



Reforming the Private Finance Initiative

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SUMMARY AND RECOMMENDATIONS

PFI: the success story

- The Private Finance Initiative (PFI) was introduced by the Conservative Government in 1992 and has been enthusiastically adopted by the Labour Government since 1997.
- PFI involves sub-contracting the design, building and operation of public services to private sector companies. A defining feature of PFI projects is the transfer of operational risk from the public sector to the private sector.
- PFI is intended to offer better value for money for taxpayers through:
 - introducing competition between contractors;
 - exploiting the greater efficiency to be found in the private sector; and,
 - exploiting the greater innovation to be found in the private sector.
- PFI projects must be distinguished from “Private Public Partnerships” (PPPs), a more nebulous operating relationship between the public and private sectors. PPPs (such as the London Underground) are backed by government guarantees and involve no transfer of risk to the private sector. PPPs also tend to be so complex as to obscure any hope of transparency, are difficult to monitor and have confused lines of accountability.

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- PFI has been introduced most successfully in the building and operating of prisons and roads. It has also been introduced, for the most part successfully, in the building and maintenance of schools and hospitals. Between 1997 and 2003, over 450 new public facilities were completed using PFI, including 34 hospitals, 239 new and refurbished schools and 23 new transport projects. In some areas, notably implementation of IT projects, the record is far less satisfactory.
- 88% of all PFI projects have either been delivered on time or early, and with no cost overruns being borne by the public sector. In contrast, 70% of comparable traditional public sector projects were delivered late, with 73% being completed over budget.
- PFI currently accounts for about 10% of all government expenditure on public services. This figure is likely to grow as the Government plans to extend the use of PFI to areas such as urban regeneration, social housing and waste services.

Criticisms of PFI

- Despite the clear evidence of PFI providing good value for money for the taxpayer, a number of criticisms have been made.
- Some PFI projects are, for accounting purposes, classified as “off-balance sheet” (in other words, that expenditure on these projects is not included as government spending). This enables the government to deliver public sector projects without affecting its borrowing requirements. A small number of schemes are said to have gone ahead as PFI projects not because they offered better value for money for the taxpayer, but because of the convenience of PFI in terms of government accounting.

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- Another criticism of PFI is that it is creating a mortgage on the public sector. Indeed, despite the Chancellor's denials, the government is committed to pay over £110 billion between 2003/04 and 2028/29 for PFI projects.
- A further argument is that, as the government can borrow money at lower interest rates than private sector companies, and that as private companies need to make a profit, PFI projects must inevitably be more expensive than those undertaken in the public sector. Proponents of PFI need to show that the greater efficiencies generated in PFI deals outweigh these costs.
- Before a deal is signed, the cost of a project being undertaken as a PFI project is compared with the estimated cost of the same project being undertaken by the public sector. This is known as the "Public Sector Comparator" (PSC). The PSC is subjective and has, on occasion, been subject to manipulation to ensure that contracts go ahead under PFI rather than the public sector alternative.
- It is also argued that PFI projects can be expensive in terms of the high level of professional fees that are incurred. In addition, in some cases, low levels of expertise, a lack of clarity over the desired outcome of a project and poor negotiating skills in the public sector have led to excessive delays in negotiation and poor project management on the part of the public sector.

Recommendations

- Britain is now a world leader in developing PFI projects. However, our experience over the last 12 years has taught us a number of valuable lessons. If Britain is to remain ahead of the pack, and export best practice to other countries, reform of PFI is necessary.

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- The accounting treatment of a deal should be considered only once the decision has been made to go ahead with a transaction as a PFI project.
- The PSC should be abolished and replaced, where possible, by sector-specific benchmarking.
- Greater transparency in government liabilities for PFI projects must be pursued. The current cut-off date of 25 years should be abolished and a single present value figure for the future payments of all PFI (and PPP) contracts published. This should include off-balance sheet contracts.
- There has been much debate on PFI private sector funding costs being too high in relation to gilt funding. Margins are, however, declining. Also, it is frequently forgotten that the interest rate margins also finance the crucially important service of constructing and monitoring all the financial disciplines that go with lending and bond agreements; and also pay to cover the transfer of risk from the public sector to the private sector.
- Public sector expertise in negotiating PFI contracts needs to be enhanced. Currently, there are too many government and local authority organisations involved in PFI projects. Expertise is diffuse and often dissipated. Specialist professional PFI units within each of the major spending departments should be charged with the authority and accountability for developing sector-specific PFI expertise.
- Compulsory tendering for all the professional advisers to PFI transactions should be introduced.
- Use of the PFI should only be expanded into those areas where it can be expected to deliver its core rationale: better value for money for taxpayers. Until better procurement methods have been introduced, it is unlikely that large IT projects will be able to meet this criterion.

FOREWORD

HOWARD FLIGHT MP

PHILIPPA ROE was in at the beginning of PFI at the Treasury, and now works in the City of London in the financing of PFI deals. She is particularly well placed to have produced this excellent survey of the development of PFI over the last 12 years and of the problems and issues that need to be addressed, with recommendations for their solution.

Philippa has been ably assisted in producing this survey by Alistair Craig. Alistair, who works for a major City professional services firm, is a CPS Research Fellow and has already had some of his work published by the CPS (*EU Law and British Tax: Which Comes First?*).

When the Conservatives first introduced PFI, it was based on the principle of bringing private sector expertise and efficiency to deliver public sector projects, on the condition that operational risk is transferred. In this respect, PFI crucially differs from Labour's Public Private Partnership (PPP) deals, as typically they do not transfer operational risk adequately. Frequently, they involve government guarantees or letters of comfort, and are so complex as to obscure any hope of transparency.

It is clear that the problems and high up-front costs of PFI deals have frequently resulted from a lack of expertise and commercial focus in the public sector in their negotiations. This argues for developing central focused professional units in each of the public sector areas whose services can be available to individual units on the ground in negotiating their PFI deals.

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There remains unacceptable obscurity as to whether PFI deals should be “on or off balance sheet” as the accounting principles are complex. There is a clear argument for a thoroughgoing reform of the relevant accounting rules or for an independent body, such as the Institute of Chartered Accountants, determining for all PFIs whether, under current accounting principles, they should be on or off balance sheet. This would also cater for ongoing changes in accounting principles.

There is also complete obscurity as to the total risk adjusted quantum of government off balance sheet liabilities, covering not just PFI and PPP, but structures such as Network Rail with SRA guarantees, and many other government contingent liabilities. While all the data is published, there is no measurement of the risk adjusted quantum. In both the public and private sectors, there is a sound case for requiring the total risk adjusted quantum for all forms of off balance sheet and contingent liabilities to be assessed and disclosed each year.

The Public Sector Comparator (PSC) has become a discredited and expensive justification of opting for PFI, where frequently it is the only option, as the funding is not otherwise available. Benchmarking represents a sensible alternative for controlled PFI activities.

Up-front professional costs are often too high. Part of the cause of this is unprofessional PFI procurement within the public sector, not only running up the public sector costs, but also increasing the legal and other professional costs of the PFI contractors. Equally, in many cases, there are only a very limited number of PFI sub-contractors on a global basis capable of delivering. There is more scope to standardise design specification, and in some areas for pooled PFI tendering. It is particularly observable that professional and competent PFI negotiating skills within the prison service have been the main factor contributing to success in the relatively complex area of prison PFIs.

There has been much debate on PFI private sector funding costs being too high in relation to gilt funding. Margins are,

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however, declining, and it is frequently forgotten that the interest rate margins also finance the crucially important service of constructing and monitoring all the financial disciplines that go with lending and bond agreements. The issue remains with the proposals and new schemes for gilt based funding that, ultimately, operating risk may not be transferred.

An important issue for the future will be as to whether PFI-style outsourcing moves more into service areas, rather than being essentially construction based as at present.

Philippa and Alistair's paper constitutes an extremely useful "everyman's guide" to the complex and often little known area of PFI and both examines most of the key issues and comes up with sensible proposals to address them.

CHAPTER ONE

INTRODUCTION

THE PRIVATE FINANCE INITIATIVE (PFI) involves sub-contracting the design, building and operation of public services (particularly capital assets and related activities, such as maintenance, used in those services) to private sector companies in such a way that the operational risk is transferred from the public sector to the private sector. It is designed to offer the taxpayer greater value for money than traditional public sector procurement methods through creating the efficiencies brought about by introducing expert private sector management, competition between contractors and opportunities for more innovation in how the service is delivered.

PFI was introduced in 1992. Since then, it has been adopted by the current Labour Government as the favoured route for procuring the building and operation of many public services, including hospitals, schools, prisons, roads, other transport projects and defence.

Why PFI is important

PFI still accounts for only about 10% of government expenditure on public services. As of 1 March 2004, over 300 PFI deals had been entered into or signed up with a combined capital value in excess of £38 billion. Total (undiscounted) payments to be made from government to the private sector under PFI contracts over the next 25 years are estimated to be almost £124 billion¹ (note that this figure does not include payment liabilities under PFI

¹ “Estimated payments under PFI contracts – April 2004 (signed deals)” – Table C19, *Financial Statement and Budget Report (FSBR)*, HM Treasury 2004.

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contracts beyond 2030).² In the context of current Government spending plans, these are still relatively modest amounts. But as the Government plans to expand the use of PFI into areas such as urban regeneration, social housing and waste services, the proportion of public expenditure allocated to PFI contracts is likely to increase further.

PFI is not only important in domestic terms: governments across the world are increasingly looking at how their delivery of public services could be improved by increasing the involvement of private sector expertise. They too are considering how public sector assets and services can be financed within tight budgetary constraints on government borrowing.

Britain's PFI concept is a world leader in this respect. However, our own domestic experience over the past 12 years has taught us a number of valuable lessons which should be acted upon if Britain is to remain ahead of the pack and export best practice to other countries.

The need for clarity

The debate about the nature of PFI has been obscured by a lack of understanding about what it involves (caused in some measure by the over-complexity of many PFI transactions); and by doubts about the political motivation behind the growing importance being given to PFI. This report aims to bring some clarity to the debate surrounding PFI by examining:

- the basic concept of PFI and why it was originally introduced in 1992, how it offers the opportunity of providing increased value for money for the taxpayer and greater innovation in how public sector projects are handled, and countering some of the myths about PFI;

² The figures provided in Table C19 of the FSBR for the period between 2004-05 and 2017-18 include estimated payments for the London Underground PPP contracts. This is evidence, as noted later in this paper, that all too often confusion is caused by the Government using the terms PFI and PPP interchangeably.

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- how it has developed under the Labour Government, and in particular why it is necessary to distinguish it from the much broader (and arguably less easy to define) concept of “Public Private Partnerships” (PPPs) introduced by Labour;
- where it works best; and,
- where it has not provided maximum value for money and innovation.

This report concludes with a number of concrete recommendations for reform and improvement of the PFI concept which should be implemented quickly to ensure that PFI projects achieve what they are supposed to: good value for money for the taxpayer and the provision of efficient and quality public services.

CHAPTER TWO

MYTH AND REALITY

Why PFI was introduced

The rationale for the introduction of PFI by Norman Lamont in 1992 was simple to understand: conventional methods of public sector procurement, whether local or national, were not perceived as providing good value for money for the British taxpayer. A combination of a shortage of expertise, poor project management skills and a lack of incentives resulted in the failure of the public sector to deliver projects on time and within budget. Indeed, the Scottish Parliament building project provides a telling current example of how capital projects managed by the public sector can go badly wrong: the building was finished three years late, and despite its original budget of £40 million, construction costs rose to over £430 million.

PFI was seen as a way of addressing these problems by subcontracting the delivery and, crucially, by transferring the risk of public sector projects to the private sector. This transfer of risk to the private sector would mean that the deliverers of the project would be more motivated and efficient in providing the service to the public sector. More efficiency and more competition for procurement contracts would, it was hoped, provide better value for money for the taxpayer than traditional procurement methods. If the private sector did not deliver, it would be penalised and, in extreme cases, could jeopardise all their equity investment in the project.

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The present Government has accepted this rationale for PFI. As the 2004 Budget Report states:

Under PFI... the public sector contracts to purchase services from the private sector on a long-term basis so as to take advantage of the private sector management skills incentivised by having private finance at risk.

The private sector has always been involved in the building and maintenance of public infrastructure, but PFI ensures the contractors are bound into long-term maintenance contracts and shoulder responsibility for the quality of the work they do.

With PFI, the public sector defines what is required to meet the public needs and ensures, by contract, delivery of the output it sets. It has rights under those contracts to change the output from time to time.

Consequently, with PFI the public sector can harness the private sector to deliver investment in better quality public services while maintaining frontline services in the public sector.³

It is clear therefore, that the primary motive behind the introduction of PFI – for both Conservative and Labour Governments – was obtaining good value for money for the taxpayer. It was not obtaining “off balance sheet” treatment. It was also hoped that bringing the private sector more fully into the design and provision of asset-based public services, such as schools, hospitals and prisons, would lead to greater innovation. More innovation in how these key services were provided would lead to greater efficiencies, better quality services and, ultimately, a best practice ethos being adopted throughout the public sector.

Another reason for the introduction of PFI was that it was hoped that PFI would bring some much-needed reforms to public sector culture, where there appears to be little, if indeed any, financial incentive to complete jobs on time and within budget. It was hoped that this “culture transfer” would spread across more

³ Paragraph C77, Financial Statement and Budget Report, HM Treasury 2004.

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of the public sector as PFI was implemented across a wider array of areas. In some instances, this has happened. However, in others, the continuing shortage of project management competence and expertise, and the inefficiencies in the public sector, have meant that the full potential may not be realised, and that this reason of using PFI for those transactions may not be met. Such mistakes should, and can, be avoided in future.⁴

Good value for money does not mean cheap

It should be noted that obtaining “good value for money” for the taxpayer does not simply mean that a private contractor, intent on “cost-cutting”, will try to complete an individual project as cheaply as possible. Naturally, private sector companies will seek a return on their investment – that is one of the key incentives for them to participate in PFI schemes in the first place. However, “value for money” should be defined in broader terms. The Office of Government Commerce has defined it as “the optimum combination of whole life costs and quality to meet the user’s requirements” – in other words, efficiency and quality in the provision of key public services at the best price for the taxpayer.

Indeed, 88% of all PFI projects have either been delivered on time or even early, and with no cost overruns on construction being borne by the public sector (any financial penalties for late completion are generally borne by the private sector PFI contractors). This compares with previous research which indicated that 70% of projects handled using traditional public sector procurement methods were delivered late; and as many as 73% ran over budget.⁵ When properly managed and implemented, PFI can clearly offer significant value for money savings, opportunities for greater innovation in asset and service delivery, and more capital contracts delivered on time and on budget than was the case with traditional public sector procurement.

⁴ See Chapter 6 for recommendations on how this can be achieved.

⁵ HM Treasury, *PFI: Meeting the Investment Challenge*, July 2003.

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Some myths and misconceptions

Off balance-sheet

The way in which PFI interacts with government expenditure and public spending commitments has given rise to a number of concerns about the rationale for PFI. One of these is the use of PFI as a means of getting large-scale public sector projects “off-balance sheet”. This enables the government to deliver public sector projects without infringing on any restrictions on the Government’s borrowing requirements. If PFI is sometimes being used solely for this purpose, then it is being used for the wrong reasons.

Another criticism of PFI is that the cumulative scale of the future financing commitments is creating a “mortgage” on the public sector, and is thereby pre-empting future public expenditure. Those who take such a view also note, in a related, but in fact quite separate point, that the rates of interest charged on borrowings through PFI deals are higher than the rates at which the Government or other public sector bodies are able to borrow. An example of such an argument appeared in the *Observer*:⁶

The detail of how the initiative works is indeed labyrinthine, but its general vices are plain enough. The Government hands control of new public works to a private consortium. The financier borrows the money to build a hospital, for example, at a higher rate than the state, the securest of borrowers, can obtain. The hospital is owned and managed by the consortium which rents it to the NHS for 30 or 60 years. As well as having to pay a higher rate of interest the consortium must take a profit. Waste of public money is all but guaranteed.

The challenge for the proponents of PFI, in countering such arguments, is to show that the increased expertise and efficiency of the private sector can generate real value for money for taxpayers. At the same time, it must also be explained how the improvements in efficiency will also fund a fair return for the private sector parties

⁶ Nick Cohen, “The Government’s passion for PFI is basically a tax that is set to bankrupt future generations”, *Observer*, 28 March 2004.

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in a PFI deal. Well-run PFI deals can generate such efficiencies, can provide good quality public services, and can result in increased value for money.⁷

Opponents of PFI also tend to overlook the constraints on the ability of government to issuing additional public sector debt instruments, in the form of gilts, to fund capital projects. In many cases, the construction and operation of new PFI projects has been possible only because of the ability to obtain up-front finance from the private sector. PFI enables government to build new public works when it wants them; and those projects are not dependent on the ebb and flow of short-term government spending requirements.

It should also be noted that the private sector companies undertaking such a PFI project are taking on the associated risks, risks which would previously have been borne by the public sector. The borrowing in a PFI arrangement is undertaken by a Special Purpose Vehicle (SPV), a company set up specifically for the purpose of borrowing and entering into the contract with government. As the SPV assumes certain risks from the government under the terms of the PFI transaction, the assumption of those risks naturally means that the SPV has a lower credit rating than a government borrower would have had, with the result that it suffers a higher cost of obtaining finance. Therefore, as the government loses risk, it pays for doing so through an increased financing cost directly related to the risks it has passed across to the private sector. It should be noted that if the government had passed no risk to the SPV, and if it merely guaranteed a payment stream for services regardless of performance, the SPV's credit rating would be similar to that of a government borrower.

The cost of borrowing is only one factor. While the government can indeed borrow more cheaply than a private sector SPV which has assumed operational risk under a PFI transaction, determining the value for money offered by a PFI deal is not simply about comparing interest rates. The greater

⁷ See Chapter 4 for some specific examples.

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efficiencies of the private sector should more than offset the additional costs of borrowing.

Even where the up-front finance has been provided by the private sector, the public sector will be making payments to the PFI contractors over the lifetime of the PFI deal. Therefore, the taxpayer is burdened with the payment of that debt, plus the interest liability, over the term of the debt issuance, just as it would be if it borrowed money for a capital project that the government built itself.

As long as PFI can demonstrate that it provides value for money, then the taxpayer does not incur any greater liability than would otherwise have been the case. This is acknowledged by a recent Institute for Public Policy Research (IPPR) report:⁸

It is also important to stress that the argument that the PFI in no way relaxes the constraints facing governments holds regardless of the state of the public finances at any point in time... concern about the sustainability of the public finances arises because the build up of debt imposes a burden on future generations in the form of the stream of interest payments required to service that debt. But the PFI also sets up a future set of obligations to service the payments that are due to honour PFI contracts. The burden is the same in principle.

Therefore, although the private sector companies provide the up-front funding for a PFI deal, the financial liabilities for PFI transactions ultimately lie with the taxpayer. If the PFI contractors can demonstrate that they will be able to provide a public service at better value than the traditional public sector procurement method, then PFI should be the preferred route for that transaction. If they can do so in an innovative manner which breaks new ground, all the better. Of course, the transparency and accuracy of the way in which this value for money comparison is made is essential if trust in PFI is to be maintained.

⁸ *Building Better Partnerships – The Final Report of the Commission on Public Private Partnerships*, IPPR, 2001.

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Privatisation by stealth?

Another misconception is that PFI is some kind of “privatisation by stealth”. As outlined above, the liabilities for PFI projects rest ultimately with the taxpayer, just as they would under more traditional, government-led provision of public services. The public service is merely being “sub-contracted” to private providers, who are accountable to the public sector purchasers under the terms of the individual PFI contract for the delivery of that service. As long as the quality of the service is not jeopardised, and it does not mean an increased burden for the taxpayer, there should be no reason why a private sector company could not provide such a service.⁹

Proper scrutiny?

Concerns have been expressed at the lack of scrutiny of PFI. Deals are often complex, involve commercial confidentiality and can be opaque to outsiders. While the Select Committee on Public Accounts (PAC) of the House of Commons has effectively appointed itself as a “watchdog” of PFI deals on a selective basis, more can be done to ensure that transactions are seen to be offering good value for money.¹⁰

PFI or PPP?

A number of criticisms levelled against the PFI concept are misguided because they would more accurately be directed at “Private Public Partnerships” (PPPs).

PPPs have been defined as “any alliance between public bodies, local authorities or central government, and private companies”¹¹. PFI is further defined as “a more formal approach of PPP... these schemes generally provide the capital asset and services relating to

⁹ Of course, a more radical option for a future British Government would be to consider the privatisation of some public services. For example, in health, this could follow the “social insurance” model common in France, Germany and Belgium. Such a discussion is outside the scope of this particular study. The point does suggest, however, that PFI is not privatisation by covert means.

¹⁰ See Chapter 6 for recommendations.

¹¹ Public Private Partnership Forum website (www.pppforum.com).

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that asset. The public sector specifies a level of service in return for a unitary charge.”¹²

Confusingly, the Government appears to use the terms PPP and PFI interchangeably on a regular basis. This creates confusion in the public mind and should be avoided. PFI deals are focused on a single service or project and are structured to transfer the inherent operational risk to the private sector. PPP is a much wider generic term which covers all kinds of deals between the public and private sectors. This includes, for example, transactions which typically require a government guarantee or “letter of comfort”, or similar support. A PPP project such as the London Underground has not involved the transfer of operating risk (which is one of the distinguishing factors of PFI). PPP schemes which do not transfer operational risk to the private sector are crucially different to PFI projects.

PPP schemes are often complex projects of significant size, whereas PFI transactions are generally smaller and more focused (although there have been individual PFI transactions of significant size). This makes the management and monitoring of PPP schemes inherently more difficult than with PFI transactions, and is an area of some concern to those involved in public sector service procurement.

Therefore, in assessing the impact PFI has had on public sector procurement, the value for money it has generated for the taxpayer, and in suggesting possible improvements, PFI should be separated from the rather nebulous concept of “partnership”. This report concentrates solely on PFI.

¹² Ibid.

CHAPTER THREE

PFI UNDER LABOUR

THE NUMBER OF PUBLIC SECTOR PROJECTS completed using PFI expanded greatly after the election of the Labour Government on 1 May 1997.¹³ Labour then launched a review of the PFI under the chairmanship of Malcolm Bates. The report of the Bates Review¹⁴ recommended the establishment of a Treasury Taskforce which was designed to stimulate interest in PFI transactions (which, although the concept had been around for five years, then constituted a very small proportion of total government expenditure).¹⁵ This Taskforce also had the responsibility for introducing greater standardisation into procurement and contracting arrangements for PFI transactions. In addition, the Bates Review included a number of recommendations on how PFI should be accounted for in the government's books.

Further discussions within the Government over the next couple of years led to a second Bates Review in 1999.¹⁶ Coupled with the

¹³ The rapid increase in the number of PFI deals signed in 1997 was largely due to deals which had already been negotiated under the Conservatives before that date reaching completion in the second half of 1997.

¹⁴ As announced in HM Treasury Press Release 69/97.

¹⁵ In many respects, this task was already being carried out by the Private Finance Panel. This body was set up in 1994 and funded by the Treasury. The Private Finance Panel consisted of individuals seconded from the private sector who acted independently of the Treasury. It had a leading role in encouraging greater use of PFI and advising on many aspects of ground-breaking PFI deals in the mid-1990s. It is not clear what benefits were obtained from transferring its function to the Treasury Taskforce in 1997.

¹⁶ *Second Review of the Private Finance Initiative*, HM Treasury, 19 March 1999.

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work carried out by (now Sir) Peter Gershon in his review of civil procurement in central government, these reviews led to the establishment of two new government bodies. These bodies have played a central role in the PFI process over the past four years and have, in large measure, taken over from the Treasury Taskforce which had been established only a couple of years earlier.

The first of these bodies, the Office of Government Commerce (OGC) was set up, in its own words, to:

...take a lead role in the modernisation of procurement in Government, and deliver substantial value for money improvements... it is responsible for a wide-ranging programme which focuses on improving the efficiency and effectiveness of central Government procurement. In addition, OGC has an important role in developing and promoting private sector involvement across the public sector.¹⁷

The second body, Partnerships UK (PUK), was set up with the intention of providing a public/private body which would develop solutions to some of the problems which had arisen in PFI transactions to date, and to help local authorities negotiate PFI deals and to assist with financing those deals. It quickly became apparent that PUK had an inherent conflict in its remit: it was both an advisor to the public sector generally and local government in particular; and it was also a potential contractor for local authority PFI deals.¹⁸

However, since the OGC and PUK were established, several more quasi-governmental agencies handling PFI policies and transactions have been created. A Private Finance Unit has been set up within the Treasury to assist other government departments with PFI contracts and projects, replicating to a large degree the functions originally carried out by the Treasury Taskforce, which itself was supposed to have been supplanted by the OGC and PUK. This apparent duplication of roles does not

¹⁷ Office of Government Commerce, 2003-04 Business Plan, page 3.

¹⁸ See Chapter 6 for more details.

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appear to be necessary. The Public Private Partnerships Programme (known as the 4ps) was also set up to provide procurement advice to local government. This has mainly advised on PPP, as opposed to PFI, deals.

In July 2003, the Treasury reported that PFI had expanded significantly since 1997 and had resulted in a total of over 450 operational (completed) new public facilities.¹⁹ These included:

- 34 hospitals and 119 other health schemes;
- 239 new and refurbished schools;
- 23 new transport projects;
- 34 new fire and police stations;
- 12 new prisons and secure training centres; and
- 12 waste and water projects.

On- or off-balance sheet?

Much of the debate on PFI has focussed on its complex accounting rules. In particular, these have enabled a significant proportion of government spending, and the associated debt, to be held “off-balance sheet”. In other words, no account has to be taken of spending on PFI projects in determining whether the Government is complying with EU rules on government debt levels or Gordon Brown’s own borrowing framework.

There is plenty of anecdotal evidence to suggest that obtaining “off-balance sheet” treatment was one of the main factors behind many public sector projects being commissioned under PFI rather than using a more conventional procurement method.²⁰

¹⁹ HM Treasury, *PFI: Meeting the Investment Challenge*, July 2003.

²⁰ This appears to be especially true for the period from 2000 to 2003. Since then, the Treasury and the OGC have made it clear that this should not be a key consideration in determining whether a deal should go ahead under PFI or using public sector procurement.

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It has been widely commented, in particular by Jeremy Coleman of the National Audit Office²¹ and others²² that this desire by central government to achieve off-balance sheet treatment left many public sector managers under no illusion that PFI was “the only game in town” – if PFI was not chosen for a particular project, then that project would not go ahead.

Of course, whether an individual PFI project is on or off-balance sheet should be irrelevant in determining the value for money of the PFI and public sector alternatives. The suspicion remains that the political consideration to reduce central government debt levels by putting as much as possible off-balance sheet has led to a number of instances of PFI being used where it was probably not the most appropriate means of procuring the public service concerned; and that it has been forced on local government authorities as the only viable means of obtaining the services they desire.

The Public Sector Comparator

One of the methods by which the Labour Government altered the PFI accounting rules was the change to the Public Sector Comparator (PSC), a calculation that is used to compare the costs of traditional public sector procurement compared to PFI. One of the key elements of the calculation is an assessment of the risk factor attaching to the different alternatives. After 1997, the method by which the PSC was calculated was changed so that this risk assessment became far more subjective and, arguably, far more amenable to manipulation to achieve a desired result.²³

Central government, and in particular the Treasury, is now making it clear that on- or off-balance sheet considerations should not come into the equation when considering whether or not to

²¹ Jeremy Coleman, National Audit Office, cited in article by Howard Flight MP for www.financialdirector.co.uk, 16 October 2003.

²² See, for example, D Price, D Gaffney and A Pollock, *The Only Game in Town? A Report on the Cumberland Infirmary Carlisle PFI*, UNISON Northern Region, 1999.

²³ Some of the comparison calculations in the old PSC formula were amended with the result that the exercise became more reliant on subjective judgement.

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choose PFI for an individual transaction. However, it is still not entirely clear, at least on the basis of anecdotal evidence, that this pressure has entirely disappeared “on the ground”, at the level of the public sector managers who have to negotiate the contracts. The key factor to be considered, along with the value for money, quality of service delivery and opportunity for greater innovation afforded by choosing PFI, should be the extent to which a spending department has access to funds to finance public works or services. Very often, PFI is the only means of finding that finance.

Obscurity over the total value of PFI projects

The Government has estimated that 57% of PFI projects *by value* are on the government balance sheet.²⁴ However, a large proportion of this is represented by the London Underground Limited Public Private Partnership, which of course is not a PFI deal and so the actual proportion of PFI projects on balance sheet, at least as measured by capital value, would be considerably lower than 57%.

When pressed about the precise extent of the government’s long-term off-balance sheet liabilities (rather than the current capital value, which is not of any relevance in determining the extent of overall government borrowing), the Government has tended to avoid the question:²⁵

Howard Flight , Shadow Chief Secretary to the Treasury:

“The Chancellor will be aware that many large businesses have off-balance sheet liabilities – I assume that is, in part, where he spotted the opportunity for the Government. He will also know that auditors are quite rightly urging businesses to take those liabilities into account in the prudent management of their overall finances. What account has he taken of £100 billion of off-balance sheet Government liabilities, which represent the present value of total PFI payments for the next 30 years and the guarantees given on behalf of Network Rail and London and Continental?”

²⁴ Lord McIntosh of Haringey, HL Deb col 1278, on 10 March 2004.

²⁵ House of Commons debate, 13 November 2003, Hansard vol 413, col 395.

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Gordon Brown, Chancellor of the Exchequer:

“As for the figure of £100 billion... it is totally bogus and completely wrong, 57% of PFI projects are on balance sheet, not off balance sheet. He is trying to count every PFI commitment from now to 2030.”

Neither the Chancellor nor his advisers would seem to have read a House of Commons research paper which stated:²⁶

The PFI has meant that more capital projects have been undertaken for a given level of public expenditure and public service capital projects have been brought on stream earlier... The increased level of activity must be paid for by higher public expenditure in the future, as the stream of payments to the private sector grows. PFI projects signed to date have committed the Government to a stream of revenue payments to private sector contractors between 2003/04 and 2028/29 of over £110 billion.

In assessing how much of the government's total liabilities under PFI are off-balance sheet (and hence not included in calculations of overall government debt under current accounting rules), account should be taken of the long-term nature of PFI transactions. In some cases, these extend for up to 60 years, whereas the current Government employs an arbitrary cut-off date of 25 years in disclosing its estimate of total PFI liabilities.

Another way in which the Government has obscured the true extent of off-balance sheet liabilities is its reference to the current capital value of each project. This is not a true measure of how much the government is liable to pay to private sector contractors over the period of each PFI deal, as it fails to take into account all the service elements which the Government pays over the life of the contract.

Calculating the true value of PFI projects

In reality, the aggregate figure for payments to be made under PFI contracts, ignoring the 25 year cut-off date, is likely to be in

²⁶ House of Commons Research Paper 03/79, 21 October 2003.

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excess of £130 billion (the figure is £124 billion at the 25 year point). However, this figure is not discounted to present day values. A discounted figure is likely to give a present day value of around £75 billion, depending on the discount rate adopted.

In assessing the extent of total off-balance sheet financing (i.e. not just PFI liabilities), certain adjustments have to be made to this figure of approximately £75 billion. Strategic Rail Authority guarantees given in respect of Network Rail and London & Continental need to be added, as well as sundry other defence and education sector sub-contract arrangements which do not fall within PFI. On balance sheet PFIs and PPPs (principally the Tube PPP) need to be excluded from the calculation (approximately £20 billion). The 25-year cap has to be removed to include all PFI contracts of 30 year or more duration. Making the assessment via this approach continues to give a total off-balance sheet liability of around £100 billion, a point which was made to the Chancellor and which he refuted less than convincingly.

The key factor in determining whether a PFI project should be on or off balance sheet is the extent of the risk which is transferred from the public to the private sector. This may be a complex assessment – but one that is necessary if the transfer of risk, rather than the convenience of central government accounting treatment, is the determinant of whether a project is suitable for the Private Finance Initiative.

CHAPTER FOUR

SOME PFI SUCCESS STORIES

A RECENT GOVERNMENT REPORT FOUND THAT “most PFI building projects were delivered by the time specified in the contract” and that this was “a further improvement compared with previous procurement experience”.²⁷ The same report noted that 29 out of the 37 PFI projects examined reported no construction related price increase after the contract had been awarded; and that 28 out of those 37 were delivered on time or earlier than specified in the original contract. Delays of more than two months occurred in only 8% of the projects surveyed. Any price increases were generally relatively small and not attributable to the private sector consortia charging more for the work than was originally specified.

It is clear that using PFI as a procurement method is generally more efficient and cost effective than conventional public sector methods. The use of PFI incentivises the private sector companies to take a longer term approach to design and construction, and also incentivises them to deliver the built asset to budget and on time.

However, it should be noted that the degree of success of PFI project varies according to the type of project, with the most successful projects being roads and prisons. These do not typically involve a clear division between “core” and “ancillary” services to be provided under the PFI deal. Hospitals and schools, in contrast, are more complicated in this respect.

²⁷ *PFI Construction Performance*, Report by the Comptroller and Auditor General, National Audit Office, HC 371, Session 2002-2003, 5 February 2003.

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Prisons

The IPPR has provided a useful breakdown of the five broad roles that public and private providers may take in the provision of key public services.²⁸ These are defined as:

- **Public sector default:** the public sector provides all services.
- **Private/voluntary sector rescue:** the public sector provides all services, except if public providers are seen as failing when the private/voluntary sector acts as provider of last resort.
- **Level playing field:** there is no preference for either public, private or voluntary sector provision and the decision as to who provides the service depends solely on a judgement of which provider will provide the “best” service.
- **Public sector rescue** – the private/voluntary sector provides all services, except if they are seen as failing, in which case the public sector acts as provider of last resort.
- **Private/voluntary sector default** – the private/voluntary sector provides all services on contract to public purchasers/commissioners”.

The construction and operation of new prisons under PFI has been so successful that the construction of all new prisons is being carried out under the auspices of PFI – i.e. within the “private sector default” category. Most prisoner escort services (with the exception of high risk prisoners who generally remain the responsibility of the public sector) also fall into this category.

The management of new-build prisons falls within the “level playing field” category: if the private sector proves that it can provide the “best” prison management service, then it will be chosen ahead of a public sector provider.

²⁸ IPPR, *op. cit.*, at pages 60-61.

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The prison sector is also recognised as a good example of how PFI, by bundling the construction and service elements together into a single package, can provide real efficiency savings through integration. Indeed, because of the breadth of experience of private sector involvement in the prison sector, ranging from the full construction and management of a new prison under PFI, to contracting out the management of an existing prison to the private sector, it should be possible to undertake comprehensive benchmarking of which model is best in which circumstances.

One of the clearest examples of a successful prison project is HMP Rye Hill, where the project was delivered on time and to budget, and was built in 16 months, compared to the average construction time for a prison of three years under more traditional public sector procurement methods.

Roads

Transport, in particular road building and operation, is also seen as a major PFI success story. In this instance, PFI has been successful either because it only involves the construction of the asset and no supplementary services; or because the services (such as collection of tolls) are core to the operation of the asset. The widening of the M40 between the M25 and Junction 3, and the management and maintenance of the 120 kilometre stretch between the M25 and Junction 15 of the M40, is an example of a successful PFI project, being delivered under PFI four months early and to budget. For a number of reasons, other transport schemes such as light rail developments have proven to be less successful.

Lessons from prisons and roads

It is worth noting that, although there have been a number of specific problems with PFI in education and health, the delivery of new assets and services in these areas is perceived to have been relatively satisfactory on the whole.

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Another major differentiator between the real success stories and those that have been partially successful may be the depth of expertise of the public sector bodies in designing, negotiating and concluding PFI contracts. In the case of prisons, only one government agency, the Prison Service, is responsible for the purchase of services from the private sector. It has built up a deep knowledge and experience of how these transactions should be handled. Similarly, in roads, the Highways Agency is the main, if not the only, purchasing body on behalf of the public sector. In both cases, PFI projects are all dealt with centrally by dedicated expert procurement teams, who have built up this expertise through experience in negotiating previous contracts. Thus, new projects are negotiated by experienced professionals on both sides who have the advantage of having discussed and settled a great majority of similar issues before signing off on previous contracts.

This contrasts with hospitals and schools, where a variety of different local authorities, school governing bodies, NHS Trusts and local health authorities have different experiences of PFI transactions. Indeed, there are over 600 NHS Trusts and 140 Local Education Authorities (LEAs), almost none of whom have been involved in any previous PFI project and who each form their own team of professional advisers, in many cases with a similar lack of PFI expertise. This means that they often lack the expertise necessary to be able to specify their desired outcomes from a PFI deal clearly, and that they lack the expertise to carry out the project management function on the public sector side.

It should be noted that this is not always the case – with the Oxford Radcliffe Hospital, the financial close of the deal was achieved in just 12 months, with the added complication that this was one of the first PFI projects to use the Retention of Employment Model, which involves transferring the management to the private sector operator, but leaving the support service operatives in the public sector.

But such examples aside, government attempts to tackle the general issue of improving public sector expertise through the

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various agencies it has created (OGC, PUK, the Private Finance Unit) do not seem to have worked. The Department for Education and Skills (DfES) and Department of Health (DoH) each also have their own central guidance teams who have become increasingly influential, but the decision-making procurement body is still the local NHS Trust or LEA: at the decision-making level, there is a real lack of appropriate expertise and experience.²⁹

²⁹

See Chapter 6 for recommendations on how this can be addressed.

CHAPTER FIVE

WHERE PFI HAS NOT PROVIDED BEST VALUE

BOTH THE PUBLIC AND THE PRIVATE SECTORS now have plenty of experience of how to run PFI projects. The key to concluding a PFI deal that will deliver efficiency savings and a good quality public service at the same time lies in harnessing that experience to maximum effect.

Too often, however, this simply has not happened. A lack of clarity about the desired outcome of the public sector purchaser, excessive delays in negotiation, poor project management on the part of the public sector and a lack of understanding of some of the key concepts of PFI have all combined to produce some cases where the taxpayer has definitely not received best value for money; and where the users of the public service have not received the level of service they are entitled to.

One of the key lessons to be drawn from the history of PFI deals to date is the need to improve the expertise of the public service and its advisers in negotiating and concluding PFI deals. Too often, public sector managers conclude a PFI deal and then move back into their normal day job, thus failing to capture what expertise has been built up.

Ineffective management by the public sector, and a failure to control costs

In a number of cases, a lack of expertise and poor project management skills on the public sector side have led to procurement processes being run inefficiently. As a result, costs,

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particularly those relating to professional advice, have not been sufficiently well-controlled and have escalated.

For example, one of the early PFI deals in the health sector was the subject of a report by the Select Committee on Public Accounts (PAC) of the House of Commons.³⁰ This identified a number of fundamental flaws in the process, leading to significant inefficiencies. The NHS Trust concerned had selected two private sector firms to submit final bids as part of the PFI tender process, only one of which actually submitted a final bid. The Trust therefore ended up with only one final bidder for what was described by the PAC as a “major pathfinder project for the use of PFI in the NHS”. The final bid was 33% higher in real terms than the indicative bid.

On the same PFI deal, the Trust incurred fees for professional advice (legal, financial and so on) of £2.4 million – this was almost seven times higher than the initial estimate of professional advice costs. The PAC report found that the lack of effective public sector management and budget monitoring was a major factor in this significant cost overrun.³¹

Another deal in the health sector four years later also resulted in £2.3 million of professional advice costs being incurred by the NHS Trust.³² This provided another example of where the procurement process was less efficient than it could have been, and where protracted negotiations at the preferred bidder stage led to increased costs for all parties involved.

When the Department of Social Security (DSS), as it then was, entered into negotiations with potential PFI partners to build its Newcastle Estate,³³ the DSS decided to appoint a preferred bidder while many important issues apparently remained unresolved.

³⁰ 12th PAC Report, Session 1999-2000 – Dartford & Gravesham.

³¹ It should not be forgotten that these figures only cover the professional advice costs incurred by the public sector purchaser. They do not include similar costs incurred by the private sector bidders, which are likely to be higher still.

³² 19th PAC Report, Session 2002-03 – West Middlesex.

³³ 19th PAC Report, Session 1999-2000.

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Exclusive negotiations with the preferred bidder to resolve these outstanding issues continued for 18 months. The cost of procuring this contract to the DSS was initially estimated at £400,000. It eventually cost £4.4 million, an eleven-fold increase. Of this, legal fees were originally estimated to cost £70,000. In the end, total legal costs were £2.3 million. The PAC Report into the deal stated that these cost overruns reflected “the Department’s inability to undertake many of the tasks required to complete this deal.”

Almost without exception, where legal costs have significantly exceeded budget in PFI transactions, this has been caused by the inability of the public sector party to negotiate the deal in a straightforward manner. Too often, a lack of clear specification at the start of negotiations is followed by changes in scope throughout the negotiating process.

The problem of ineffective public sector management does not exist only at the level of individual transactions – it is also in evidence at the central government level. Private sector companies are experiencing “log jams” in the central government procurement system, particularly in the health sector. This means that many companies are becoming increasingly reluctant to bid for further projects because they have exhausted the capacity of their bidding teams, who are tied up with existing projects which are not being efficiently handled by the public sector. Equally, the “start-stop” approach which has been adopted by many government departments has led to instances of private sector teams being unavailable to deal with sudden surges of enquiries from the public sector procuring bodies, and times when they are underemployed. The OGC is beginning to take steps to smooth out this process, but it is clear that fundamental reform of public sector management practices is needed to ensure that the process is as efficient as possible at both the central government level and individual transaction level.

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Poor end product specification by the public sector

Another problem has been a lack of clarity about the specification required for the end product. For example, when the Home Office decided it needed to move to a new office building,³⁴ the PFI tender process was opened in July 1996 by the publication of a notice, as required under standard EU procurement rules, in the Official Journal of the European Communities (OJEC). A private sector party was selected as preferred bidder in July 2000, and the financial close of the deal was finally achieved in March 2002, almost six years after the tender process started.

During this time, the Home Office apparently closely monitored professional advice costs at each stage of the process. Despite this, total costs still reached £9.1m, including £2.5m for financial advice and £2.6m for legal advice.

After the new building was completed, the PAC issued a report³⁵ which stated that the new building is “too small” to accommodate the planned increase in Home Office staff numbers from 8,712 in 1998/99 to 19,727 in 2003/04. Leaving aside the issue of whether it is necessary to more than double the number of civil servants in the Home Office in a five year period, it is clear that this increase was not factored into the specifications for the new building by those responsible on the public sector side.

In some other areas, the lack of clarity on the public sector side about what is required, and indeed what is attainable in respect of any particular project, has led to increased costs and unnecessary work. On a typical hospital deal, it is the norm for private sector contractors, before preferred bidder stage, to produce drawings on a design scale of 1:200 and to have no fewer than three iterations of discussions with clinicians, only for the public sector client then to come to the realisation that what is being proposed cannot be achieved – in other words, insufficient thought has been put into the exact specification and requirements at an early stage.

³⁴ National Audit Office Report, HC 954, Session 2002-03.

³⁵ 18th PAC Report, Session 2003-04.

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In some other countries, the bidding process is shortened when negotiations at the early stage of a project are based on the overall concept and on price. When the indicated price is market tested, that is done with one other bidder. Although the experience of such a model has been limited so far, early results would seem to indicate that this model allows the amount of detailed design work – and the number of costly and time-consuming iterations thereof – at the early stages to be scaled down. This also means that affordability issues are addressed before the concept is translated into detailed drawings, again saving time which is currently wasted on detailed design work for a project which ultimately proves unaffordable.

Use of inappropriate measurements

The use of the Public Sector Comparator is one of the more controversial aspects of the whole PFI concept. One example of where its use could be perceived to be straining credibility was in the transaction to construct the new main building in Whitehall for the Ministry of Defence (MoD).³⁶

Where PFI is selected as the preferred procurement option, the PSC calculation is prepared at the end of the bidding/negotiation process in order to compare the anticipated costs of the traditional public sector procurement route with what is on offer from the PFI contractor. If the PSC comes out in favour of PFI, then the transaction should go ahead under that route.

However, the PSC calculation can be highly subjective, and depends on a number of crucial assumptions, one of which is the “riskload adjustment factor”. For the MoD building deal, a factor of 29.5% was used in the PSC calculation. This showed that the conventionally financed public sector option would cost £746.2 million, which turned out to be a mere £100,000 more than the PFI bid of £746.1 million. On this basis, the PFI bid was selected. If a factor of 25% had been chosen, the PFI route would have turned out to be £10 million more expensive.

³⁶ 4th PAC Report, Session 2002-03.

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It is almost impossible to calculate how much the public sector option would have cost over the long term. With the benefit of their greater commercial and PFI experience, private sector bidders will tend to be more accurate with their long-term cost estimates. Basing PFI decisions on apparently spurious calculations does not enhance the credibility of the PFI concept. As the PAC stated in their Report,³⁷ “the small margin in favour of the PFI deal provided no assurance that the deal would deliver value for money.”

However, given the acknowledged complexity of the MoD Main Building project, it is perhaps doubtful that having the same project run by the public sector would in fact have resulted in a better managed project or a final product delivered within the timescale or budget (which the private sector contractors actually achieved). But this, of course, does not justify the use of an arbitrary PSC to justify the decision to award the contract to PFI contractors. For the benefits of PFI to be more accurately measured, and to determine whether it is the right route for any particular transaction, less arbitrary comparison methods than the PSC need to be looked at.³⁸

Ineffective contingency planning

Many PFI deals get into difficulty because of the lack of contingency planning in the public sector, particularly in relation to large government IT contracts.

For example, a new IT system for the Immigration and Nationality Directorate³⁹ aimed to overcome backlogs of work amid concerns that applications and cases were not being dealt with thoroughly or in reasonable time. The delivery of the system was delayed. In these circumstances, the PAC found the Directorate’s contingency planning to be “inadequate”, consisting as it did of resorting to pen and paper.

³⁷ Op. cit.

³⁸ See Chapter 6 for recommendations on how to achieve this.

³⁹ 7th PAC Report, Session 1999-2000.

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The United Kingdom Passport Agency encountered severe problems in its ability to deliver passports to members of the public in 1999 because of faults in the IT system.⁴⁰ Despite the lessons which should have been learned by the Agency's public sector management after the flawed implementation of its last computer system ten years previously, the Agency's contingency planning in 1999 proved to be "inadequate". As a result of a lack of expertise in negotiating the PFI contract to cover all foreseeable contingencies, the Agency was unable to hold the private sector contractor liable for meeting the vast majority of the extra costs which arose.

Again, when the DSS decided to introduce a new Benefit Payments Card to replace existing paper-based methods of paying social security benefits with a new magnetic strip payment card, PFI was used to engage a private sector contractor to build the necessary IT systems.⁴¹ The contract was awarded by the Conservative administration in 1996. For various reasons, the contract was cancelled by Labour in May 1999. However, it took a full 18 months from the time when the DSS took initial steps to preserve its right to cancel the project, to the time when it actually took the decision to do so. During this period, the abortive costs were rising and the development of alternative arrangements to secure the effective delivery of social security benefit payments was delayed.

⁴⁰ 24th PAC Report, Session 1999-2000.

⁴¹ 3rd PAC Report, Session 2001-2002.

CHAPTER SIX

RECOMMENDATIONS FOR REFORM OF PFI

SOME OF THE FOLLOWING RECOMMENDATIONS are fundamental, others less so. They are all designed to maximise efficiency and innovation, introduce real PFI expertise into the public sector, eliminate waste and bureaucracy, bring greater transparency and simplicity to the whole PFI process, and above all to maximise the value for money which the taxpayer should get from PFI without jeopardising the delivery of quality public services. This last aim was, after all, the original purpose of introducing PFI in 1992, and it needs to be refocused on as a matter of urgency if PFI is to remain the preferred method of procuring public sector contracts.

Bringing PFI expertise into the public sector

The issue

The shortage of specialist PFI experience in the public sector is a major contributing factor to some of the excessively long negotiation periods, lack of clarity about desired outcomes and poor project management which have characterised previous PFI deals.

The current Government has attempted to tackle this issue by locating public sector PFI experience in a number of places – the Office of Government Commerce, Partnerships UK and the Private Finance Unit within the Treasury amongst others. These people are being stretched by the sheer workload imposed by the volume of different PFI projects being negotiated and concluded at any one time across all the different sectors of public service.

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What seems to be lacking is real experience and expertise. Too often, what experience that does exist is not being captured as public sector managers are all too often put back into their “day job” after concluding a PFI transaction. Anecdotal evidence from those involved with a number of deals, primarily in the health sector but also in other areas, suggests that PFI experts from a central government agency, for example PUK, are often “parachuted” in for a couple of meetings before heading off to the next deal. Although nominally supervising a PFI project on behalf of central government to ensure value for money and best practice guidelines are being followed, it appears that this role is not effective; and the procuring public sector body, for example the NHS Trust, is left to negotiate the PFI deal almost on its own. The Trust’s lack of expertise in PFI can mean that maximum value for money is not obtained.

Getting a PFI project approved for implementation also involves going through a number of different levels of approval at both local and departmental level. This takes time, with many points of contention having to be re-negotiated with the private sector. The excessive time periods and extra costs involved in this process often dilute the value for money potential inherent in a PFI transaction.

Recommendation

The current “layered” structure of PFI expertise in central government is ineffective and costly. It should therefore be abolished and be replaced by the creation of new PFI “units” within each of the major government spending departments likely to be involved in negotiating and concluding PFI deals (Department of Health, Department for Education and Skills, Department of Work and Pensions, Department of Transport, Ministry of Defence and the Home Office in particular). These units would, subject to final sign-off from the Treasury, also act as the approvers of proposed PFI deals, replacing the current duplication of approvals required. Such units need to be given high status and authority within the

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context of their individual spending departments to ensure that PFI is given the importance it deserves, and is subject to maximum accountability and transparency.

These central units within each spending department would undertake intensive training of specialist “PFI project managers”. These PFI project managers would obtain a thorough grounding in the knowledge and experience gained in PFI deals in their particular sector (for example, health, if employed in the DoH). This would be achieved through analysis of best practice from previous PFI deals.

On any PFI deal, the PFI project manager would effectively run the entire process from the public sector side. Each project manager would be accountable to senior people within the spending department, to ensure consistent decision-making and common standards for all PFI deals within that sector. To ensure genuine accountability and responsibility, such project managers would report directly to the Permanent Secretary within the relevant spending department.

The PFI project manager would work very closely with a small committee drawn from the board of the procuring public sector body (for example, the NHS Trust) throughout the whole process, rather than simply dropping in for the occasional meeting. The project manager would work with the board to determine and specify their desired outcomes from the PFI deal; to run the negotiation process on behalf of the board (although always acting in close consultation with them to ensure their needs are being met); and to manage the public sector side of the delivery of whatever asset/service is being provided under PFI.

It is unlikely that each PFI project manager would be involved in any more than two PFI deals at any one time, to ensure that the right amount of specialist expertise is being devoted to each negotiation process. More specifically, no project manager should be involved in more than one deal which is at the negotiation stage, as this is a very demanding role which requires full-time concentration. The limit of two deals should only be permitted

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where one is in negotiation and the other is, for example, in the process of final paperwork being completed.

These “sectoral” specialists would also be expected to share their experiences with others in the same departmental PFI unit, so that best practice and any particularities of PFI in that sector are widely disseminated.

The number of PFI project managers in any individual department unit will clearly depend on the level of PFI activity in that sector. However, for a major procuring department, it is probable that between 15 and 20 project managers would be able to cover the current level of PFI deals.

A typical PFI project manager will either have had significant prior expertise in managing PFI deals on behalf of the public sector, or will be recruited from the private sector where he or she will again have had significant experience of negotiating and managing PFI deals from a private sector perspective. Such project managers are likely to be relatively senior with the ability to communicate effectively with all parties involved in a typical PFI deal, such as Ministers, senior civil servants, public sector boards, private sector bidders and professional advisers on both sides.

The level of remuneration offered to these individuals should be commensurate with the seniority and importance of the post, and should be sufficient to attract high calibre individuals from the private sector. With the exception of obtaining final sign-off from the Treasury, the project manager will have full negotiating authority on behalf of the public sector procuring body (although, as noted, he or she will always consult closely with the board of that body to ensure that their wishes are respected), and it is important that their reward package reflects this level of responsibility.

As well as locating specialist PFI units within each of the main government spending departments, consideration should be given to setting up a specialist unit to advise and support local authorities in their negotiation of PFI deals. At present, such authorities are largely left to their own devices, which causes delays and cost overruns. Such a specialist unit would act as a

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resource and repository of expertise for local authorities in much the same way as the departmental units. Such a body could be funded either by central government, or by imposing an additional levy on local authorities.

One possible route to set such a body up might be to adapt the functions of Partnerships UK (PUK), an existing body which already carries out a great many transactions with local authorities, and which therefore has already developed a certain expertise in that area. Another route might be to take some of the PFI expertise which is located within the 4ps and use that within a specialist local authority PFI unit. Although, as acknowledged above, 4ps has played a useful role in developing local authorities' knowledge of PFI, the fact that this is in the context of a wider PPP procurement agenda would suggest that not enough attention is being given to PFI as a stand-alone concept, and how it can bring value for money and innovation to the taxpayer in local authority deals.

Consideration should be given to providing a clear demarcation between PFI and PPP in the local authority context. The 4ps is currently funded by the Local Government Association (LGA) and it is possible that this funding formula could be adapted to the needs of a new local authority specialist body.

It will be necessary to continue to have some PFI expertise located within the Treasury to look after the PFI concept at a more general level and to direct policy; and to provide a central mechanism for reporting data on the effectiveness and value for money being generated by the initiative. However, this function should be relatively small; the majority of PFI expertise should be moved to the spending departments which need it, and not reside in any of the numerous agencies which currently operate under the auspices of the Treasury.

Such a unit located within the Treasury should also be responsible for ensuring that the standard contractual terms which are used in PFI deals are being employed in the most effective manner across all the sectors where PFI is used. At

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present, the standard terms which have been developed by the Treasury Taskforce and Partnerships UK are often being used too prescriptively in transaction negotiations, stifling the opportunities for innovation and value for money generation which can be accessed by the use of PFI. As the standard terms typically only form a relatively small part of the overall arrangements in a PFI deal, a central Treasury unit should have an overseeing role in ensuring that the standard terms are not being used too prescriptively. Sector-specific variations to the standard terms which are required to meet the needs of, say, health sector PFI purchasers, should be handled by the PFI units within each spending department.

Getting rid of surplus functions – Partnerships UK

The issue

When PUK was set up by the Government in 1999, it was designed to build on work already done by the Treasury Taskforce and to provide a source of expertise for public sector bodies wishing to enter into PFI and also, more broadly, PPP deals. PUK is itself a PPP, being a joint venture where the public sector owns a minority interest and various private sector bodies combine to hold the majority interest through equity investments in PUK. According to its website:⁴²

The governance structure has been designed to balance private sector disciplines with PUK's public sector mission. A majority of board members come from the private sector and the public sector is represented by two non-executive directors appointed by HM Treasury.

As well as encouraging greater private sector involvement in PFI and PPP transactions, and acting as a source of expertise to public sector bodies, because it has access to both public and private sector capital, PUK also takes a stake in some of the PPP and PFI deals it advises on. PUK's website explains its role thus:

⁴² www.partnershipsuk.org.uk

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The interests of Partnerships UK are aligned with those of the public body. Partnership UK's return is linked to the success of the PPP and both Partnerships UK and the public body share in the costs of development and procurement.

If a development or procurement fails, Partnerships UK loses some or all of its money. If it is a success, Partnerships UK and the public body share in the benefits.

Partnerships UK intends to provide finance for PPPs where this will achieve better value for the public sector. For instance, it can provide development and bridging finance or other forms of capital or support where these are not readily available from established financial markets.

Recommendation

The role given to PUK is inherently contradictory in its aims and lacks logic. On the one hand, it works with the public sector body in developing and procuring the PFI/PPP contract and takes on certain rights and duties in relation to that contract. On the other hand, it has a financial interest (namely, the maximisation of its commercial return) from that same contract. These are mutually exclusive aims which should be confined where they best lie – in the public and private sectors respectively.

This body should therefore be abolished as soon as possible as it merely adds confusion and contradiction to the current plethora of governmental or quasi-governmental bodies in the field of PFI and PPP.

Some of the significant PFI experience residing within this organisation might be usefully redeployed either in the proposed departmental PFI units, thus capturing what expertise does exist in PUK and using it to best advantage in the departmental units; or in the small core PFI policy/oversight team which should remain within the Treasury; or back in the private sector using their experience to benefit private sector PFI bidders and advisers.

The role of providing development and bridging finance, or “seed” capital, using public money for PFI and PPP projects for

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which support is “not readily available from established financial markets” should also be abolished. If capital markets are not prepared to advance finance for a project, that is almost certainly because they believe that it is not sustainable. Public money should not be used to prop up projects which the private sector does not believe will succeed. Private sector investors are incentivised to put their equity at risk where they believe that they can make a return on their investment. Using the public purse as a source of capital for unviable projects means that this risk never leaves the public sector.

As noted above, there is also the possibility that the experience built up by PUK in dealing with PFI deals for local authorities could be captured by using that experience to form the basis for a new specialist body to advise local authorities in the negotiation and conclusion of PFI contracts. This could be achieved by adapting some of the functions carried on by PUK, allied to the PFI experience built up in the 4ps, to create a single public sector PFI advisory body for local government without the overlap and duplication of roles which characterises the current system.

In addition to PUK, the Government has established a number of bodies in specific sectors, such as Partnerships for Schools and Partnerships for Health, which provide a form of localised public-private partnerships in those sectors. Partnerships for Schools was set up as a “joint venture” between the Department for Education and Skills (DfES) and PUK, with the support of the 4ps, to coordinate the national delivery of the “Building Schools for the Future” investment programme. Similarly, Partnerships for Health is a “joint venture” between the Department of Health (DoH) and PUK to deliver “NHS LIFT”, which is described as “a major new initiative to develop and encourage a new market for investment in primary and community based care facilities and services.”⁴³ The greater involvement of the private sector in the delivery of assets and services which have traditionally been the exclusive domain of public sector providers is welcome. But

⁴³ As quoted in www.4ps.co.uk/publications/health

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concerns remain about whether the scrutiny of the value for money offered through Public Private Partnerships is adequate.

It is also doubtful that such long-term “partnerships” between public and private sectors, which do not have the risk/reward incentive profile of PFI deals, will generate significant efficiencies. Without having private sector capital at risk, these could well result in a “cosy” arrangement which operate to the mutual satisfaction of all those involved in the process, but which does not provide the maximum possible value for money to the taxpayer or opportunity for innovation.

There are a number of other examples, most notably in France, of such long-term arrangements which have resulted in the creation of quasi-governmental agencies which are both overly bureaucratic and vastly inefficient. Such schemes cannot be compared to joint venture schemes in the private sector, where both parties share in true risks and rewards, and so are incentivised to run them as efficiently as possible.

Consideration should be given to reforming such schemes in the UK to make them much more similar to the PFI model, which we believe is a more effective, rigorous and transparent one than the PPP model.

Accounting for PFI transactions

The issue

The public sector accounting for PFI transactions has caused some controversy. There have been widespread suspicions that, at least until relatively recently, getting the debt associated with PFI off the government books was a primary factor in getting many projects into the PFI process rather than the traditional public sector procurement process.

It goes almost without saying that this should not be a factor at all in determining whether a particular deal does through PFI or is conventionally procured. Value for money and the quality of the public service for the end user should be the determining criteria.

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The complexity of the PFI accounting rules does not give any transparency to the situation.⁴⁴

The accounting for a particular PFI transaction will depend on the terms of the contractual arrangements being entered into, and is subject to the accounting test. The purpose of the accounting test is to determine if the PFI deal should be on or off the government balance sheet. The main part of this is an assessment of which party (the public sector procuring body or the private sector contractor) has access to the benefits of the property (for example, the hospital) and exposure to the associated risks. This will be reflected in the extent to which each party bears the potential variations in property profits or losses.

Of course, there may be features of the PFI contract which could lead directly to variations in profit for reasons that are purely related to a service, for example penalties for under-performance or variations in revenues or operating costs. Again, such variations should be ignored, whatever their magnitude, when determining which party is entitled to the benefits of and exposed to the risks of the PFI asset.

There are various factors which are taken into account in this regard, according to the standard accounting guidance on PFI transactions. It should be noted that none of these factors would be a determining one in its own right, and the weighting given to the individual factors in any particular PFI deal will vary, as it is a subjective judgement. Each of these factors will be given due weight by the accountant determining what the appropriate accounting should be.

However, what is clear is that their complexity, and the subjective nature of the judgements involved in deciding whether a particular transaction should be on or off balance sheet, have not helped the PFI concept to achieve the appropriate level of transparency. Currently, if, on an assessment of all the factors, it is

⁴⁴ When the authors attempted to write a concise summary of the relevant rules, it ran to seven full pages. These are not reproduced here.

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judged that the public sector purchaser bears the overall benefits and risks relating to the property under the PFI contract, then both the asset (the property) and the associated liabilities (payments to be made to the PFI contractors) should be recorded in the balance sheet of the public body (and ultimately at government level in the case of a purchasing department).

Where the private sector operator is deemed to bear the risks and rewards of the property, then it should account for it in accordance with the normal rules of commercial accounting. The public sector operator should not record anything (off-balance sheet treatment has been achieved) except for any other obligations or entitlements which it may have under the contract (for example, acquisition of the residual value of the property at the end of the contract).

Recommendation

It is now clear that the accounting rules have become very complicated and, to the layman, neither an ideal nor a transparent method of determining whether something should or should not be counted as being part of government debt.

One crucial recommendation, and a point which has been made before in other studies of the PFI,⁴⁵ is that the accounting treatment for a PFI transaction should be decided after the decision to go ahead with the project has been made on value-for-money and innovation grounds. How the project should be accounted for in the government's books should not be a factor in deciding whether the project goes ahead under PFI or not.

Consideration should also be given to introducing a more "American style" prescriptive method of accounting for such transactions. Such rules would dictate that if certain specific criteria are met, then the transaction must be on-balance sheet. The introduction of such rules would remove the element of subjectivity inherent in current judgements of PFI accounting. Prescriptive accounting rules may be much more in the American

⁴⁵ IPPR, *op. cit.*, page 96.

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than the British tradition of accounting practice. But it is clear that more transparency needs to be introduced into the way PFI transactions are accounted for.

The fact that PFI is now a well-established method of public sector procurement also means that there are unlikely to be any “surprises” from an accounting perspective in any individual transaction. Therefore, it should be relatively easy to accommodate all of the key features of PFI within a prescriptive accounting framework.

Use of the Public Sector Comparator (PSC)

The issue

The PSC is the financial modelling mechanism which determines whether, over the long term, PFI or the traditional public sector procurement method will provide the best value for money in any particular PFI deal.

The PSC has become a discredited method of justifying the use of PFI. This is because, firstly, it is almost impossible to calculate with any accuracy how much a project would cost to run in the public sector over a period of between 25 and 30 years; and secondly because there are clear examples, as with the MoD building, of the PSC using self-evidently manufactured calculations to produce a result showing that PFI is allegedly the better financial option over the long term, often by no more than a hair's breadth.

The purpose of this, in a number of instances, appears to be to get the deal into the PFI process, and then to use the accounting rules to move the transaction off the government balance sheet. This is an unacceptable use of the PSC, and has led to it becoming tarnished. The current Government also changed the criteria relating to the riskload assessment factor to make that element of the PSC calculation much more subjective (and hence potentially subject to greater manipulation to achieve a desired result).

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Recommendation

The use of the PSC should be halted, and more appropriate and accurate measurements of the potential value for money aspects of a PFI deal should be put in place.

In sectors where there is significant experience of PFI and where there is plenty of evidence and precedent, it should be possible to conduct a sector-specific benchmarking exercise to ensure that a proposed PFI deal is maximising its value for money potential. For example, when an NHS Trust chooses to construct a new hospital using PFI, the Trust (or its financial advisers) should look at other hospital deals of a similar size, identify what the typical costs should be and clarify what level is needed to achieve maximum value for money for the taxpayer. It is important to emphasise that such a benchmarking exercise should not be used to create an artificial comparison with the conventional public sector procurement route because of the lack of relevant data for the latter route in areas where PFI has been the main form of asset procurement for some time.

The benchmarking exercise can also be used as a negotiating tool with potential PFI partners. For example, if the Trust managed to identify some efficiencies or innovations in previous deals which were not being offered to them, the Trust could suggest these as a way of bringing down the cost of the PFI deal even further.

At present, the public sector body, working with the PFI bidders, produces an Outline Business Case (OBC) for the PFI option to justify why PFI looks the better choice. A full business case is completed after the PSC calculation has been used to check that PFI is the option which provides the best value for money.

The benchmarking exercise should be completed before the OBC is finalised to determine if the case put forward in the OBC document makes financial sense and whether it can, on the basis of previous experience in that sector, deliver the anticipated savings and efficiencies. This will give the whole exercise greater transparency and will mean that, if PFI is chosen as the means by which the asset will be constructed and operated, at least it is on a

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more realistic financial footing than appears to be the case presently. Indeed, it is possible that the introduction of a simple benchmarking exercise could reduce the costs of tendering for certain projects which are currently excluded from PFI because of the prohibitive expense involved in the current tender process.

There will be occasions where such a benchmarking exercise is not possible (for example, because of the relative lack of PFI experience in that sector). In these cases, the new PFI units in each government spending department should undertake a “value for money” assessment of both PFI and public sector routes before the PFI outline business case is completed. Such an assessment should be constructed to avoid the inclusion of various assumptions which can be “tweaked” in the same way as the PSC currently can to produce what is seen as the right result for the government. Again, the purpose of this is to provide greater transparency and more realism about the potential costs and benefits of the PFI option.

A more radical alternative, which could replace benchmarking or similar exercises altogether, would simply be to assume that the effects of a competitive bid process carried out under PFI will always lead to a more cost-effective result than traditional public sector procurement. This assumption should hold true in most cases as competitive pressures, in a true market situation, should always produce the most cost-effective result. Care has to be taken, of course, that the market is as open as possible to potential bidders. For political reasons, more evidence of the cost effectiveness of PFI may be required before it becomes the default option.

Disclosure of government liabilities under PFI

The issue

At present, the Government uses a “cut-off” date of 25 years when disclosing the extent of its liabilities under PFI in the Treasury Red Book. Given that a significant number of PFI deals are 30 years in length, and some as much as 60 years, this 25 year limit is arbitrary and masks the true extent of the government’s long-term liabilities to private sector contractors.

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Recommendation

This time limit should be abolished. To ensure maximum transparency and to enhance public understanding of PFI, the full extent of potential government liabilities under the scheme should be disclosed, regardless of the potential duration of the transaction.

On a related point, there is a wider argument that the disclosure rules in respect of government liabilities generally need to be tightened up. At present, there exists no single figure covering all PFI, PPP and other contingent liabilities which go to make up the total expected off-balance sheet exposure. Clearly, a risk assessment of the probability of crystallisation of contingent liabilities would be required in arriving at such a figure. Therefore, the end result would be a single present value figure for all future payments under PFI and PPP contracts and other contingent liabilities. This would lead to much greater transparency around total government liabilities.

Indeed, a recent change in government practice about how PFI liabilities are disclosed only serves to illustrate the real and urgent need for greater transparency.⁴⁶ Under Standing Order 2823, which was not discussed in Parliament, Government PFI liabilities will no longer be listed in the Supplementary Statements to the Consolidated Funds, a table of liabilities published at the end of each year. Instead, they will be reported separately by each individual government department. This will make it even more difficult to get a total picture of overall government liabilities under PFI. Additionally, under the Standing Order, no detail is to be given of any liability worth less than £1 billion.

Such a change in government practice can only give ammunition to the opponents of PFI. In line with the recommendation for greater transparency and disclosure generally around PFI liabilities, the practice which is being adopted under this Standing Order should be halted.

⁴⁶ Reported in *The Times*, 13 November 2004.

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The discount rate

The issue

When measuring the costs of PFI against conventional public sector procurement (as happens currently using the PSC mechanism), account must be taken of the fact that, whereas with a conventional scheme, the capital element of the asset purchase is made up-front, with a PFI scheme the payments from the public purse are spread over the lifetime of the payment stream. As a payment made later in time effectively costs less because of the effects of inflation, a discount rate has to be used in the calculation to obtain a “real terms” comparison of the costs. The same discount rate is also generally used in disclosing the present value of PFI liabilities in the Treasury Red Book.

This discount rate used by the Treasury in comparing and disclosing long-term liabilities is 6%. However, concern has been expressed by many people involved in PFI transactions that this discount rate is too high and inflexible, particularly in view of the current low levels of interest rates and government bond yields.

Recommendation

Consideration should be given to lowering the discount rate to a more appropriate level. In a number of financing deals in the private sector, the rate typically used is 1.5% above the government bond yield (looking at the most appropriate gilt rate for the length of the PFI transaction being discounted). This rate should also be appropriate for the disclosure of PFI liabilities.

Costs of professional advice

The issue

The cost of professional advice of both the public and private sector parties in a PFI deal can quickly grow out of control. Often this is the fault of poor management and lack of expertise on the public sector side.

Some of the previous recommendations to strengthen PFI expertise and management skills in the public sector should go

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some way to reducing the burden of professional advice costs on the taxpayer. They should also mean that private sector bidders might not incur increased costs either, which would mean that they could make more cost-efficient bids.

As PFI has developed, the growing expertise and experience of professional advisers has meant that their costs per transaction have fallen. However, in some cases, the costs incurred, particularly by the public sector, on professional advice are still far in excess of what they should be. In a number of cases, this is because an NHS Trust or an LEA has appointed its usual lawyers or financial consultants to advise on the deal, even though they do not have any, or have only very limited, experience of PFI.

It is also the case that professional advice costs incurred by public sector bodies are not readily disclosed. With the exception of those PFI deals which have been examined by the National Audit Office or the Select Committee on Public Accounts, there are few examples of PFI transactions where a layman can easily quantify professional advice costs. This leads to a lack of transparency and accountability, and the impression that PFI is a revenue creation scheme for professional advisers.

Some steps have been taken recently to ensure that the costs of professional advice are better controlled, and that only advisers with a requisite degree of PFI experience are chosen to advise on such transactions. These have included the establishment of panels to assess the relative merits of professional advisers and enhanced criteria for the selection of such advisers by public sector procuring bodies. However, it is not clear that these reforms will prove sufficiently robust to solve the problem. Radical reform is required.

Recommendation

PFI public sector project managers should have the primary responsibility for choosing professional advisers with sufficient expertise in PFI transactions.

To maximise competition and drive down professional advice costs, it should also be mandatory for public sector procuring bodies to have a tender process for professional advisers at the beginning

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of every PFI project. This will ensure that, rather than relying on their usual professional advisers at whatever cost, an open and transparent competitive tender will result in the most appropriate advisers being selected at a level that gives the taxpayer value for money and the best possible level of expertise. The PFI project manager from the relevant unit within the government spending department should have the final say in the selection of advisers to ensure maximum accountability and transparency.

One of the key performance measures of the PFI project manager should also be their ability to successfully control professional advice costs and keep them within budget, as at present there is virtually no incentive for public sector bodies to actually control such costs.

Maximising competition in PFI bids

The issue

In a number of sectors, most notably defence, there have either been no bidders at all for a PFI project, or at best just one or two – only one of whom turns out to have a realistic chance of handling the project. This can be due to a number of factors, including the significant professional advice costs which can be incurred by private sector bidders in tendering for a PFI contract and the excessive length of the process caused by poor public sector project management.

This lack of competition between bidders means that the taxpayer is not getting value for money. If only one bidder is left in the process before the procurement has been completed, there is no competitive pressure on them to provide the best possible deal for the public sector body. If there is no bidder, and the procurement takes place using the conventional public sector method, this may not be the option which offers maximum efficiencies.

By comparison, certain other sectors, such as healthcare, are generally good at keeping the competition between different PFI bidders open for a realistic period, ensuring maximum competition and good value for the taxpayer.

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Recommendation

To encourage competition between bidders in all sectors, and to provide an incentive to enter the market in those deals where no bidders come forward at all, the best practices from sectors like health should be adopted across the board.

One innovation to the current process would be for a winning PFI bidder to pay a proportion of the bid costs of the losing parties, and then to factor these additional costs into the overall PFI package. This should ensure that there are no significant financial disincentives to bidders entering and staying in the competition, thus ensuring that the cost of the PFI deal is as low as possible in a competitive situation. This practice should be adopted in those areas of procurement where it has proven difficult to get any bidders to enter the market at all.

It should be noted that, with the implementation of some of the other reforms, better procurement processes should be in place anyway as a result of improved public sector project management expertise. The reduced bid costs and negotiation periods which would flow from improved project management by the public sector should, on their own, attract more bidders into the market anyway, as these factors were amongst the key disincentives to private sector companies bidding for PFI projects.

Pooling of small transactions within PFI

The issue

Because of the complicated nature of the negotiations and contractual arrangements involved in a typical PFI scheme, the concept has not generally been considered appropriate for transactions at the smaller end of the scale. Generally, PFI has been considered to be inappropriate for transactions below around £30 million in capital value. This means that some smaller projects, such as setting up individual schools, have not been able to benefit from PFI.

To overcome this, the Government has encouraged “pooling” of some small projects into larger groups which can be put out to

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tender under PFI. For example, a PFI bidder might enter into a deal to construct and maintain five local education authority primary schools with a total capital value of £50 million, when on their own they would not have been considered for inclusion within a PFI scheme. Local authority education provision is the area where “pooling” has been used the most to date.

While the concept of “pooling” as a means of extending the potential benefits of PFI to smaller-scale transactions is welcome, recent experience has shown that the way such pooling is being implemented in practice is not resulting in the full benefits of PFI being realised. For example, in a number of cases, two or more local education authorities are grouping together and offering a “pool” of schools across local authority boundaries for PFI tender. The result of this is that the number of parties at the negotiating table is unfeasibly high, each with different and sometimes competing interests. The inherent complications and protracted negotiations which result from such arrangements (along with the increased costs for all parties involved) mean that this is not an efficient way to carry out the process, and the benefits of PFI can quickly be lost in such circumstances.

Recommendation

Pooling, where it is considered appropriate at all, should only take place within the confines of a single local education authority, or single other public sector purchasing body. Having a number of different public sector purchasers at the same negotiating table adds too much confusion and complexity to negotiations. This might mean that some LEA schools were not being built under PFI. If so, then that will be the right result, for the cost/benefit analysis would indicate in those circumstances that it would be uneconomic for the LEA to contract under PFI on its own.

In a number of cases, even where PFI is being implemented within a single local authority, the negotiations are being carried out on the basis of a “standard format” to be applied to all schools which are to be built and maintained under that PFI arrangement. This is taking insufficient account of the needs of a

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particular primary or secondary school and its locality, and too often results in a building or facilities which are not right for the needs of that community.

Both local authorities and PFI partners should ensure that the specification of a project are sufficiently rigorous in taking account of local needs and priorities. Implementing projects on a standard basis may be more efficient, but where this results in the quality of the end public service being compromised, it should be avoided.

“Pooling” should not be confused with the concept of “batching”, which is currently being trialled in the health sector. Batching involves running a number of different PFI deals (which are often large) on a common basis with a view to solving common issues. In practice, this means that negotiations proceed at the pace of the slowest. As a result time delays are incurred, and costs undoubtedly increase. It is unlikely that batching is a concept which improves taxpayers’ value for money. It should therefore be discontinued.

Reform of the procurement process

The issue

Certain elements of the PFI procurement process, when combined with the lack of expertise and experience of public sector management, can sometimes lead to inefficiencies, delays and cost overruns in PFI deals (although it should be stated that the vast majority of PFI deals have provided value for money compared to the traditional public sector procurement option).

Recommendation

The pre-qualification process which all bidders currently have to go through should be removed. At present, before being allowed to tender for a specific PFI project, private sector companies are required to submit a detailed “pre-qualification” document setting out substantial amounts of information about the bidder, their experience and so on. Such a document has to be prepared separately for each potential PFI bid by each of the bidders. This is clearly expensive.

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To cut down on time delays and costs, each government spending department should therefore keep certain statutory information in relation to every potential PFI private sector company. This should be supplied to individual public sector procuring bodies as necessary. This will avoid unnecessary duplication and wasted effort. Similarly, modifications to the design process could bring substantial efficiencies. For example, it should not be necessary to produce detailed design specifications before the preferred bidder stage. And as always, the public sector should be clear about specifying realistic end product requirements.

The cost of funding PFI deals

The issue

One concern often expressed about PFI is that it will be more expensive to the public purse than conventional public sector procurement because, over the long term, the government is more likely to obtain cheaper financing than private sector companies.⁴⁷ Normally, such concerns can be allayed if other efficiencies and innovations in the PFI project as a whole mean that it would generate better value for money than the public sector alternative. However, in some cases, the more expensive financing may make the benefits from PFI only incidental.

The Government is experimenting with a scheme that it believes will reduce the cost of funding PFI projects. This involves the Treasury providing the funding for the debt portion of the project at current gilt rates. In return, the Treasury receives a guarantee that the money will be repaid in full with the interest due from a financial institution (this is intended to address the issue that, under the basic proposal, no transfer of operating risk away from the public sector would otherwise take place).

⁴⁷ Those expressing this concern often overlook the fact that, as the PFI market has evolved, commercial lending rates have fallen to a level where they are reasonably competitive compared to government lending rates.

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Currently, there is no minimum credit rating being proposed for the financial institution. Even if this was corrected, the proposal ignores the fact that the government is providing debt at rates that reflect its own (sovereign) risk and receiving a guarantee from a financial institution which will have a lower credit rating. There is therefore a risk that the institution will not be able to honour its guarantee under the arrangements.

It may appear, on the surface, that this is a low risk, but PFI contracts can last for around 30 years (longer in some cases). Much can happen to financial institutions over this time period. This is why they all have lower credit ratings than the British government. If this form of funding is adopted as standard practice, the proposals must be modified to ensure that any financial institution providing such a guarantee has a minimum credit rating of AA.⁴⁸ The risk of the financial institution not being able to honour its obligations under the guarantee needs to be calculated and assessed when appraising whether this is a suitable form of financing PFI projects in future. This risk must not be ignored or undervalued in order to present this solution as a success to silence the critics of PFI.

Whilst there is precedent in the bond markets for guarantees and, indeed, many PFI projects have taken advantage of this financing structure, the guarantees currently available only relate to the safest (or the most senior) portion of the debt. It is not yet known if there is a market that will provide guarantees at a reasonable cost to cover all the debt relating to PFI projects.

If the guarantee relates only to the most secure part of the debt, other debt providers will be needed. This will require complex documentation between debtors and, given the cost (in professional fees) and time related to producing these documents, may mean that the scheme is only suitable for larger projects (for example, those above £250 million).

⁴⁸ It might be noted that, before its collapse in 1995, Barings Bank had a credit rating of A1.

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Initial results from the experiment with this form of third party guaranteed gilt financing should be available in the next six months. It seems that the most positive contribution the experiment is likely to make to the enhancement of taxpayer value for money could be to exert a downward pressure on current commercial PFI lending margins, thus reducing the overall cost of PFI deals.

Recommendation

To lower the cost of funding for certain PFI transactions which are on the government balance sheet, or for those off-balance sheet deals where an ascertainable low-risk proportion can be left on-balance sheet, funding the most senior proportion of that debt (which is relatively small) at least partially through the issue of government bonds should be considered. This will generally be at a lower borrowing cost than private sector financing.

In terms of the ascertainable low-risk proportion for off-balance sheet deals, this can generally be identified as the most senior tranche of debt which is regarded as the safest. This small proportion of the overall debt is virtually risk free, as it will be paid out in all circumstances. It is important to emphasise that this change would not reinstate any risk to the government. All other borrowing, which is inherently more risky, can be carried out by the private sector, thereby ensuring that an appropriate level of risk is transferred to the PFI contractor and off-balance sheet treatment can be justified from the government's point of view.

Because the contractor assumes more of the risk under a PFI transaction, the private sector charges are justifiably higher. It should be stressed that if this risk stayed in the public sector, in the event of the risk actually crystallising, the government would be faced with a significant liability. The government therefore pays a small premium to ensure that the risk is assumed by the private sector. The reform suggested above, while lowering the overall cost of funding for a PFI deal, would not affect the risk profile. Neither would this be more complicated – one intercreditor agreement between the relevant parties should ensure that the debt is allocated in the appropriate way. It may be that this reform is only worth

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implementing for larger PFI deals, as otherwise the benefits obtained may be too small to justify the additional complication. This should be examined on a case by case basis.

Expansion of PFI

The issue

Certain sectors, particularly information technology, have not provided many successful examples of how PFI should be negotiated and operated. Instead, they have generated numerous examples of poor public sector specification and project management which have led, in some cases, to massive cost overruns which are a burden on the Exchequer and which have resulted in poor outcomes for the taxpayer.

With the Chancellor's proposal to extend the remit of PFI to cover urban regeneration, social housing and waste services, there is a danger that there may be more examples of cost overruns which could further tarnish the image of PFI as a concept if some of the lessons of previous PFI deals are not fully appreciated.

Recommendation

A more rigorous approach should be taken to determine which sectors PFI works best in, and which sectors it is inappropriate for. There is a danger, possibly partly driven by the Government's desire to get public sector projects off the balance sheet, that PFI will become the "default" means of procuring public sector works and services, even when it is not the best method of doing so.

In general, PFI has proven suitable for asset construction and maintenance (roads and prisons); largely successful (when properly implemented) for health and education facilities; and inappropriate, to date at least, for very large-scale service contracts, such as IT. We would recommend that PFI continue to be used in those areas where it has been proven to work and, in relation to areas such as IT where it has been less successful, much closer monitoring needs to be made of such projects to ensure that they are being run in such a way as to deliver value for money.

REFORMING THE PRIVATE FINANCE INITIATIVE

Implementation of the recommendations set out in this study should lead to a culture change in public sector project management. Real expertise in the public sector should be developed and maintained across spending departments and local authorities. Such a change should result in major procurement projects, such as IT contracts, being run much more efficiently, with improved accountability and transparency.

Very large multinational companies have been able to successfully implement single IT systems across a number of countries. It should be possible for a single national government to do the same. PFI should therefore not be abandoned entirely in areas such as IT, as some have suggested – but it does need much more efficient and effective management from the public sector. This includes developing a real expertise in deciding what systems specifications are required on the government side, and the ability to ensure that such systems are implemented properly.

This probably requires a designated IT specialist within each departmental PFI unit with the knowledge of the IT systems and infrastructure required by that department. Such a specialist, who is likely to be someone relatively senior with significant experience of public sector IT requirements, can be trained in the project management skills required to successfully implement a PFI project. Within the context of such a framework of effective project management and the use of appropriate specialists, PFI can deliver real value for money for the taxpayer, even in areas where it has not hitherto proven to be successful.

Part of the problem with IT contracts in particular seems to be that they are not being dealt with in a “bottom-up” way – in other words, insufficient attention is being paid to the current systems specifications and how compatible these would be with a new IT system before the latter is commissioned. Anecdotal evidence suggests that this is certainly true of the major IT contract currently being implemented in the NHS, which has cost approximately £6 billion to date, but which may well produce an IT system in hospitals which is not compatible with the different

RECOMMENDATIONS FOR REFORM OF PFI

systems which are used by GPs. It seems that a more sensible approach would have been to standardise the various systems used by GPs before commissioning a single system to be used by all hospitals. Again, this is a clear example of a lack of expertise on the part of the public sector which the reforms proposed here are intended to address.

The extension of PFI to cover such areas as the construction of social housing is welcome. PFI is the ideal means of securing the delivery of that asset and service in a way which should ensure value for money is delivered for the taxpayer. However, PFI may be unsuitable for very small procurement contracts (except where they can be “pooled”, as is currently happening in the education sector); for refurbishment contracts; for contracts which are inherently very flexible over time (and thus lacking certainty in specification from the point of view of the private sector operator); and for projects consisting of new and untested technology (as evidence to date from the IT sector shows).



The implementation of these reforms should ensure that PFI is used where it has been proven to be most beneficial and to provide real value for money. It should avoid some of the inefficiencies and waste which have occurred in the past.

PFI could also be extended as part of a wider programme of “outsourcing” the delivery of public services to the private sector.⁴⁹ For the potential for real value for money savings and greater innovation is significant. It is one which politicians from every party should consider examining in more detail as it offers an opportunity to reshape the way our public services are delivered in the years ahead.

⁴⁹ This has also been suggested by the IPPR, *op. cit.*

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