of gilts, and particularly around inflation protection and counterparty risk. The extent to which that is distorting or has the potential to distort the market I would not underestimate.

Q72 Mark Garnier: Do you think that is making it that much more difficult for you to go into these? I know I am slightly coming back over old ground, but what I am trying to do is bring all this together.
Perry Noble: It is always complex, and investment decisions when you are looking at investing for 20 years plus, in what will be a changing world over that period, are clearly very complex decisions to make. On the current environment, I cannot recall macroeconomic conditions of the nature that we are facing, which have such a big effect on what we are doing. It is an incredibly important part of all of our analysis at the moment, and I am sure has influenced Joanne's and Robert's discussions. It is a very difficult environment to look through and see where we are going to get to, and that may be the biggest challenge we all have currently.

Q73 Mark Garnier: To slightly summarise that, on the one hand you are saying we have to get a return. You have assets under management. You have to invest in something. You are trying to find a return.
Perry Noble: Yes, rather than a negative return, yes.

Q74 Mark Garnier: Exactly, you have 190 basis point yields—
Perry Noble: Negative real return.
Mark Garnier: Yes, exactly, so 190 basis points on 10-year gilts and inflation at about 3%, yes. So you are already 1.2% the wrong way. Equally, the other side of this, with your knowledge—all of you seem to have been around for 20 years or so, and perhaps I am guessing how old everyone is, but you have been in this business for a long time—you will have seen much better returns. Actually, no matter how hard you look at it, if you were looking at it on a long-term basis, now is not the time to be taking on too much risk, given the fact that you are not getting the return for the risk because you are taking a 20 or 30-year view on this stuff, aren't you?
Perry Noble: Yes.

Q75 Mark Garnier: To a certain extent, if I was going to try to come to some sort of summary on this, you are almost looking for a time when quantitative easing has disappeared, the economy is back into some sort of growth but, importantly, interest rates are back up to a more—
Perry Noble: Long-term normal.
Mark Garnier: Yes. Therefore, it would be a lot easier for you to go in. We have a slight catch-22 situation where it is just too difficult, with these incredibly low gilt yields and, therefore, the very, very low value pricing of risk, to be able to get involved in it.
Perry Noble: I think the reality is we need to put money to work and, for all the reasons that Joanne and Robert described, there is an appetite to put money to work in this sector. It is our job to find ways to manage the risks that you have identified. As I mentioned, the inflation risk and the leverage risk, if that leads to refinancing, plays exactly to the issues you have identified. I would hesitate to say that would mean that we are not capable of doing it. I think we are all gearing up in order to do it.

Q76 Mark Garnier: But an equity investment, therefore, gives you that much more excitement. On the subject of equity investment, clearly it is treated differently for taxation purposes. Is that something that is also a stumbling block? If there was a change in taxation—rather like the Mirrlees report on the equity dividends—would that be one of the things that could help this infrastructure investment on its way?

Perry Noble: Tax treatment of debt I think has a big impact on the way in which we approach this type of capital structure.

Mark Garnier: Skewing you towards debt.

Perry Noble: It leads into the leverage, the whole issue of what risk are you building into the project by the nature and the extent of leverage. There is an inbuilt incentive to leverage up, and that is it.

Q77 Mark Garnier: If that incentive to leverage up was reduced by having a different tax treatment on equity dividends—rather like Mirrlees—then actually you would start moving towards having a greater return on your investments, which is what you are really after, and a better valuation for risk.

Perry Noble: I think we would regard it as more of a prudent capital structure consistent with such a long-term investment. It is all about risk rather than return.

Robert Hingley: I would agree with that, too. Can I just pick up one point, which is on the yields? I think that everybody has indicated—and I would certainly share that view—that the yields across all areas of fixed-term income have become highly compressed. Quantitative easing has compressed yields in the gilt market and there has been a knock-on effect into corporate debt. As Glenn said earlier, there is a search for yield.

In terms of are people willing to invest in current circumstances, then certainly from an insurer's point of view if you look at the liabilities that you are matching, people write annuities. They need assets to match those annuities, and the fact that yields are very low means that by historical standards annuity rates are quite low. But it does not mean, on the basis that you are fixing a liability against a certain rate, if the asset is matching that rate and you are going to hold that asset to maturity, that can work. It is a slightly longer version of saying you need to put money to work.

Q78 Mark Garnier: I expect half of you don't have the internal expertise but do have the cash, and the other half of you do have the internal expertise but don't have the cash. Mr Fox and Mr Noble, you have investors who come to you because you have that expertise and, Joanne Segars and Mr Hingley, you have the money but not the expertise. Surely the obvious answer—dare I say this?—is for you to get together and for two of you to give your money to the other two, obviously for a—

Perry Noble: If you take a commission on the low price, yes.

Mark Garnier: I would be delighted to take a brokerage fee. But there is an important point, isn't there? Given the fact that you don't within the pension fund and the insurance industry have that expertise, surely it makes it worth while coming to the investors with the expertise and giving them the money, rather than necessarily having to try to develop that yourself.

Joanne Segars: We are developing that ourselves so we will have the money and we will have the expertise.

Robert Hingley: Same answer.

Chair: Thank you very much indeed for coming this morning. It has been relatively brief but extremely thought-provoking, and an enjoyable canter around an old subject. Thank you very much indeed.

Examination of Witnesses

Witnesses: **David Heald**, Professor of Accountancy, University of Aberdeen Business School, and **Richard Abadie**, Global Head of Infrastructure, PricewaterhouseCoopers, gave evidence.

Q79 Chair: Thank you very much for coming in. As is usual on this Committee, we are pressed for time. We are always trying to do too much in too short a time, but that is the way of things. Can I begin with you, Professor Heald? The original intention of PFI was that it would bring better value for money in projects, construction and management, and that there would be a very high level of risk transfer. A PFI panel was created to police that transfer. That later transmogrified into quite a different type of PFI in which, by implication, we now know there was a lot of risk transfer. We are now going round the same circuit, amplified by a macroeconomic incentive and an opportunity to do this because of the downturn in activity and the slack in the construction sector, and an opportunity because of yield compression at the long end of the market. How can the Government better protect itself this time from being taken to the cleaners, as it was in the last PFI?

Professor Heald: That was a complicated question but I will try to answer it. I think that we are at a rather dangerous moment, which reminds me of 1992 when there was equally a great desire to get spending on infrastructure facilities, partly because the infrastructure was needed and partly because of macroeconomic reasons. The reason why I say it is a dangerous moment is, listening to the previous discussion of guarantees, it strikes me that guarantees might be the next big problem. One of the driving motives for PFI became the accounting treatment—getting things off balance sheet. So one of the things that Parliament has to watch very carefully—and it needs to ask the Treasury questions very soon—is to avoid the Government just issuing guarantees about very long-lived projects, which don't score in public finances at the present time but will actually have long-term consequences.

Going back to your point about the PFI in the past, my view about PFI is quite nuanced. I think the accounting treatment issues have been quite outrageous. It has taken about 20 years to sort the accounting treatment issues out, and we still haven't fully done it because the last spending review and, I suspect, the new spending review will still be on national accounts basis for PFI and not an IFRS basis. On the value for money side, I think the picture is much more mixed than the impression one often gets—the idea that the taxpayer is being ripped off by PFI. If you look at Parliament, if you look at the difference of tone in some PAC reports and the Treasury Committee report in 2011, in comparison with the House of Lords Economic Affairs Committee, you will see between the lines quite a lot of difference. In the PF2 document, the Treasury seems to be quite ambiguous about whether it really did get the construction risk transfer and really did get better performance, in terms of time and construction costs. I think there has been an unhealthy interest in the excess returns on particular projects. If certain projects had very high excess returns but at the same time the thing got delivered on time and to cost, I don't think the very high returns or very narrow equity base necessarily contradict the fact the public sector got good value for money.

On the accounting, I think this is one of the areas where the Committee has to pay attention to make sure it does not take 20 years again to sort things out. On the value for money side, the picture is more nuanced. The proposals in PF2 very clearly involve less risk transfer than in conventional PFI. That will have implications not for the financial reporting accounting, not for the Government accounts or the whole of Government accounts, but it might well have implications for national accounts treatments. One of the things in the PF2 document is that 90% of PFI projects are on balance sheet for financial reporting purposes, but only 15% for national accounts purposes.

Q80 Chair: I want to clarify one point. Prior to the late 1990s there was very little risk transfer. When you said compared to early PFI, you were presumably referring to middle period PFI?

Professor Heald: Middle period, yes.

Q81 Chair: Mr Abadie, is there anything you want to add to what has been said before I pass on to other colleagues?

Richard Abadie: No, Mr Chairman.

Q82 John Thurso: Professor, can I follow up on the accounting issues? Because I rather agree with you that they are the heart of a great deal of what we need to get right. One of the key observations in our past report was the fact that PFI was possibly quite often being decided upon, not as the best way of undertaking a particular project but precisely because the accounting treatment meant that it minimised the short-term current account spending, and the actual expenditure itself was off balance sheet. You make the very good point that following adoption of IFRS, 90% of that was shown to be on balance sheet, but for the purposes of how national accounts are dealt with only 15% would appear. To what extent is PF2 open to similar flaws, in the sense that the motivation will be not for procurement and funding but to get things done so that it doesn't appear on the budget that the particular Department is dealing with?

Professor Heald: That goes back to the point I made about the ambivalence of the Treasury PF2 document. If the spending reviews are conducted on national accounts basis, and the off balance sheet PFI is not included in the budgetary numbers, there very clearly is a budgetary incentive to adopt that route. In fact, I think the public image of PFI was damaged by that accounting arbitrage, because there has been a lot of justified criticism of the accounting arbitrage but I think that has actually created a bad impression about PFI as a whole. My understanding is that what the Treasury intends to have is a control total of PFI liabilities, which is a different matter, which is not treating it on balance sheet but is actually showing what the future obligations are going to be. One of the benefits of getting whole of Government accounts is that we do know the scale of the regular reporting and the total of PFI liabilities. That is a matter for the Treasury. If the Treasury doesn't want the bias, the Treasury can actually remove the bias.

Q83 John Thurso: What we really need from the Treasury, or from any contract that any Government Department or local government body is wishing to enter into, is a clear statement of purpose setting out each of the different aspects in balance sheet terms, current account spending terms and cash flow terms, and where the risk lies, so that the value for money calculation, which is as much about transferring some of the risk as it is about the cost—and, indeed, the two are obviously linked—is clearly understood by all the participants at the beginning and does not come as a shock five or 10 years down the track.

Professor Heald: One of the things about PFI that has always surprised me is that, compared with any other topic in my academic life, I have found that people tell me different things in private than they say in public. That is one of the significant difficulties. One of the things that one wants in the new round of PF2 is that people tell the same story in public as in private. My concern at the moment is not particularly about PF2 because, as I say, it is not going to alter the IFRS treatment; 90% off balance sheet is not going to affect control. I am certainly interested in what actually happens with, for example, taking out soft services, larger capital contributions, Government equity contributions. I suspect that in national accounts terms that is more likely to bring future projects on balance sheet. But my major concern is about guarantees—guarantees, for example, for power station output or high-speed rail projects. For example, if the Government guarantees the price of future nuclear output, how is it going to account for that? There are technical issues about whether that falls, as a financial guarantee contract, within international accounting standard IAS 39 or not, or some other kind of financial instrument. The question about how the Government is going to account for it is important, but I would also add how the private sector counterparty is going to account for it. Because there is no requirement under IFRS for symmetry in accounting, but one of the things I have learnt over time is when you get asymmetry that is a clue that you ought to investigate more. For national accounts purposes, there obviously has to be a symmetry.

Q84 John Thurso: If I have understood correctly what you are saying—particularly where there is that asymmetry you are referring to—the danger is that the desire to achieve a policy objective, such as building nuclear reactors and getting them up and running, and a similar but unconnected desire to have a certain series of numbers in the books, means that you take a decision on the former, which is not necessarily based on the best financial decision but it is one that allows you to achieve the objective on the latter.
Professor Heald: I agree with that explanation.

Q85 John Thurso: I am glad I understood it. Can I come to you, please, Mr Abadie, because I think you have advised the Treasury? Taking a specific example, supposing, say, the Department for Education decided to reject PF2 for its schools programme, on the basis of value for money, are there actually any practical alternatives available for funding the programme, or does that then mean that that programme doesn't go ahead?
Richard Abadie: I think that is a key question. I would emphasise I am not an accounting specialist, so David can answer all those questions. But the reality, as David has said, is in the past projects have taken place because there has been this accounting arbitrage. The new building schools programme is about £2 billion. It will be off the national accounts for all intents and purposes as far as I understand. If it were on the national accounts, the Department for Education would have to find a £2 billion capital budget to replace it. So there is a risk. I don't think that warrants all of the projects being treated as off balance sheet or off budget. I think there should be accounting symmetry. I don't know whether control totals get you there, but the bottom line is we do need to find a way of investing in the UK's infrastructure, that is key. What we cannot afford—and we have already had it over the last couple of years—is infrastructure investment drying up. The £2 billion schools programme, frankly, is relatively small in the bigger scheme of things. We need to be investing a lot more than that, and it would be tragic if we see investment further slow down because of some of the accounting issues. That having been said, exactly like David, I wish that just weren't an issue—

Q86 John Thurso: What I am trying to get my head round is, when I used to run businesses and I looked at the three legs of what I was trying to do, which was cash flow, available cash, P&L and balance sheet, there were circumstances where I did not have the cash flow to buy a big asset, which over time would generate more profit to invest in whatever it was. Therefore, there was a very sensible argument to be made for buying that asset on other finance terms, which would be more expensive but, ultimately, I would be making profit and improving the overall balance sheet. On the other hand, if I happened to be in a company that was flush with cash, the best decision would be to buy the asset with my cash. But if I don't have the cash I cannot do that, so a good decision is still to buy the asset slightly more expensively through whatever finance vehicle. To what extent does PF2 allow Government to basically say, "The best would be if we had lots of cash in the kitty, we would just go and buy it and do it, but we haven't so this enables us to do it"? How much is it just that and how much is it about other things, i.e. smart procurement, transferring risk from the public to the private sector? I have not quite got my head round what is actually the objective.
Richard Abadie: PF2 looks exactly like PFI from our point of view. The decision as to how we pay for the infrastructure that we need is a key decision. We either use PFI or PF2—whatever we want to call it—or we use Government borrowings. There is no way round it; we have to pay for this stuff, and if we want to repay it over a longer period of time, i.e. not out of taxes, we have to find some method of raising money. The trade-off is relatively simple. It is either through private finance sources—forget what the acronym is that we attach to it—or through public finances through the DMO's gilt programme. Either way, there is a price tag associated with it.
Coming back to what PF2 does, as I say, it is exactly like PFI from our point of view. What PF2 seems to seek to do is to improve efficiency and transparency. That appears to be its primary thrust. You look at disclosure requirements, and you look at some minor changes in risk allocation. That is an efficiency play. The other big element from what I can see in PF2 is that, as you had in the last panel, there is a long discussion around alternative sources of capital into the institutional markets, pension funds, life houses, insurance companies—alternative sources of finance. The reality, though, is that doesn't change the underlying point, which is that these assets need to be paid for in some shape or form.

Q87 John Thurso: My final question is, on the accounting treatment, then, what is absolutely fundamental is that both sides account transparently and openly so that the decisions that have been taken to fulfil the need are actually exposed clearly and openly in the accounting process. The question is: is what the Treasury proposes as its controls in PF2 going to achieve that? Either of you, or both?
Richard Abadie: Perhaps David after me, but I would agree with you in terms of the objective. I don't think PF2 achieves that outcome as laid out by David.
Professor Heald: Can I come back to John Thurso's point that the Treasury doesn't say that PFI is worse than conventional procurement. Basically, the Green Book procedures get corrupted to get the answer that is actually required.
The other point I want to make is that one needs a sense of proportion. It is very difficult. Governments tend to defend a particular fiscal mandate when they have actually determined it, particularly if you think about the present fiscal mandate and about the earlier fiscal rules. One should have a sense of proportion about PFI. Roughly, PFI if all on balance sheet would add about 2.5% to the public debt. In January 2013—

Q88 John Thurso: You think it is what, about £35 billion?
Professor Heald: It is 2.5%. In January 2013 public net debt, as a percentage of GDP, was 73.8%, in the way that the Treasury publishes the numbers. But if you go to the public sector *Statistical Bulletin* published by ONS and the Treasury, it shows you that if they had not excluded the impact of financial interventions it would be 138.9%. The financial crisis had a huge effect both in increasing the net debt and also in creating the vast margin between the two measures of the net debt- the one we used to use and the one we use now. The amount of energy that goes towards getting the things off balance sheet is disproportionate to the actual numbers involved.
John Thurso: That is the point that I understood very clearly. The only other area where this Committee has seen that is with banks and SIVs, things of that nature.
Chair: Brooks Newmark has a few quick questions and then Mark Garnier.

Q89 Mr Newmark: I want to talk about Government taking minority stakes in businesses. The Government states that it will look to act as a minority equity co-investor in future projects. Under PF2 it argues that this will improve value for money as the public sector, i.e. the taxpayer, will share in the ongoing investment returns, reducing the overall cost of the project to the public sector. Do you agree that the Government taking minority equity stakes will improve value for money for taxpayers, Richard?
Richard Abadie: Not particularly. Let me explain why I say that. If you looked at it on a standalone basis—i.e. you were in the world of 10% equity and 90% debt; so where we used to be before PF2—Government taking, say, half of that equity would do something that I think adds value and that should make the deals cheaper. Whether cheaper is better value for money is a separate discussion. Why I say it would make it cheaper is if Government took half the equity and the return was paid back effectively to the taxpayer, you would argue that the net cost of PFI, being the payment that goes to private sector less the dividends that come back to Government, would ultimately make the deal cheaper. If your point, which is not how it is made out, is, let's get the cheapest potential source of capital—on average the lowest weighted average cost of capital—it achieves that outcome, and you tick a particular box or objective or policy initiative.
When it comes to value for money, you heard today there is substantial appetite in the private sector to take equity. Ironically, some of the previous panel were talking as if equity is a problem in today's market. It is not. There is so much equity flowing into infrastructure on a global basis that we do not have a shortage of equity. The latest estimate is about US$150 billion. My question around that is: what is Government's policy intervention around equity? If it is to reduce the overall cost, as I say, that is not a problem at all. That is an understood and logical policy objective.

Q90 Mr Newmark: There is a bigger thing. Again, from a private equity standpoint, we sometimes got management to put money into businesses with us because it actually also aligns interests. Would you agree with the statement that it is going to help align the interests of effectively the project manager and the institutional investor and the taxpayer? I only say this because historically there is this sense, and the evidence is there, that Government and taxpayers got ripped off by the charges as you stretched out time, and so on. It is almost like a form of schmuck insurance—that you want to reduce being thought of as an idiot for giving you guys this deal, and then three, four, five, 10 years down the line all these extra costs come in, and it is protecting a little bit of that, too.
Richard Abadie: It is an indictment on the model that we have deployed that we have not been able to—as the public sector and through procurement—achieve that outcome through the actual contract. That would be the preference, rather than participating in the risk of capital.

Q91 Mr Newmark: That is because the guys negotiating the deals are much smarter than the people on the Government side. That is why that happens. What has happened is that people have run circles around these people because they are not business people. They are not sharp people. They are smart people but they are not business people. As a result, the various loopholes in the contracts have enabled these add-on costs. Trying to align those interests, I am thinking that having them as co-investor might help that. Professor Heald, you have not commented.
Professor Heald: I don't know whether it would actually align interests. There is a danger of rolling out a very standardised model—for example, the discussion about what kind of maintenance would be part of the contract and soft services being necessarily outside. Your point is that there is a centralising tone to the PF2 document, pulling things back to Whitehall, and one can see conflicts within the public sector, between the local public sector client and central Government.

Q92 Chair: But the question for both of you is exactly as Brooks put it. He did not quite put it this way but it is what he was driving at. How are we going to stop the Government being taken to the cleaners by these very clever people when it comes to writing the detailed contracts?
Professor Heald: You hire very clever people yourself but that runs into the—

Q93 Chair: They are very clever people. We have very clever people, as Brooks pointed out, but they did not have the right technical expertise.
Professor Heald: Well, the people with the right skills. But that runs against the argument that nobody in the public sector should earn more than the Prime Minister, and also it exposes the Government to the revolving door, whereby one of the problems is the people who write the rules at the Treasury and other Government Departments then actually move back into the private sector. One of the worrying social economic things is the way that people arbitrage rules. Having been responsible on secondment to the

Treasury for writing the rules, one then moves back to the private sector, and knows exactly how to arbitrage those rules. The answer to your question is the Government has to hire the skills itself and pay the market rate for those skills. If it is not prepared to do that, it is going to hit trouble. If it is not prepared to do that, it also has to go for simpler contractual forms.

Q94 Chair: Before long, we are going to be into European Parliament reports on PFI bonus and salaries, aren't we?
Professor Heald: If Governments want complicated forms of procurement, you have to make sure you have sufficient skills that belong to you, long term, that enable you to run those contracts. Things are becoming much more complicated. Thirty years ago, if the Government wanted nuclear power stations built, it would have told the Central Electricity Generating Board to build nuclear power stations or British Rail to build a new railway line. We are in a much more complicated world. If you are in a much more complicated world and if you are not willing to hire the skills and pay the market rate for the skills, you are obviously going to get into trouble.

Q95 Mark Garnier: I must finish up on this one particular point, but actually this is the key to the problem—it is asymmetry between the skills of the negotiators and the negotiatees.
Chair: And the moral hazard in that.
Mark Garnier: And the moral hazard, absolutely. If you are a provider of PFI, it is in your DNA that you know about return on equity and risk, and all this kind of stuff. Even if you are the highest paid, most skilled individual that is available to humanity, employed by the Government on the procurement side, you don't have that tension when you wake up at three o'clock in the morning thinking, "Am I going to lose my job as a result of this?" because you have different dynamics. Is this just a problem we are never going to resolve in terms of the asymmetry? That was a question, sorry. Feel free to answer.
Richard Abadie: Yes, it is an issue. I was in the Treasury—so I am perhaps one of these people that cycled in and cycled out; I'm happy to have that as a separate debate—and the reality is the civil service prides itself on generalists, people who rotate in and out of roles on a regular basis, rather than having a cadre of specialists. In that policy document there is talk of doing that. As David was saying, it does run up against a contrarian view that you should devolve responsibility and authority rather than consolidate it. That is something that Government needs to work its way through. Procurement generally is complicated, and to get best execution you need specialists in that field. PFI is at one of the extreme ends of complexity.

Q96 Mark Garnier: Moving on, because that is a subject you can go on for ever, I think you were here for the last session and you might have noticed I was digging into the risk-free rate and what effect QE has had on the whole of the risk-free rate returns that you can get. PF2 now suggests that potentially, there will be a greater deal of equity in investment decisions. What is the solution with all of this? Do you see that the equity side of this is going to be the answer to investors getting a better return compared with what the risk-free rates are, and do you think in the future we will look back on this period as being a disastrous period for investment because the returns are going to be so low starting from where we are? Professor Heald, why don't you try to address that?
Professor Heald: I think that is a question more for Richard than for me, but we are in a very, very strange period. It is not clear whether the proposal for more equity is based upon principle or whether it is a pragmatic response to the lack of debt finance because the banks have moved out of the business.

Q97 Mark Garnier: Yes, but there is plenty of money around that will lend money on debt. We have pension funds that are desperately looking for risk-free investments or very low risk-free investments, but their risk-free rate is 1.9% based on 10-year gilts. That is simply not enough to be able to meet the expectations that they have in the future. How are they going to achieve it and is PF2 going to give the answer to that through equity?
Richard Abadie: If we separate out debt and equity, my earlier point was—and I am not criticising the panel—the concept of debt and equity got muddled very, very quickly. Answers were being given around financing generally, rather than separately. On the equity side, we do not have a problem with equity. There is a lot of discussion around it. You even heard some resistance from some of the panel saying, "We don't want to take construction risk". How we are going to increase economic growth, deliver jobs, is through investing in infrastructure that has to be built. All of us want no risk and to earn a return in every single one of our individual lives. Equity is not a problem in the current market. The key issue we face on any form of leverage—whether it is mortgages, whether it is any form of debt instrument, including in infrastructure, not just PFI and social infrastructure but our wider infrastructure market—is access to long-term debt. Currently, we have a situation where the banks are retracting. There is a handful of them, and no more than that, offering them long-term debt and the institutional market is where that policy document is headed to try to get institutions to lend long term. But it is not clear to me that that is going to be as big and as liquid as we all wish. One of the panellists mentioned that he had spent three years trying to raise debt for his fund. It is not easy. It is not clear to me that we are going to get the level of debt coming in.
In terms of return, the other point the panel made—which I think is absolutely true and it is actually a concern—is that investors, both equity and debt, are chasing yield at the moment. They are getting no yield if they invest in Government gilts, or very little, so they are chasing absolute yield. As long as infrastructure gives them that yield, they will invest. I don't think it is particularly scientific. I think it is literally the highest return they can get in the current market to meet their long-term liabilities that they are going to seek. Why I say it could be a bit of a concern is if the market changes, and liquidity comes back more generally and rates improve, you may find the reverse happening, whereby people say,

"Infrastructure is not that attractive. I am going to put my money somewhere else". That is a real concern. Whatever we create has to be sustainable in the long term. The last thing we want—and this policy document may or may not achieve that—is some short-term fix for a problem that unwinds itself at some future date.

Q98 Mark Garnier: I have seen in the past where a completed infrastructure project has been sold off in the equity market as an IPO. I am thinking particularly of the gas distribution network in Malaysia. You have one customer, which is the Government or the gas supplier, who rents the space in the pipeline. The equity market investors then own that investment, and there is a very, very simple return on that and it is a very low-risk equity investment. Ultimately, I would suspect there is an implicit guarantee behind that because clearly you want to get your gas distributed. There are things like that in the UK; for example, the railway network and the motorway network. Is there a possibility that that type of asset could be sold off to the equity market and then rented back by the Government?
Richard Abadie: The accounting issues aside, because it is worth understanding how that may happen, that does happen all over the world. You get not necessarily sale and lease back per se, but you get assets. We have a long history in the UK of energy and water assets being developed by Government, at the taxpayers' risk over time, and then being privatised. The key difference between—
Mark Garnier: A slightly different thing, though, isn't it?
Richard Abadie: I would hypothesise it is pretty much the same because when you talk about cost of capital, they are all regulated. Whether you are in the gas networks, the energy networks—not generation but distribution and transmission—whether you are in the water networks, there is a concept of regulating the cost of capital on a periodic basis, say, five years, which is the current convention. The difference with some of the PF2/PFI methodologies is that you are looking to transfer a fixed price on the cost of capital for 30 years. I know there was a debate somewhere in that document around whether we should move closer to a model that resets the cost of capital on a periodic basis, like a regulator would. Perhaps in this uncertain time when rates are uncertain, the future direction of finance costs are uncertain, we may be better off setting an environment where rates are reset—debt rates, equity rates, whatever the case may be. The weighted average cost of capital is reset on a periodic basis because—

Q99 Mark Garnier: It is quite a big ask, though, isn't it? Because if you are somebody who wants to buy a hospital, then there has never been a better time to do it than now because of the very, very low rates. Whereas if you are the provider of the PFI financing, you will want it changed every year for the next 25 years in order to keep up with the changes.
Richard Abadie: I remember that same argument in the late 1990s. People said rates surely cannot go any lower, and they did. We may argue that through the 2000s it was artificial. I struggle to know where rates are going to go. They do feel exceptionally low at the moment, but I guess my point is: what is the risk that we are trying to transfer? If we are trying to get the private sector, through PF2, to commit to a fixed cost of capital for 30 years, we have to accept that, in a market that is uncertain and liquid, people are not going to take on that risk themselves. The taxpayer will pay whatever is the market clearing prices in a very liquid market. There is an argument that says the taxpayer may be more willing to pay based on what the current conventions are at a given point in time, rather than a fixed price for 30 years. Most of us cannot even think forward five years, let alone 30 years. That is where the regulated utilities come from, or the regulators come from. It is much more difficult where you have a substantial construction risk, I do accept that. The gas network is a lot simpler because the asset has been built and you have some contracted off-take as well.

Q100 Mark Garnier: Is there an argument for issuing—this is my last question, Chairman—specifically infrastructure bonds? There is a lot of talk about the Government borrowing at a very low rate at the moment. Rather than having a general gilt, which would then obviously increase as a general asset, specifying an infrastructure bond that is dedicated to this thorny problem?
Richard Abadie: Infrastructure bonds do occur in other markets. For me, it is more a debate about hypothecation of revenues and hypothecation of fundraising, and whether or not we are willing to do that as a country. On that theme, if we want retail investors—people around this table—to invest in infrastructure directly, right now you are dealing through a pension scheme, or not, as the case may be, listening to the absurdly low levels of infrastructure investment in UK pension funds. But if you want to do it directly yourself, you don't have access to the retail investment side. If you move to markets like the US, you have tax exempt municipal bonds. In other words, there is a scheme whereby you can buy directly into infrastructure, either through your pension fund or as an individual, but there is a tax arbitrage opportunity in that. There is a question for me, if we are keen to attract retail investors into the debt products we have in our market, as to whether we shouldn't be looking at something similar. Just to be crystal clear and for the avoidance of doubt, what that is effectively is tax flowing from the Treasury, i.e. from the centre, down to the project. That is a tax benefit that flows down through the structure. Again, that is another allocation of scarce resources. I would expect the Treasury to say they are not prepared to do that, although I know they are looking at tax incremental finance, which has some of those elements. But if we are looking at retail products to try to get individuals to invest in that infrastructure, bond or municipal bond as it is constituted in the US may be some way to do it. But I think what you have to then do is provide some incentive to buy it. Tax incentives would be the way.

Q101 Mark Garnier: That argument presumably applies exactly the same to the different tax treatment for equity dividends, does it?
Richard Abadie: Correct.

Q102 Mr McFadden: Mr Abadie, you said in the past, "I'm supportive of an infrastructure bank as well as these things". Going to David Heald's point about precautionary measures and all the effort put into creating these fancy vehicles, which can often be expensive—and given Mark Garnier's point about the Government's ability to borrow 10-year money at less than 2% at the moment—is all this stuff about trying to attract other investors worth it? Why shouldn't the Government use its historically low interest rates, whatever the reason for them, to finance the infrastructure investment it needs for growth?
Richard Abadie: I will come back to the infrastructure point, because your wider question is: why not just fund it ourselves? There is an argument for that, absolutely. As a country, we can still borrow relatively cheaply, notwithstanding the Moody's downgrade. Let us say we were to go out to the market today and say—I think David was saying it is £35 billion and it could be slightly more, in terms of debt—well, actually, no, let us put it another way. We have announced an infrastructure programme of £250 billion, a good proportion of which is coming from Government but not the majority. If we were to go to the market today and say we are going to launch Government gilts to fund our infrastructure valued at—I need to make up a number—£100 billion, the market may take a fairly dim view of it. If we are using Government gilt programmes and we are going to shock the market with that level of borrowing, I don't know how the financial market will react. It is certainly not going to be positive. It may be negative; it may be neutral. At best it is neutral.
I had this discussion with somebody in the Treasury once where the Treasury said, "We should just fund this all ourselves", and I said, "Nobody is stopping you". This is the honest answer. Nobody in the private sector has said, "We are not prepared for you to do that". It is not within our gift in the private sector. Government is fully entitled to go out there and borrow the hundreds of billions of pounds it needs. I assume the reason they are not doing it is the potential consequence to our cost of borrowing and our credit rating. Therefore, you look at these alternative structures. The problem specifically with an infrastructure bank, and it is used in other markets, is that is an extension of Government borrowing. It is normally Government guaranteed. It is owned by the Government.
So, back to your point, while I may have said that it is an interesting idea, I don't think I would have advocated it, per se, because I think if you are going to set up an infrastructure bank you may as well have Government do the borrowing yourself.

Q103 Mr McFadden: You might have been misquoted. The quote we have been given is, "I'm supportive of an infrastructure bank".
Richard Abadie: Well, I probably said "Not".

Q104 Mr McFadden: Rather than pin you on this, what I want to get my head around is how this would work. We have these things in other countries. We have KFW in Germany and various other things. Given your experience around the world, how might such a public sector body work in the UK?
Richard Abadie: I have an interesting example. Just on KFW, if I can reflect on that. KFW is an interesting organisation, very successful, very active. Its accounting treatment is grandfathered to just after World War II, so that a lot of its borrowing is actually off balance sheet. It is a unique financial institution that we could not replicate in today's environment. The example I did want to give you that is of interest to me, but it requires some mandation of our pension fund industry, is in Brazil, about 80% of their substantial infrastructure programme is financed through a state-owned development bank called BNDES in Portuguese—basically, the National Development Bank. Most of the debt in that market, and a substantial chunk of the equity for the infrastructure programme, comes from the state-owned bank. The question is: where does the state-owned bank access its capital from? It is from the pension fund industry. What happens is there is a mandatory allocation from pension savers in auto-enrolment environments to this infrastructure bank, or development bank if you want to call it that, and that money in turn finds its way into infrastructure. When I, as a pension saver, say—and I cannot remember exact numbers—5% of my pension savings go to infrastructure, inevitably it is actually going into the Brazilian National Development Bank, which is stated owned, to in turn allocate into infrastructure. If we are looking at deploying capital out of the institutions, it is on a voluntary basis. You have heard some of the resistance to some of the investment that is taking place due to of the risks. There is a question as to whether you have a mandation environment where you actually mandate a minimum allocation to infrastructure and you put an intermediate vehicle in place—quite possibly Government owned, entirely up to us as a nation—but you have a means of allocating that capital back into infrastructure. Your question is: are there alternatives? There are, but they do require some pretty significant shifts in how we regulate pension funds or insurance companies, the allocation that we need, and whether Government has the appetite to own and manage something that looks like an infrastructure or development bank.

Q105 Mr McFadden: Professor, I want to give you the last word on this. You have had a long, long involvement in all of this over decades, and you have seen what you describe as a disproportionate effort to keep this kind of investment off the balance sheet. Looking at the terrain of state-owned vehicles in different countries, the announcement here about the Green Investment Bank and so on, what is your view of something in this space that would be perhaps more straightforward and perhaps trying to use the current low levels of public borrowing that the Government can access?
Professor Heald: I am instinctively very suspicious of things that are off balance sheet. Accounting tries

to portray economic reality. However, one of the problems one has is that sometimes the accounting can actually distort what becomes economic reality. The key question is whether the Government will borrow more through conventional means, conventional borrowing, to actually fund more public investment, or whether it regards the way it has formed its fiscal mandate—be it fiscal rules of the previous Government or the precise fiscal mandate under this Government—as actually justifying distorting economic choices. At the margin, I would finance more public investment out of conventional borrowing. I worry about the discussion earlier at this meeting whereby if the Government cannot get the skills to match the people facing it across the table, that suggests that the contractual means that are being used are actually too complicated.

Mr McFadden: Whether the borrowed money is borrowed through the PFI type thing or whether the Government borrows it, it is still a private sector construction company that builds the school, the hospital, the power station and so on. Anyway, I think I will leave it there for today.

Q106 Chair: Can I just end, Mr Abadie, with a question to you? Previous witnesses have told us that the move towards more equity finance will increase financing costs for PFI compared to PFI1. Do you agree?

Richard Abadie: Yes, I do.

Q107 Chair: How much? Obviously, you cannot say, but give us a feel.

Richard Abadie: I estimate that the overall cost could go up by up to 10%. Only for the sake of argument, if the weighted average cost of capital is 8%, it could go up to 9% or 8.8%. I would caveat that, though. If the pension funds and life insurance companies that we saw at the table earlier today are able to invest their debt at a lower price than banks are currently lending at, that difference would come down. It is quite an easy calculation, but my estimate is that the pension funds and insurance companies putting debt into projects, as opposed to equity, would have to have their debt in the projects 20% cheaper than the current banks to break even. It is an approximation, so effectively they would have to come in with much cheaper capital on the debt side than the current banking model.

Q108 Chair: Would it be a lot of work to set out that calculation on a scrap of paper and send it to us?

Richard Abadie: It is already on a scrap of paper. I can send it to you. It is not a problem.

Chair: Thank you very much indeed. Is there anything either of you want to add at this stage? No. We are very grateful to both of you for coming along—two serious experts on a complicated and serious subject. Thank you very much indeed.

Tuesday 21 May 2013

Members present:

Mr Andrew Tyrie (Chair)

Stewart Hosie
Andrea Leadsom
Mr Andrew Love
John Mann
Mr Pat McFadden
John Thurso

Examination of Witnesses

Witnesses: **Lord Deighton of Carshalton**, Commercial Secretary to the Treasury, and **Geoffrey Spence**, Chief Executive, Infrastructure UK, HM Treasury, gave evidence.

Q109 Chair: Thank you very much for coming to see us this morning. Could I begin by asking you why PFI2 was abandoned for use for the Crossrail rolling stock?
Lord Deighton: Yes, indeed. I think the trade-off that the group involved were examining was really making sure that we reduced the delivery risk, the timing risk for the arrival of the trains, and so we wanted, on balance, to make the procurement as straightforward as possible so when the tunnel was ready, the trains were ready. It was a pretty finely-balanced analysis. The analysis was that there was more risk inherent in going with a private finance route than going with a straight—

Q110 Chair: The risk of what being—
Lord Deighton: Delay.
Chair: Not cost?
Lord Deighton: No, delay. It was the timing issue. The analysis from a value for money perspective, if I recall, was pretty balanced and so certainly my perspective is that the principal thing with many of these big infrastructure projects at the moment is to make sure that we deliver and keeping the project on schedule was the priority. So that is why the people involved overall went with the recommendation of a direct procurement route.

Q111 Chair: It was widely reported that the Priority Schools Building Programme would be funded in the majority of cases, or in the majority of total projects, through PFI2. Is that going to be the case?
Lord Deighton: The announcement that has been made is that 46 of the schools, about £700 million, which is just under half the programme, has been—
Chair: So just a little less than half—
Lord Deighton: Just a little less than half.
Chair:—but I thought that the programme had 261 schools in it.
Lord Deighton: If I remember, the original programme was £1.75 billion, so you are right, it is a little less than half in terms of the original programme that was looked at.
Chair: When you say "a little less than half"—
Lord Deighton: £700 million as a function of £1.75 billion, yes, so less than a half.
Chair: Quite a lot less than half.
Lord Deighton: Less than half. £700 million is a sizeable programme by anybody's measure. I think the point you are making is the original idea or the original conception was that the Priority Schools Building Programme would be a PF2 programme. I think this is in some respects a relatively good news story, reflecting the work that this Committee has been doing, because my reflection on how this progressed was that the Department for Education were extraordinarily focused on the relative value for money of each of the respective approaches and decided frankly that value for money was in the balance. There was not a very clear answer in favour of one route versus the other; that the Department did not have a significant analysis of how schools had been delivered in the past upon which to base a decision to move wholly to a PF2 model and that with the introduction of the aggregator—which is the mechanism that is being used to ensure that we can batch all the schools together and access the capital markets as opposed to bank funding—as that was an innovation, they adopted a more cautious approach, which I think is a good thing.

Q112 Chair: You had some exchanges with us on the cost of capital and they took place after we had heard that the overall cost of these projects could go up 10%. You were asked, "Will these projects be more or less expensive? What are your thoughts on that?" to which you replied, "I have no thoughts on that at the moment, but I am looking forward to looking into it."
Lord Deighton: Yes. I assume I cannot get away with that answer again.

Q113 Chair: What is your conclusion?
Lord Deighton: The way I look at cost is by examining the alternatives at any given point in time, because of course so many other variables are moving around, in particular the state of the financial markets. So for me, looking at the cost of PF2 today versus PF1 five years ago is not really that helpful, it is just looking at what you could accomplish in the financial markets today, given the availability and cost of bank finance; given the developments in institutional finance; given the appetite of investors for the equity portion; and so on. The broad conclusion I have drawn about the evolution of the cost advantages or disadvantages of PF2 are that bank finance is less available and much more expensive, therefore we need a structure that can accommodate institutional lending. To do that, we need a structure with more equity in the capital, so let us say moving from a 10% to 20% equity component. I think with that greater degree of equity, we are able to come up with

structures from a ratings point of view that can attract what I would describe as the "sweet spot" for the institutional market, which would be in the range of single A-type ratings. I think the cost saving on the 80% of the debt component at that higher rating, which brings in the institutional market, more than outweighs the extra return you have to give on the additional equity capital. So on balance, the weighted average cost of capital in the current markets is better served by the structure that we have developed for PF2.

Q114 Chair: So what is the cost of capital going to be—higher, lower, the same?
Lord Deighton: I think the cost of capital for the PF2 structure will deliver a lower cost of capital today than an equivalent PFI structure would deliver today.

Q115 Chair: Is the overall cost going to go up, as we were told by a number of experts, or not?
Lord Deighton: I think we will have to see, because the way we will negotiate these transactions will be through creating a competitive market, and there are a number of different components that will determine the cost. For me, frankly, probably the single most important component in determining the overall cost is the efficiency of the procurement model we put in place and ensuring that we have people, in the case of schools, who understand how to establish a standard approach to a template for a school, drive out cost, run an efficient procurement process. The financing through the aggregator should be done on the same basis, with people who understand the capital markets and how to negotiate with the equity providers. So I think the approach we have in place should enable us to drive the most efficient outcome both in procurement and financing.

Q116 Chair: You are using very general terms. Perhaps I could summarise; what you are saying is you have now started looking at it; you do have some thoughts; there are quite a lot of things that you are not yet sure about in order to form a firm view, and so you are not able to tell the Committee whether the cost will be higher or not.
Lord Deighton: All my experience in the financial markets tells me the only time you will know the answer to that is when you have completed the deal. The reality is, since I was here we have not done a PF2 deal. In some respects I think that tells a considerable story.

Q117 Chair: Okay. I am just trying to get to that. You don't know, is the answer, but you are not convinced that the cost will be higher?
Lord Deighton: The financing costs are a function of what interest rates are in the marketplace. I think it is too general a question. Is this the most efficient model to transfer risk to the private sector? Is the process in place for examining value for money? When we make the decision to go ahead with a PF2 decision, is it very focused on value for money; are we transferring sufficient risk in terms of construction risk and maintenance risk to justify a higher cost of capital?

Q118 Chair: What we are discussing here is the cost of capital at the moment. Colleagues will discuss these risk transfers in a moment in other questions. I am just trying to get the cost of capital question clear. Will the cost of capital be higher?
Lord Deighton: Than?
Chair: Than it would be if we financed this in the public sector.
Lord Deighton: I am sorry. The simple cost of capital will be higher in return for the supposed risk transfer; that is a straightforward question.

Q119 Chair: How much?
Lord Deighton: We will determine that when we have done the first transaction.

Q120 Chair: Therefore you cannot tell me whether you will get that back in value for money savings from better management of the project?
Lord Deighton: The analysis, for example, that is the heart.
Chair: That is the question, but I have broken it down into two pieces now.
Lord Deighton: Yes. For example, you can construct a value for money matrix, which would define the break-even point. For example, the analysis that was done for the schools programme would show that, broadly speaking, if the construction costs went to 10% above the expected level and the maintenance costs were above the 10% level, the benefit of having taken the private finance route, i.e. having effectively insured yourself against those risks, those risks having been transferred, would be just under 2%—I think it is about 1.7%. So that is the kind of analysis behind the risk transfer.

Q121 Chair: Lord Deighton, I think you probably know we are going to carry on asking these questions in a variety of ways, and they are just going to keep coming every time you come before us, so it might be helpful if you could set out in a note where your thinking has come to on these costs.
Lord Deighton: I think when we have financed the programme—
Chair: Why don't you just say yes to that?
Lord Deighton: No, no, I am delighted to do that—with real examples, I think is the way to do it.

Q122 John Thurso: Can I just follow up this question of costs a tiny bit? You are making the point, quite rightly, that market conditions of seven years ago versus market conditions today means you have an apples and pears comparison.
Lord Deighton: Yes.
John Thurso: I completely accept that. However, if you look at the formula for a weighted average, that remains constant in this respect: if you have 10% equity and 90% debt—and broadly speaking, ever since the 1980s, equity has been relatively considerably more costly than debt finance for reasonable projects—then if you multiply 10% by the cost of equity and 90% by the cost of debt, you arrive at the weighted average. If you then say, "We need 20% to 25%," and you take the 20% to 25% and multiply that by the cost of equity and the other 75%

to 80% by the cost of debt, you arrive at a number that is greater than the first number. So the model of PF2 will, in all circumstances, be more expensive than the model of PF1 because of the requirement to go to 20% to 25% of equity.
Lord Deighton: Unless—
John Thurso: Isn't that a no-brainer for a banker?
Lord Deighton: No, not necessarily. I think the point I was making to the Chairman was that if at a lower debt equity ratio you are able to access a different financing market—for example, shifting from the banking market, which has become very expensive, into the capital markets, which are more competitive now—then the lower average cost of that 80% versus the prior 90% could well outweigh the fact that you have a more expensive slug of capital going up from 10% to 20%.

Q123 John Thurso: But if you look at investment grade bond returns and you look at high-grade borrowing to a plc, FTSE100—which I would imagine a PFI ought to be in the region of, because if it isn't, why is it doing it?—there is not a lot of difference in the cost. There is a 1.5% maximum difference, probably less, so it is not a huge difference, whereas there is a 5% difference or more in the cost of capital as between equity and debt, either a bond debt or bank debt.
Lord Deighton: Yes, though it is a smaller proportion of capital.

Q124 John Thurso: Exactly. If you move from 10% to 25%, that is a significant increase in the higher cost for a relative saving on the lower cost.
Lord Deighton: Yes. No, I agree. That is why it is a weighted average cost—
John Thurso: I just thought I would add some clarity to that.
Lord Deighton:—so it depends how much it goes up and down. No, I think we are all agreed on the arithmetic.

Q125 John Thurso: Can I turn then to the question—and I don't know whoever would feel best able to answer this question—of PF2? The proposal is that some of the equity will be taken by Government. Presumably therefore the Government will be receiving some of the dividends. To what extent is this an aim of Government policy? Explain to me how the Government sees having equity as an important part of the overall policy.
Lord Deighton: Let me start off, and then Geoffrey, who has more history in this, can perhaps fill in. For me, Government taking an equity share in these structures is really based on a very simple principle, that what we are really trying to establish here is a partnership—and that was one of the key terms in the original conception—and when you are on the same side of the table at the board meetings, receiving a portion of the same returns, it is a much better relationship in order to both negotiate these transactions initially, but probably more importantly to run them over the very long term that most of them take place. So it works well for both sides, so we are not left with a sense that it is all about extracting profit if you are one side and on the other side you are sort of left at the mercy of a transaction that was done, in many cases, years ago. So for me, the heart of it all is really about trying to establish a true partnership approach to these transactions for the benefit of both sides. So I don't know, Geoffrey, if there any specific policy things there.
Geoffrey Spence: Yes, to build on that, there are probably two other aspects of taking equity in this. The first is that by taking equity, and therefore increasing the amount of equity capitalisation, we do access long-term institutional debt finance, but at the same time, the plan is that the benefit of that equity return—which will be completely in line with the other shareholders—will be rebated back to the authority who is paying for the particular service. So in that sense, if you like, the potential extra cost of having higher equity is mitigated significantly, if not wholly, by the fact that that shareholding benefit in terms of dividends or any other payments that come from that shareholding will go back to the authority that has paid for the service. It will go through Treasury, but the commitment that the Treasury has made is that will go back directly to the procurement authority, so their net cost will be lower than their gross cost to the tune of the equity return. That is one other reason, and then the third reason is to do with transparency. This is a better method in terms of dealing with the private sector to achieve the levels of transparency that Government and Parliament want to see, particularly transparency on the level of equity returns that are made in this context. I think, without having to create a huge bureaucracy to establish that, by us being able to publish on an annual basis a full report on what happens to all of these projects from the point of view of the shareholder, as well as of course from the point of view of the procurement authority, that achieves a level of transparency that everyone wants.

Q126 John Thurso: Can I just be clear, because I think, Mr Spence, you have said that the Government would be looking to take somewhere between 20% to 25%, up to a maximum of 49%, which I assume is of the equity stake and not the overall project?
Geoffrey Spence: That is correct, although the equity can come in two forms, of course. It can come by way of ordinary share capital and subordinated debt.

Q127 John Thurso: Can I just ask you on that, because it is quite a big question, how much are you seeing Government being involved in equity and subordinated debt, or could you envisage a situation where the Government has all the equity and the private side provide all the subordinated debt?
Geoffrey Spence: No. I think that would go against some of the benefits that the PF2 model would give us by way of private sector management.

Q128 John Thurso: So if the equity side is being made up of pure equity and subordinated debt or other capital instruments—and presumably you could go to pref stock or whatever—at that moment, the Government's stake would reflect the other shareholders' stake, in other words, if they had X of

equity and Y of subordinated debt, you would take the same ratio?
Geoffrey Spence: Pro rata, yes.

Q129 John Thurso: You would pro rate it. So to all intents and purposes, we can put to one side how it is split into which forms of equity instruments?
Geoffrey Spence: Yes.

Q130 John Thurso: For the purposes of my question, therefore, we can assume it is equity of whatever type.
So you are looking to take between 20% and 25%, up to 49%, and that is of the equity stake, so do you expect every PF2 to have a public sector equity proportion?
Geoffrey Spence: Yes, I do.

Q131 John Thurso: How do you work out what is the appropriate size of public sector equity stake as against the private sector side?
Geoffrey Spence: I think the 49% is an important barrier, because I think for both the private sector and the public sector, we want the private sector to retain control over these entities, subject to various safeguards that we will have in the shareholders' group of the sort you would expect. So I think the 49% is a barrier.
In terms of the minimum amount you would want, in company law there are various shareholding levels that provide blocking majorities for certain decisions, and if you like, that is the minimum. That sets the framework. I think in terms of the specific—

Q132 John Thurso: Can I flesh that out? This will effectively be taking equity in the special purpose vehicle?
Geoffrey Spence: Yes, that is correct.

Q133 John Thurso: So let us say it is 25% equity, so the other 75% is relevant for control and voting purposes, it is relevant for financing. So of that 25%, the Government takes a minimum of 25%, so that then puts it in a position to have a blocking on all of the various triggers for shareholders that run at 75%.
Geoffrey Spence: Yes, and I think the big gap in between, which is where do you go between 25% and 50%, is a very pragmatic matter of looking at each procurement to establish in terms of the dynamics of that procurement what is the right level? Is it the size of the project that may encourage you to have a smaller percentage, simply because you want the other shareholders to have a larger amount of capital at risk? So it is those sort of dynamics that we would want to consider.

Q134 John Thurso: You have made clear that one of the parts of the thinking is the barrier at which you get into having a certain amount of minority control or there are areas where that minority stake has to be taken into account. Will there be some instances where you will not do that, in other words, you might take 10% of the equity or are you aiming to be at that 25% of the equity, somewhere between 25% and 50% on all occasions?
Geoffrey Spence: We will expect to be somewhere between 25% and 50% on all occasions.

Q135 John Thurso: That is a significant investment. That is the level that you make that sort of investment—you are an active investor, not a passive investor.
Geoffrey Spence: Yes, that is correct.

Q136 John Thurso: How is the Treasury going to manage those investments? Let us say you have 50, 60 of these. How is the Treasury going to be an active manager and investor in all of those?
Geoffrey Spence: At the moment we do not have 50 or 60 and it would be some time before that situation would arise.
John Thurso: So you have five?
Geoffrey Spence: So we will have, in the short term, say five to 10 of these positions. What we are doing in response to this is setting up a separate unit within the Treasury. We have appointed someone from outside the Treasury with a commercial background, a former partner in Linklaters, and also with experience of non-executive posts, to help us set up this separate unit that will operate within the Treasury with the—

Q137 Chair: What is the name of that person, please?
Geoffrey Spence: Margaret Bonsall. Basically, we don't think we need very many people. In fact, we don't think we probably need more than three people to sit on the relevant boards. They will work for the Treasury in the sense that they are civil servants, but with the right skills, looking at this from a commercial point of view, and also engaging with the private sector partners.

Q138 John Thurso: Why not the Shareholder Executive?
Geoffrey Spence: We thought about the Shareholder Executive in terms of framing this policy and we came to a number of conclusions. The first is it was rather important, given the transparency objective behind this, that it sat closest as possible to the policy team that is responsible for the policy within the Treasury. The two really have to go side by side if we are going to publish a report annually to Parliament as to what is happening within these investments. I think there is a natural symmetry there. We also looked at what we would have to do to set this up, and I think whether it was the Treasury or whether it was the Shareholder Executive, we would have to bring in people who have experience of this type of investment. The Shareholder Executive didn't have quite those people, so they would have had to build a capability as well.

Q139 John Thurso: Forgive me if I express a degree of scepticism. There is quite a long track record of the Treasury not distinguishing themselves in these kind of things, and indeed there are a number of companies that used to be dealt with by the Treasury that are now in the Shareholder Executive. And of course, for the banks, Treasury set up UKFI, which again has some question marks over it. Here we are, we have UKFI, who does investments; we have the Shareholder Executive with a complete team who do investments; and now the Treasury are setting up a small team of three or four people. Doesn't this have some pretty chunky management question marks over it?

Geoffrey Spence: I don't agree, although I can understand why you can see that parallel. I think the Shareholder Executive skills are in running on a very activist basis shareholdings that are owned by the Government and bringing better management performance. I think what we are doing here is slightly different. We are preserving some public interest through our shareholding, but we are leaving the private sector to run this within those parameters.

Q140 John Thurso: Sorry, can I just double-check that? You are taking a 25% stake so you can be an active investor, but you are not going to actively take part because you want to let the private sector get on with it? Forgive me, which is it?

Geoffrey Spence: I think these are all very nuanced arrangements between the public and private sector. We want to be the voice at the table that preserves key public sector interests, particularly in terms of transparency, but what we do not want to do is to meddle in the day-to-day activities that the private sector is bringing to managing these assets. We also want, with that shareholding, to bring to the table the procurement authority to share in understanding what is going on at the SPV level.

Q141 Chair: It does sound a bit like Groundhog Day, if I may say so.

Geoffrey Spence: We have not done this before, so—

Chair: Not quite this, but we have done plenty of PFI. Sorry, John, do carry on.

Lord Deighton: This is a good debate to have. We have thought about organisationally where is the right place to house this expertise. I think on balance we felt that sitting on the board of a PFI-type business is quite a specialised activity, and that building it up in Treasury, where this kind of expertise exists, probably stood as good a chance of being effective as anywhere, frankly. I mean, that is the rationale.

Q142 John Thurso: Effectively you are seeking to have your influence by placing a non-executive on the board of the particular SPVs, and therefore you are going to go out and recruit the appropriately skilled person to be a non-executive. I mean, they do not necessarily need to be in the Treasury. They can be somebody like any non-executive that goes on to a board—they can do that job. My question started off because the Shareholder Executive are rather good at sourcing non-executives. They have the non-executives for the NDA; they have the non-executives for the Royal Mail; they have the non-executives for the other 14 or 15 companies that they have. I am just slightly taken aback by firstly the concept of a special unit of three people in the Treasury providing non-executives, which is a job that seems to me can be done—

Geoffrey Spence: They are the non-executives.

John Thurso: They are the non-executives?

Geoffrey Spence: They are not providing them.

Q143 John Thurso: Okay. But then there is this whole question of what is the point? You are getting into a bit of not active management, but active corporate governance of the vehicle in order to avoid the pitfalls of PF1, but at the same time sort of leaving it to the private sector. I think there are two conflicting ideas here that have not been fleshed out and worked through, which is where my mild cynicism sort of stems from.

Geoffrey Spence: I can understand the cynicism.

John Thurso: After years of experience of Government.

Geoffrey Spence: I would say there is a question here of partnership between the public and the private sector, and partnerships are a bit messy.

John Thurso: Yes, you are not kidding.

Chair: It is going to be better this time, isn't it?

Geoffrey Spence: One of the aspects that we have looked at in taking this forward has been the model of the LIFT companies for providing primary care, where these sort of arrangements did induce a better sense of partnership between the public and the private sector, and what we have been trying to do is reproduce that.

John Thurso: I am going to stop there, Chairman, because it is slightly circular. I think you have a strong understanding of the concern I have, and one that we will return to in the future.

Chair: I think we will.

Q144 Mr Love: Lord Deighton, in our reports on PFI in 2011, we highlighted the incentive to use PFI because it effectively kept the cost off the national account balance sheet. Experts tell us, in our approach to this report, that that will not change with PF2. Is that correct?

Lord Deighton: I think you are absolutely right. If you look at the history of PFI, it is clear that one of the motivations for using it was to keep the debt off the Government's balance sheet. I think the best illustration of that was the utilisation of the PFI credits, which were a specific incentive to utilise this technique for the Departments. Those of course were abolished in 2010.

In terms of how PF2 addresses that, firstly I can just give my own experience, and if you look at what has been happening, the flow of PF2 transactions has clearly slowed down considerably, which reflects that people are not just trying to pull through projects for which there isn't balance sheet room. The approach I have found in all of the Departments looking at projects is absolutely focused on value for money. It hasn't been focused on, "We cannot do it on our balance sheet because we do not have approval, therefore let us find another way of getting around it." That is just not the way the process works.

In terms of transparency, you are right, the changes to the PF2 do not include putting it fully on the Government's balance sheet. What we are doing is from 2010, we had the liabilities laid out in the whole Government accounts, the contingent liability, and the undertaking that has been given is for the PF2 total—and of course we have nothing yet—that the spending round, which finishes at the end of next month, will lay out the basis upon which a control total for PF2 will be recorded. So we have moved some of the way, but you are right, it will not be on the balance sheet. The behaviour is very focused on value for money, so my experience since I have been in Government is it is not used as a way to spend money for which there isn't balance sheet room. That is not how it is governed.

Q145 Mr Love: Let me ask you, our experts tell us that PF2 has been structured specifically in a way that will keep it off the balance sheet. Would you accept that, that you have gone out of your way to structure PF2 to achieve that?
Lord Deighton: I don't think so. I think the evolution of PF2 was a very straightforward evolution. There were many drawbacks from PFI.

Q146 Mr Love: Let me just quote to you what our expert says, "To qualify as off the national accounts, PF2 need only transfer construction and availability risk. They will almost always do this—the structure outlined has been put together very carefully to ensure this."
Lord Deighton: The essence of the structure is that it does transfer risk and the nature of the test as to whether it appears on the national accounts is that transfer of risk, you are absolutely right. I think it is appropriate because of that to make sure that we have full visibility of the liabilities that are being created, which is what we have now, and that the process that is gone through to determine how these projects are financed, whether they are fully Government financed, on balance sheet or whether they are off balance sheet, is one that focuses on value for money rather than trying to find ways around expenditure limits.

Q147 Mr Love: Given the difficulties of Government expenditure at the present time, how can you reassure this Committee that PF2 will not be perceived as the only game in town for much public expenditure? How are we going to overcome the difficulties about getting value for money from PF2, as we did with PFI?
Lord Deighton: I think that is, if I may say so, a very important question. I think the simple answer to that is by examining the evidence of each deal, each transaction that is put in place. I think you can see from the pipeline we have and the way that these transactions are approached that enormous care is applied to making sure that those that go down this path represent good value for money, and I think that is the test. We have to review them and determine that those tests have been applied and to make sure that we are consistent in that application, absolutely.

Q148 Mr Love: Let me ask you, there has been a lot of concern expressed about public sector comparators and whether they are realistic in the context of keeping things off the balance sheet, but what criteria are you going to use to establish value for money for these projects and who will take responsibility on individual projects to ensure that those criteria are met?
Lord Deighton: Of course each project and sector will tend to have a slightly different approach. If we look at the schools programme, because that is one that is currently about to go through the PF2 model, the focus has been clear that the two risks we are determining or evaluating whether they are better off managed in the private sector are the construction risk and then subsequently the maintenance risk over the whole life cycle of the asset, and those are the ones that we manage there. The process—and maybe I can turn to Geoffrey here, as he sits right in the middle of it—goes through a series of reviews at departmental and Treasury level to assure those value for money tests are fulfilled.

Q149 Mr Love: Before you speak, can I just remind you of what the Chairman said earlier on? We will no doubt be interviewing you again when PF2 is established.
Lord Deighton: Absolutely.
Mr Love: So it will be very clear that we want to hear clearly how you are going to assure value for money on the PF2 programme.
Geoffrey Spence: The value for money process is, Departments of course do a value for money assessment that then at different stages has to be approved by the Treasury if it is above a delegated limit for expenditure, and that is the process that we use. We are giving further thought as to how we assess value for money before PF2, but it is worth just remembering that we have changed direction on Crossrail rolling stock, because we did not think that the solution that we had, which would have been a PF2 solution, was the best one. We have adopted a slightly different approach to schools than the market expected, because we did not think it was the right one. So I would say that shows that, certainly over the last six months, the centres in Government have been far sharper in helping people come to the right conclusion as to what to do next and they are not approaching this on the basis that there is only one alternative, which is PF2, because there isn't: there are many alternatives.

Q150 Mr Love: Let me go on. You touched upon it, Lord Deighton, the new framework for managing off balance sheet liabilities, control totals and transparency in relation to that. Can you explain further how you think that will operate? We have had a paucity of information on this, but I think everybody recognises it will be a contribution towards ensuring a better outcome for PF2.
Lord Deighton: It has not been finalised yet. It will be announced with the spending round at the end of June.

Q151 Mr Love: Can you just confirm that that will happen, because it was meant to come out at the budget, and then it was moved to the spending review.
Lord Deighton: Yes.
Mr Love: You are not going to move it again?
Lord Deighton: No.

Q152 Mr Love: So is there anything you can tell us now about how this will operate?
Lord Deighton: The concept of a control total is clear. The only extra thing you will hear about at the spending round is the precise mechanism, so exactly how we will cap it or what it should be a proportion

of, so the exact measure, but the principle, the total amount will be laid out very clearly I think is at the heart of it. It is the transparency that matters. What sort of limit we put on it will just be a particular way of measuring it, and that is the specific detail you will hear at the spending round.

Q153 Mr Love: Can I just press you a little bit, because in making that announcement about the control totals, they also talked about a wider set of reforms for managing the off balance sheet liabilities. Is there anything you can say about that, the wider set of reforms?
Lord Deighton: The Treasury's website includes a very extensive range of information on the historical PFI transactions, so there is already a considerable amount of information available. The heart really of all these reforms has been to lay out the detail of these transactions as far as possible so people can see what is there, even though, as you have already pointed out, it does not appear against the public sector net deficit.
Geoffrey Spence: Can I just add one thing on that? The significance about this is it is a control total, and for the first time what we are proposing to do is to have a mechanism to control what happens in terms of off balance sheet liabilities, so I think that is a major step forward and in many respects a response to what this Committee has argued for for many years. I think the second thing about it is that what it does give in terms of assessing projects coming forward is a greater focus on the whole of life cost beyond a spending review period. One aspect of why we are introducing this is that definitely with some PFI projects, particularly in the Department of Health, there was an over-emphasis in the early period and not enough emphasis in the later period, and that favoured things like indexation to inflation over a contract life. This is going to deal with the assessments that came up on that sort of issue and that is one of the other reasons that we are introducing this control total, which is to ensure that there is far more of a whole of life assessment as to potential cost that goes beyond a short-term spending review period.

Q154 Mr Love: That is very welcome. We were moving in that direction with whole of Government accounts, but drawing it all together and putting it into one control total will undoubtedly be a contribution to the debate.
Let me just ask one final question, and that is going back again. I want it to be clear, all our experts are telling us that PF2 will be more costly than PFI. Do you agree with that or not?
Lord Deighton: I think in principle—
Mr Love: Not with public sector comparators, but with PFI. They are saying, because of the leveraged structure, the policy structure, it will be more expensive.
Lord Deighton: That is probably the case. I think I agree with that.

Q155 Stewart Hosie: Lord Deighton, there has been a lot of talk about the cost of capital, quite right, but the general public don't care about the cost of capital or the balance between equity and debt in financing. They care about the total lifetime cost compared to the capital cost of the project, which is why the horror stories of the £200 million hospital costing well over £1 billion over its lifetime caused such a scandal. The solution in PF2 appears to be to strip out the soft facilities management costs and so there is a more accurate cost of capital with the other stuff allocated separately. Will that reduce costs overall or will it simply add complexity, that there are now multiple contracts on what is effectively the same project and will risk be priced up accordingly?
Lord Deighton: That is an important question, which I think does get into the heart of some of the things that we are trying to improve. One way of answering the question is to look at the work that has been done on the existing portfolio of transactions in order to reduce their ongoing lifetime costs. The team at the Treasury has been working at this for a year or so now and I think the rolling target of savings now is about £1.65 billion and there is a target to accumulate another about £1.4 billion of savings from the existing portfolio. So that is really doing the work on the existing portfolio, which you are now discussing, should be applied in how we approach the new transactions differently. So I think that is proof that there is some value in doing this differently, and in the schools programme, for example, I think you are absolutely right.

Q156 Stewart Hosie: No, I want to really focus on the new contracts, not trying to pick apart some of the old contracts, which were appalling, and try to save some money. That is all very sensible and good luck to whoever is doing it.
Lord Deighton: It is the same principle.
Stewart Hosie: Possibly, but we are talking here about separating out the cost of construction fundamentally and maintenance from the soft facilities management stuff, which added enormously. The question is—does that put up the overall cost compared to PFI; does it add to risk being costed up the way, and if so, is there some kind of metric there? What are we talking?
Lord Deighton: Look, I think it is more efficient to break up these bundles of services into their different kinds and to place them with people who can provide them in the most flexible, cost-efficient way. I agree with you, there is an element of management or overhead or complexity in order to accomplish that, but I do not think it is so incredibly complicated, and I think the opportunity is demonstrated by what we have done with the existing portfolio.

Q157 Stewart Hosie: It is interesting you say that it can be more efficient, because Noble Francis, the Director of Economics at the Construction Products Association, warned that because in the long term the return on PFI for the private sector investor or contractor is over the course of the service contract, separating the long-term service contracts may impact on those who are willing to invest. So it may be more efficient, but it may impact hugely on those willing to invest, and what would the impact of that be if that were the case? Would it mean a larger public sector stake in these contracts?

Lord Deighton: Like all these things, it is a question of balance. In terms of some of the sort of heavier maintenance and facilities management, I think in many—if not most—cases that works very naturally as part of the construction, because they go together very well. In terms of the softer services/elements, as you effectively acknowledged this, good examples of those are obviously cleaning and catering. I think it works very well to separate those out, particularly as the provision can change over time, you can work very hard at the efficiency. I think certain kinds of services do go better bundled, others are definitely more efficiently delivered on a separate basis under a separate contract from a separate provider.

Q158 Stewart Hosie: But on that specific point that Mr Francis makes, that it might impact on those willing to invest because of the lifetime profit over all parts of the contract, do you think that is a legitimate concern or do you have no additional concerns about the ability to attract investment because of the nature of the contracts?
Lord Deighton: No, I think in every component of these transactions, clearly the return that we provide to the investor, the constructor, whoever it is, needs to be sufficient to bring them to the table. That is the balance that we are trying to establish the whole time, absolutely.

Q159 Stewart Hosie: Just on that point, I think it was said earlier that the public sector will have a stake in these special production vehicles, whatever the stake might be, and I think you said that dividends would be rebated back to the procurement authority via the Treasury. I think that is the way it was described. The public will look rather askance that costs on PF2 are likely to be higher than PFI, which was recognised to be a shambles. The Public Procurement Authority will be funding this through the taxpayer fundamentally at the end of the day, and that by sitting on the board of the special production vehicle they will have dividends rebated back to them, which is taxpayers' money in the first place. It is all rather complicated when we are only really talking about building schools and hospitals, isn't it?
Lord Deighton: The first thing I would say is I think the discussion about the relative costs was focused on the financing cost, if I can just separate the two out. I think what everybody is trying to accomplish on the other costs is that we have a procurement model and a contract structure model that enables us to continue to drive those down to a more efficient level. Again, that opportunity is the opportunity that has been realised in the savings we have made on the existing portfolio. That tells you the efficiency shift, because the new contracts should embody those better terms, which we are now having to extract retrospectively from the existing portfolio. That is the opportunity to do it better.

Q160 Stewart Hosie: I would like myself to go back to the Treasury table that shows the total lifetime ongoing costs against the original cost of capital and see what this potential savings from renegotiation really amounts to as a factor of the total cost, because I suspect it will be rather small.
Lord Deighton: I think we are having the NAO review that, aren't we, the process, so we will be able to give you some facts on that.
Geoffrey Spence: The NAO is validating our claims about cost savings, yes.
Lord Deighton: So we have something you can look at there.

Q161 Stewart Hosie: Sorry, just a couple of other small questions. The Government said they were looking for up to £20 billion of private sector financing for new infrastructure and that the pensions infrastructure platform had the target of around £2 billion. Is £2 billion from the pension funds enough? Are you looking for more from them?
Lord Deighton: Pension funds provide a lot of money already through other funds, so when they are investing in infrastructure at the moment, they do it via other managed funds. The point of the pensions infrastructure platform is so they can develop the expertise to do it directly, which they are hoping would be more efficient. They so far have £1 billion. The intention is to take that to £2 billion over the next year. The £20 billion target that the Government announced when this all started is a sort of 10-year horizon, because what we are really trying to do is just encourage them directly into the market.

Q162 Stewart Hosie: Is there any chance at all that you are going to find that missing £18 billion?
Lord Deighton: Over 10 years, yes, absolutely, if it works, though my view on the market generally is our approach is to ensure that we access the global capital markets for the private money we need. Whether it comes from pension funds, life companies, sovereign wealth companies is less of an issue as long as we get there in total, so we are doing everything we can in each sector to encourage them along.

Q163 Stewart Hosie: Just finally on that then, what efforts specifically have you made to reach out to those bits of the capital markets in order to get some of this extra cash and are there specific projects that you are dangling in front of these investors?
Lord Deighton: There are a number of different ways in that private capital gets involved in these big projects. If we are talking about PF2 specifically, just remember we have at the moment one programme for £700 million, so in terms of the capacity of the markets, this isn't a particular challenge. The broader question of how we finance our overall infrastructure requirements over the next 15 to 20 years is I think where this question is much more valid. If you look at national infrastructure plan, we lay out a pipeline of projects in excess of £300 billion. We expect something like, in round numbers, 70% of it to be found in the private markets. However, much of that comes in the form of existing corporate entities. If you look at the way we finance our water companies, if you look at the way our energy companies are financed, if you look at the way our airports are financed, it is in a corporate form, so the private equity

goes into those corporate forms that have both existing assets and that are building new assets.

Q164 Stewart Hosie: So you are expecting private contractors to go to the market rather than you to go to the market and offer up investments that might be worth investing in?
Lord Deighton: It is a combination of all those things. I will give you some examples. If we are rebuilding Terminal 2, Heathrow Airport does that, and it can do that from its own cashflow and from its existing investors, who are institutional investors who very much like the characteristics of infrastructure, and they are bearing the burden of that expansion programme. In the case of our water companies, it is a very good case of a regulated asset-based model, which is an alternative model to a PFI. The regulator will set prices that allow for capital investment to take place, and again that comes in at the asset level.

Q165 Stewart Hosie: Sorry, both of those examples are private companies. One is a regulated model and one is a very important bit of infrastructure, but they are both private. I am more concerned about the stuff that is not in the private sector, where it is dependent on public procurement bodies and Government to raise the cash. So in terms of the schools programme, for example, do you go through a prime contractor to raise the money or do you or somebody else go to market to get the cash?
Lord Deighton: What I was really pointing out was given the scale of them, there are many different ways of doing this, and I think it is important to understand them all. Frankly, the structures where we have effectively created entities that are able to do this independently is probably the most efficient structure, which leaves us with the rump, if you like, of the difficult to do deals that may be of a much bigger scale. You are absolutely right, I spend a lot of my time with all those institutional investors, right from sovereign wealth funds, which have vast sums of money at their disposal, life companies and pension funds. We absolutely spend significant amounts of time with them, on understanding what their requirements are and in looking at the pipeline of specific proposals, so the aggregator structure that has been put together for the schools programme will be the vehicle through which we then discuss with the market their appetite for that deal. So each one is specific, but we have a plan for it.

Q166 Mr McFadden: I would like to ask you about this issue of Government guarantees underwriting infrastructure investment. There was a Treasury press notice from July last year that said up to £40 billion worth of projects that are ready or nearly ready could qualify. The first guarantees are expected to be awarded in the autumn, and to qualify, the projects must be ready to start in the 12 months following a guarantee being given. Could you give us a progress report on this? Of the £40 billion, for example, how much has been taken up?
Lord Deighton: It follows on very logically from the discussion we were just having, this is one of the Government's interventions to support the markets with a guarantee for those projects that the markets cannot quite get done. So the concept behind it is, if there is a risk there that the markets in their current state will not quite absorb, the Government is prepared to step in to ensure these important projects happen. The progress report—and Geoffrey runs this programme, so he can fill in some of the details—but broadly speaking, two transactions have been announced, one completed, which was the conversion of the Drax Power Station from coal-fired to biomass earlier, I think we announced that a couple of months ago. The second transaction that has been announced has been the support of the extension of the Northern Line to Battersea, which of course unlocked the big development in Battersea, for which I think a construction contract is about to be announced. So those are the two that are in the public domain.

Q167 Mr McFadden: Do you know what the value of those two are?
Lord Deighton: The value of the guarantee for Battersea, a round number, it is £1 billion. The Drax is £75 million.
Mr McFadden: £75 million?
Lord Deighton: Yes, £75 million. And then there is a pipeline of other pre-qualified transactions that are in the process of being discussed and negotiated, all of which have various confidential aspects, so we cannot talk about the specifics, but they are pre-qualified and the sponsors involved there are in the process of finalising the deal, so we would expect a series of announcements in the latter half of this year and the beginning of next year.

Q168 Mr McFadden: The press release said, "Now 'UK Guarantees' will use that hard-won fiscal credibility to provide public guarantees of up to £50bn of private investment in infrastructure and exports." That was the Chancellor's claim 10 months ago. The projects had to be willing to go in the next 12 months. We are now 10 months on, so we are not far away from 12 months on, and of this potential £50 billion, these guarantees have been used for around £1 billion and £75 million so far?
Lord Deighton: So far, yes.

Q169 Mr McFadden: There is quite a lot to do in the next two months then, isn't there?
Lord Deighton: Yes, there is for that pipeline.
Geoffrey Spence: We have publicly pre-qualified a further £10 billion of projects.

Q170 Mr McFadden: What does that mean?
Geoffrey Spence: Because we do have commercial confidentiality issues with quite a number of the projects that we are talking about—
Mr McFadden: I understand that.
Geoffrey Spence:—what we have been trying to do is to find a way of communicating what progress is, so the way we have done that is to say, "We have had over 100 people come in to see us with proposals and projects." That probably only amounts to about 50 projects, because some people come in to talk to us about the same project. We probably have at the moment about six to seven a month come in to talk to

us in terms of new projects that they want us to consider and guarantee. I think the last public statement we have made is that about £10 billion in total of project value is being taken forward under the guarantee scheme in addition to what we have just referred to.

Q171 Mr McFadden: Just define this "being taken forward". Does this mean that you are saying there are £10 billion of projects out there that we think might potentially qualify for this guarantee or is it more than that, that there is £10 billion that will qualify? I can confidently tell you that in a few months' time, if I was to ask you the same questions as today, you would be telling me, "We have about £12 billion of projects that are using these guarantees." Which is it?
Geoffrey Spence: I think the £10 billion is a snapshot at the date of the announcement as to those projects that qualify for the scheme, and where we are doing further work with them to see what the price of a guarantee would be, given the State Aid rules, and what the risk would be.

Q172 Mr McFadden: Yes, so the £10 billion might not happen? It is under discussion. What I am trying to explore is, is it—
Geoffrey Spence: So we are not saying they have been approved.
Mr McFadden:—a maybe or is it a yes?
Geoffrey Spence: We are not saying they have been approved.

Q173 Mr McFadden: Right. So of those that have been approved so far, it is £1 billion and £75 million?
Geoffrey Spence: That is correct.
Mr McFadden: Of the £50 billion.
Lord Deighton: An interesting observation to make is the ones that have not happened, when they do not happen, they generally don't happen because they manage to pull together the financing on their own, so the key thing for us is getting the projects done and delivered, not just using our guarantees. So we are delighted when they go ahead without our help.
Geoffrey Spence: Just some clarity on the numbers, the £50 billion includes £10 billion that is there for a housing scheme that is run by DCLG, but is not an infrastructure scheme. We probably could not comment on that, because it is run by DCLG. So there is a £40 billion pot, if you want to call it that, of money available, and that was put forward in the legislation. We have not at any stage said that we think that there are £40 billion of projects that are going to need the guarantee. What we did do was an assessment of what we thought could be eligible by looking at the national infrastructure plan, looking forward two years and saying, "Of those, what could come forward in terms of something that could be eligible for a guarantee?" So that was a sighting shot as to how big this scheme could be.

Q174 Mr McFadden: What the Chancellor said is, "Now 'UK Guarantees' will use that hard-won fiscal credibility to provide public guarantees of up to £50bn of private investment in infrastructure and exports," and the Chief Secretary said, "The measures we're announcing today will help work get started on many important infrastructure projects." I am just trying to explore how many have been started since these claims were made, and the answer is two.
Geoffrey Spence: Two have been completed, not two started.

Q175 Mr McFadden: I am just trying to explore the facts. I understand the difference between guarantees and things that get their own financing. Will these guarantees apply to PF2 projects?
Lord Deighton: They could do.
Mr McFadden: They could do?
Lord Deighton: But I don't think our expectation is that they will. The idea is that they are meant to be flexible, because the whole idea is, "What do we need to make sure we get projects moving?" so that is why you would not preclude anything.
Mr McFadden: That is fine, thank you.

Q176 Chair: Just while we are on the guarantees, what criteria have the Treasury set for deciding whether or not to guarantee a project?
Lord Deighton: Do you want to take that one, because we set it out, I think, didn't we?
Geoffrey Spence: So we include all of the projects that are on the national infrastructure plan in terms of saying they will be eligible. We also say that PFI/PPP projects and we also say that in addition, if the projects have national significance that we haven't identified, then Ministers can decide to say that those are eligible.

Q177 Chair: That is the envelope of what is eligible?
Geoffrey Spence: That is the envelope.

Q178 Chair: My question is, how do you rank the eligibility?
Geoffrey Spence: When we go forward with this, there is obviously consideration of value for money in terms of whether these potential candidates offer value for money, and there are also questions of risk. When it comes to questions of risk, we have a separate Risk Committee within the Treasury that grades the project in terms of its riskiness. The grade of the project is similar to what you find in a rating agency, but it is not identical with what a rating agency would do in terms of grading projects from more risky to less risky, and of course there is well-established criteria they use for establishing that, which we mirror when it comes to the Treasury assessment.

Q179 Chair: I think we had better see that, please. We had better take a look at that as a Committee. I think that is essential. The risk-rating agencies' grading systems are published, and I think this had better be published.
Geoffrey Spence: Yes. We have provided some information on the website and will be doing more so, but we are very happy to come back to the Committee on this.
Chair: Okay. I may have interrupted. Was there something else you wanted to add there?
Geoffrey Spence: Yes, I did. Basically the way it works is that the Risk Committee advises the

Chancellor as to what the riskiness of the project is and Ministers then decide, as they would on any other type of public expenditure, whether on that basis they wish to proceed with the guarantee or not. The price of the guarantee is related to the riskiness.

Q180 Chair: Okay. The long-run discount rate, the Green Book rules, those are the criteria normally used by Treasury Ministers. Do they have that at their elbow?
Geoffrey Spence: They have very good advice on matters of value for money.
Chair: That is a very careful answer. Have another go at the same question.
Geoffrey Spence: I think they have also read the Green Book too, yes.

Q181 Chair: Okay. They are applying the Green Book in order to make that assessment?
Geoffrey Spence: As to whether the guarantee is value for money, yes. I think the one thing you have to remember though is that the vast majority of these projects are not public procurements. If we take this £10 billion, the vast majority are not public procurements.

Q182 Chair: That is back to the definitional questions we were asking, which is the effect on the balance sheet.
Geoffrey Spence: What that means is that they are completely private projects, so some of the criteria for value for money that we use in the public procurement, it is slightly different when you come to completely 100% private projects.

Q183 Mr McFadden: Just explain to me how this will score, Geoffrey, because the whole advantage of the PF2 thing, as we have been talking in PF2, PFI, whatever, is that it is off balance sheet. The advantage of getting private finance into infrastructure projects is that the Government is not paying for it. If the Government guarantee was taken up in a big way and we weren't at £1 billion, but we were at your potential £12 billion or the potential £40 billion, £50 billion that the Chancellor talked about, how does that score on the books if it needs a Government guarantee to get it going?
Geoffrey Spence: It is a contingent liability in terms of the way it is classified, unless the assessment of risk is such that the guarantee is likely to be called, at which point it is classified as the public sector.

Q184 Chair: So it is defined by more than 50%? Sorry, Pat.
Mr McFadden: That is all right.
Geoffrey Spence: I think it is not as magic as a particular number that you have to go through, but if it is—

Q185 Mr McFadden: Is there a risk here from the Government's point of view that using this guarantee negates the advantage of private finance by bringing these projects on to the balance sheet rather than keeping them off it?
Geoffrey Spence: I think this is the point about these are not public projects.
Mr McFadden: That is why I am asking.
Geoffrey Spence: If you look at Drax—the Battersea arrangement is slightly different—this is a completely private sector company that we are supporting by way of providing a guarantee to enable them to convert to biomass to generate. So the sole assessment for us is where the risks of that venture are such that there is significant risk that the guarantee could be called, and obviously if there is significant risk, the whole transaction gets classified to the public sector, but otherwise it is treated as a contingent liability.

Q186 John Mann: I just want to ask a question of Mr Spence, because you were singing the praises of LIFT Co before and contrasting it with BSF, or that is how I took it to be. Any schools built with PF2, will there be the same bureaucracy as there is at the moment for maintenance, which leads to huge delays in even the most minute maintenance and a hidden public sector cost in the bureaucracy involved?
Secondly, will there be the same restrictions on community use of schools that the current PFI schools have now, both through their charging structure and through their hours, which totally contrasts with non-PFI schools?
Thirdly, if a school has a huge change in numbers, let us say a fall in numbers, but not a fall in standards, so it does not hit any education problems, where will the flexibility be to change the physical structure of the school to allow it to meet its on-cost when it does not have the revenue because of the significant reduction in numbers, which is already a critical problem for a number of schools?
Geoffrey Spence: I think the answer to the first two questions is no. In other words, what we have ensured with the new model is that we retain within the school's control some of the smaller-scale maintenance that otherwise there has been instances where people have charged an awful lot for. We experienced that in the Treasury, because we have to pay at the moment quite a lot of money to shift a TV from one place to the other, so I think we are very aware of that issue, which is why in this model we have basically left the janitor with the school.
I think on the third point you make, that is one reason also why we think there will be benefits of having public sector equity to bring a better process to deal with significant change orders in terms of the configuration of the school and what happens to the school in these various circumstances. We have also changed the approach to life cycle and maintenance costs in such a way also that will not be a given incentive on the private operator to be difficult when it comes to these changes.

Q187 John Mann: The second one on community use, both the cost and the scale of it?
Geoffrey Spence: I believe we have also addressed that issue. What I would rather like to do on that is just confirm that in writing by way of a note.

Q188 John Mann: So it is clear, the absurdity that the local communities see is that they have paid

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through their taxes for new theatres or new sports facilities that they then cannot afford to use because the costing structure is above the market rates, and the suspicion being because it is not cost-effective to bother with that because the profit level is so low, and that the times of use are so limited because of the way that the contracts have been structured. I want to be sure the taxpayer is involved again, that the community will not suffer such absurdities with PF2 that it did suffer with PFI.
Geoffrey Spence: I agree, and I think that has been addressed, but what I would like to do is just to confirm it in writing to you.

Q189 Andrea Leadsom: Mr Spence, I would just like to ask you, in the context of your risk rating and value for money, how HS2 measures up on that scale as one of your most expensive high-profile projects.
Geoffrey Spence: Of course, HS2 is taken forward on a different basis. We don't do the same sort of benchmarking against the rating agency, because that is not appropriate for that sort of project. That follows the guidance that has been set out in terms of the Green Book by way of how to assess value for money, and there are different points in the process. I mean, this assessment has been made for High Speed 2.

Q190 Andrea Leadsom: My question still stands: how have you risk assessed HS2 and how does it stack up in terms of value for money according to the assessment that you give it?
Geoffrey Spence: I think when you come to HSL2, obviously it is a very large project over a large period of time, and you do take account of the risk when you make the value for money assessment as a Department, as the Treasury and also when it is reviewed by MPRG. Of course it carries quite a lot of risk in terms of construction costs and in terms of operation and maintenance costs, but we take account of that by a concept of optimism bias, which is used in the appraisal to assess what is the potential for cost overrun and for delay and for operating costs overrun. That optimism bias, if you like, is added to the sum whenever comparing the cost to the benefits.

Q191 Andrea Leadsom: Is the optimism bias a percentage added to the overall assumed cost; is that how it works?
Geoffrey Spence: Yes, at different stages. Yes.

Q192 Andrea Leadsom: What is that percentage that is added?
Geoffrey Spence: I would have to come back to talk about that by way of a note.

Q193 Andrea Leadsom: In terms of value for money, can you give us an idea of what your conclusion is in terms of that measure?
Geoffrey Spence: I think this has to be taken at different stages in the project's life as more facts are known, but it does present a positive value for money in terms of the benefits outweighing the costs.

Q194 Andrea Leadsom: Can you be more specific? Can you answer that question directly: what is the value for money measure?
Geoffrey Spence: I think we would have to come back and write to you on that.

Q195 Chair: This is a technical subject, and we have asked for a good deal of further information in writing. We will be wanting to put that in the public domain, but we understand that there may on occasion be material that cannot be put in the public domain. If there is, we would be grateful if you would initially discuss that with the Clerk of the Committee, and if necessary we can have a conversation and decide how to handle it. But we need a much higher level of transparency than we had last time on the PF1 and we have heard quite a number of assurances this morning that I think need to be bottomed out with some substance. Thank you very much.
Lord Deighton: Thank you.

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