PUBLIC PRIVATE PARTNERSHIPS

THE GOVERNMENT'S APPROACH

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Front cover photographs:

1 and 2. Since May 1997, The Government has signed 35 major hospital PFI projects and projects covering 520 schools.

3. PPPs are also making a difference on a smaller scale, for example the project to improve street lighting in Brent.

4. In June 1998, the Government stepped in to rescue the Channel Tunnel Rail Link project.

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Foreword by The Chief Secretary

Partnerships between the public and private sectors are a cornerstone of this Government's modernisation programme. They are delivering better quality public services by bringing in new investment and improved management, and are helping state-owned businesses achieve their full potential.

Since May 1997, we have signed contracts for some 150 projects, leveraging in capital investment of over £12 billion. These include:

- 35 major hospital projects, representing the largest investment in new hospital facilities since the NHS was established;
- projects covering 520 schools and 4 prisons;
- 28 defence contracts;
- projects to modernise the Government estate.

We are bringing investment to all parts of the UK - for example, we have signed contracts with an estimated capital value of over £750 million in the North East of England, almost £1 billion in the North West and over £1 billion in Scotland.

Public Private Partnerships (PPPs) are also providing a major boost to the construction industry. Combined with the Government's Achieving Excellence Initiative, the wider improvements to the construction industry through the Movement for Innovation, the emerging work of the Local Government Construction Taskforce, and the commitment of the industry itself, PPPs are helping to ensure that the £25 billion the public sector spends each year on construction is used more effectively, leading to a major enhancement in this country's infrastructure.

Looking forward, over the next 3 years we expect to sign contracts for projects with an estimated capital value of a further £20 billion, under an expanded range of PPP models, focusing on our priorities - health, education and transport.

All this compares with less than £4 billion of private finance contracts signed during the whole of the last Parliament, and is on top of the £10 billion of additional public sector investment in public services which Gordon Brown announced in the 1998 Comprehensive Spending Review.

We are committed to partnerships with the private sector because they help to deliver the quality public services this country deserves. Partnerships enable the public sector to benefit from commercial dynamism, innovation and efficiencies, harnessed through the introduction of private sector investors who contribute their own capital, skills and experience. In this way, they provide better value for money, which means that, within the resources available, we can deliver more essential services and to a higher standard than would otherwise have been the case. On average, privately financed projects are delivering savings of 17% compared to public sector alternatives - this represents savings of £2 billion on a £12 billion programme, equivalent to 25 new hospitals or 130 new schools.

Our approach to partnerships is built on the foundations we laid in Opposition. The groundbreaking document, Financing Infrastructure Investment: promoting a partnership between public and private finance, produced in 1994 by Gordon Brown, John Prescott and Robin Cook, demonstrated how a new, more constructive relationship between public and private sectors would help to renew Britain's infrastructure - from railways, to inner city and regional regeneration, to housing and to childcare. We recognised that public and private sectors have distinctive, but potentially complementary, parts to play. In our rapidly changing world, in which our public services need to meet the rising expectations of their customers and the wider community, and in which our state-owned businesses increasingly have to compete in fast moving commercial markets, the best way to deliver our objectives is often through some combination of the public and private sectors.

However, to create this new partnership approach we needed a fundamental shift of thinking, putting behind us the ideology and dogma of the past. In the modern world, governments are judged not on what they own, or on how much they spend, but on whether they deliver. In Government, therefore, our focus in all that we do is on outcomes rather than inputs. In place of the debates between left and right, nationalisation versus privatisation, our goal is the modernisation of Britain.

Public private partnerships are not a single model applied to every circumstance, but are instead a tailored approach. This paper includes the full range of partnerships that the Government is seeking to develop with the private sector - from the Private Finance Initiative and joint ventures and concessions to the sale of equity stakes in state-owned businesses. We are also looking to develop innovative forms of partnership.

However, as this paper also makes clear, the same principles and themes apply to all types of public private partnership. By learning from the experience of past attempts to bring the private sector into public sector activities, we are delivering partnerships that meet the needs of customers and protect the wider public interest, allow for greater public accountability, recognise the contribution of staff and provide value for money for the taxpayer.

We have achieved much in our first 1000 days in Government. But this is only the beginning. As we continue to extend the concept of partnerships with the private sector across a widening range of public sector activities, so we will bring the modernisation this country needs.

Introduction

1 Public private partnerships (PPPs) are a key element in the Government's strategy for delivering modern, high quality public services and promoting the UK's competitiveness. They cover a range of business structures and partnership arrangements, from the Private Finance Initiative (PFI) to joint ventures and concessions, to outsourcing, and to the sale of equity stakes in state-owned businesses.

2 The Government took action to enhance PPPs within days of taking office in May 1997, starting by overhauling the PFI. The flow of investment from PFI deals is set to rise rapidly as a result:

- contracts with an estimated capital value of over £8 billion have been signed since the election in areas as diverse as hospitals, schools, military helicopter training and water treatment services;

- in addition, in June 1998 the Government renegotiated the Channel Tunnel Rail Link project, with a capital value of over £4 billion;

- the Government's other PPP plans are expected to generate at least a further £20 billion of investment. This includes PFI projects currently out to tender and the Government's plans for PPPs for London Underground and National Air Traffic Services (see below). All this compares with less than £4 billion of private finance contracts signed during the whole of the last Parliament.[1]

3 The Government announced plans in July 1999 to build on this success by establishing Partnerships UK - a private company with a public interest mission, which will enhance the public sector's ability to use public private partnerships to achieve its objectives.

4 The Government is also using PPPs to help state-owned businesses to compete and to provide improved services to their customers, while retaining responsibility for public interest issues in the public sector. These include:

- a PPP for London Underground in which private sector partners will be granted long-term concessions to upgrade and modernise the tube infrastructure, including some £8 billion of new investment in the first 15 years, backed by a rigorous performance regime to ensure that this investment leads to better services;

- the introduction of a private sector strategic partner into National Air Traffic Services (NATS) to fund and manage more effectively the company's large, modernising investment projects, while separate, public regulation will ensure NATS maintains its high safety standards and offers value for money for airlines and their passengers;

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[1] Excluding the original Channel Tunnel Rail Link contract.

- plans to sell a minority stake in BNFL, subject to further work by the Government and its advisers and to the company's overall progress towards achieving a range of performance targets set by the Government. This would enhance commercial disciplines as BNFL seeks to exploit opportunities in the competitive nuclear and environmental clean-up markets worldwide, while retaining the regulation that is essential to meeting high safety and environmental standards;

- the Government has legislated to enable the sale of a majority stake in the CDC (formerly the Commonwealth Development Corporation). This would enhance the business's ability to raise funds which would continue to be invested in the poorest countries in the world;

- the Government has announced its intention to sell the Horserace Totalisator Board (the Tote), in order to give the business greater freedoms in a rapidly changing market; and

- the Government is considering the form of a PPP for the Defence Evaluation and Research Agency (DERA) to enable it to respond to the changing demands of MoD customers, and to unlock its extensive store of expertise and knowledge to benefit the UK economy as a whole.

5 In addition, the Government is extending the partnership approach to an ever widening range of public sector activities, drawing on business skills to develop and implement policy, and using the expertise of private sector partners to make better use of public sector assets.

6 PPPs are not only vital for the modernisation of the UK. There is huge international interest in the UK's approach to developing partnerships between the public and the private sectors. It is an area of public policy where the UK leads the world. Over 50 countries have consulted the Treasury about the PFI. Some, like Italy, Ireland, Japan and the Netherlands are following us in the way we organise within government to deliver partnerships. Some are legislating to enable them to happen. PPPs also offer British companies the opportunity to use the skills and expertise they have developed in providing services within the UK to enter new export markets.

7 This paper sets out the underlying principles and themes which apply to all the various forms of PPP, and which are central to the way in which the Government goes about designing new partnerships with the private sector. By applying these principles in each case, and learning the lessons from the privatisation programme and the early years of the Private Finance Initiative, the Government will deliver partnerships with the private sector that will provide better public services for customers and local communities, greater opportunities for staff and better value for the taxpayer.

1 OBJECTIVES AND PRINCIPLES

WHAT ARE PUBLIC PRIVATE PARTNERSHIPS (PPPs)?

1 Public Private Partnerships bring public and private sectors together in long term partnership for mutual benefit. The PPP label covers a wide range of different types of partnership, including:

- the introduction of private sector ownership into state-owned businesses, using the full range of possible structures (whether by flotation or the introduction of a strategic partner), with sales of either a majority or a minority stake;
- the Private Finance Initiative (PFI) and other arrangements where the public sector contracts to purchase quality services on a long-term basis so as to take advantage of private sector management skills incentivised by having private finance at risk. This includes concessions and franchises, where a private sector partner takes on the responsibility for providing a public service, including maintaining, enhancing or constructing the necessary infrastructure; and
- selling Government services into wider markets and other partnership arrangements where private sector expertise and finance are used to exploit the commercial potential of Government assets.

DRAWING OUT THE BEST FROM THE PUBLIC AND PRIVATE SECTORS

2 The Government recognises that there are some things which the private sector does best and others where the public sector has more to offer. The old argument, as to whether public ownership was always best or whether privatisation was the only answer, is simply outdated. The Government firmly believes it will only deliver the modern, high quality public services that the public want and increasingly expect if it draws on the best of both public and private sectors.

3 The starting point is, therefore, a recognition of the contribution that the public and private sectors can each bring to the partnership.

The fundamental role for Government

4 First and foremost, while the best way to deliver the Government's objectives may be through some combination of public and private sectors, Government retains the responsibility and democratic accountability for:

- deciding between competing objectives;
- defining the chosen objectives, and then seeing that they are delivered to the standards required; and
- ensuring that wider public interests are safeguarded.

5 In the case of PPPs introduced into public services, this means that, while responsibility for many elements of service delivery may transfer to the private sector, the public sector remains responsible for:

- deciding, as the collective purchaser of public services, on the level of services that are required, and the public sector resources which are available to pay for them;
- setting and monitoring safety, quality and performance standards for those services; and
- enforcing those standards, taking action if they are not delivered.

6 Similarly, in the case of state-owned businesses, while PPPs bring the private sector into the ownership and management of the business, the Government remains responsible for safeguarding public interest issues. This includes, in particular, putting in place independent regulatory bodies, remaining in the public sector, whose role is to ensure that high safety standards are maintained, and that any monopoly power is not abused.

The potential of the public sector

7 Second, the Government recognises that in many ways the public sector represents a reservoir of potential, including:

- dedicated and professional staff, who are motivated by a desire to improve Britain's public services, and more generally to raise the quality of life of people in this country and beyond;
- a portfolio of assets and businesses, which are often central to the delivery of key public services;
- a unique source of data, and a wealth of ideas and intellectual property which are the product of top class scientific research;
- a range of trusted brands and marques, which may have unique commercial potential.

The contribution of the private sector

8 But third, PPPs recognise that this potential is only partially released in the absence of the private sector. The private sector can expand opportunity through the following disciplines and skills.

commercial incentives

9 Private sector organisations operate in a fluid and fast moving environment. If they do not generate profitable business, they will not survive. The realities of the private sector market-place exert a powerful discipline on private sector management and employees to maximise efficiency and take full advantage of business opportunities as they arise.

10 These disciplines can never be fully replicated in the public sector, since there are a multiplicity of policy objectives, and a more risk averse culture driven in part by the desire to safeguard taxpayers' money. Compared to the private sector, therefore, the public sector can be less equipped to challenge inefficiency and outdated working practices, and to develop imaginative approaches to delivering public services and managing state-owned assets.

11 With public private partnerships, the Government seeks to harness the innovation and disciplines of the private sector, by introducing private sector investors who put their own capital at risk. This is achieved either by introducing private sector ownership into a state-owned asset or business, or by contractual arrangements in which the private sector bears the financial risk involved in delivering a particular service or other form of specified output. If the business or service provider operates in a competitive market, market disciplines will provide an incentive to maximise quality of service. If such disciplines do not exist, and cannot easily be introduced, quality standards can be enforced through regulation or by performance requirements in the contract with the public sector. By harnessing private sector disciplines in this way, PPPs can help to improve value for money, so enabling the Government to provide more public services and to a higher standard within the resources available.

a focus on customer requirements

12 The need for private sector businesses to generate a return means that they are forced to look for ways to enhance the service they offer their customers, and to adapt to their changing requirements and expectations. Unless they do, customers will go elsewhere. Such incentives tend to be less clear for public sector providers, so they can tend to respond more slowly to customer demands.

new and innovative approaches

13 Similarly, the search for new opportunities to develop profitable business provides the private sector with an incentive to innovate and try out new ideas - this in turn can lead to better value services, delivered more flexibly and to a higher standard.

business and management expertise

14 The private sector is normally far more skilled in running business activities and some elements of service delivery, including managing complex investment projects to time and budget, and assessing the commercial opportunities of potential new business ventures.

15 In summary therefore:

- PPPs enable the Government to tap into the disciplines, incentives, skills and expertise which private sector firms have developed in the course of their normal everyday business ...
- and so release the full potential of the people, knowledge and assets in the public sector ...
- so enabling the Government to deliver its objectives better and to focus on those activities, fundamental to the role of Government, which are best performed by the public sector - procuring services, enforcing standards and protecting the public interest.

THE OBJECTIVES OF PPPs

16 In bringing the best of the public and private sectors together, the key test of any partnership arrangement is not whether it is classified to the public sector or to the private sector. Instead, what matters is whether it provides the structure most likely to deliver the Government's objectives. The Government develops public private partnerships with three broad objectives in mind:

(i) to deliver significantly improved public services, by contributing to increases in the quality and quantity of investment;

(ii) to release the full potential of public sector assets, including state-owned businesses, and hence provide value for the taxpayer and wider benefits for the economy;

(iii) to allow stakeholders to receive a fair share of the benefits of the PPP. This includes customers and users of the service being provided, the taxpayer and employees at every level of the organisation.

(i) Investing for modern, quality public services

17 A key priority for this Government is to increase investment in Britain's public services after many years in which the public sector asset stock was allowed to deteriorate. The Government announced in its Comprehensive Spending Review in July 1998 a significant increase in public sector investment with over £10 billion being made available over three years. The Departmental Investment Strategies published in April 1999 set out details of departments' plans for using this additional investment, and how these plans link to their overall objectives. They also outline the procedures and systems which will ensure that value for money is obtained.

18 The Departmental Investment Strategies also show how the Government is using private finance and other types of public private partnerships to add to and complement this additional public sector investment, or in some cases using public sector investment to leverage in private sector funds. This can relieve the pressure on public finances, allowing Government to concentrate resources on other public services. Reforms already made to the PFI will lead to a significant increase in the contribution made by private finance to public-sponsored total gross investment, growing from 10% in 1998-99 to an average of 15% in 1999-2000 to 2001-02, in particular as PFI projects are brought on stream more quickly, and PFI is expected to generate some £11 billion worth of new investment over the period 1999-2000 to 2001-02. The contribution of private finance should continue to grow as further reforms help to extend the range of public sector activities into which PPPs can be introduced.

19 Central to the Government's approach is to use PPPs where they provide better value compared to public sector investment. Under PPPs, the public sector specifies the outputs required from the investment, but the responsibility for, and many risks associated with, delivering those outputs is transferred to the private sector partner. This can offer better services, delivered more efficiently and providing better value for money for the taxpayer than public sector investment, provided the outputs can be clearly specified from the outset and that both parties fully understand the risks they are taking on. In addition, PPPs encourage innovative approaches, as the private sector partner is given flexibility over the design of the assets and operational procedures.

20 PPPs can also act as a value benchmark against which wholly public sector providers can be compared. In this way, they are helping to reinforce the pressure being applied across the public sector by the Government's Public Service Agreements, ensuring that the additional investment announced in the Comprehensive Spending Review delivers substantive improvements in public services.

(ii) Helping state-owned businesses and other public sector assets achieve their full potential

21 There are now relatively few large commercial organisations in the public sector, for example London Transport, BNFL, the Civil Aviation Authority and CDC. In most cases, the customers of these businesses are largely outside Government and pay for the services they receive along normal business lines. By introducing greater commercial disciplines, for example through private sector management and ownership, and through competition, the Government is looking to help these businesses fund and better manage their investment programmes, to operate more efficiently, to take advantage of new commercial opportunities to expand their businesses in the UK and beyond, and to improve the services they provide. This benefits their customers and the economy as a whole, and in turn will enhance their long-term commercial prospects and their value to the taxpayer.

22 Similarly, PPPs are contributing to the Government's drive to use publicly-owned assets more effectively and efficiently. The National Asset Register, published in November 1997, provided the first ever list of the assets owned by the Government. Since then, Government departments have been encouraged to sell off assets they do not require, and make better use of irreducible assets that they do not use to full capacity, often by harnessing the expertise and finance of a private sector partner.

(iii) Sharing the benefits fairly between all stakeholders

23 PPPs should create genuine economic benefits for all involved. This means ensuring that the benefits of PPPs are shared fairly:

- between public and private sectors. Private sector partners and investors benefit from the new and profitable business that PPPs represent. But it is for Government to ensure there is a fair deal for the public sector;

- and within both public and private sectors, that all the stakeholders receive a fair share of the benefits. This includes the customer, the taxpayer, private sector investors and employees at every level of the organisation.

COMMON PRINCIPLES

24 In designing partnerships with the private sector that deliver these objectives, there are five key principles and themes which underpin the Government's approach.

25 These are summarised below, but set out in more detail in Chapters 2-6.

Learning the lessons from the past (Chapter 2)

26 The Government is learning the lessons of past attempts to involve the private sector in public services and businesses, in particular from the privatisation policies of the 1980s and early 1990s, and of the early years of the Private Finance Initiative. Following the election, the Government moved quickly to address some of the key deficiencies in these programmes:

- in the case of privatisation, by using the windfall tax and the review of the regulation of the utilities to redress the balance in favour of the consumer and the taxpayer;

- and by rapidly overhauling the PFI, for example by introducing greater expertise within Government, by ending the universal testing rule and by better prioritising PFI projects.

Becoming a better partner (Chapter 3)

27 Government is applying the lessons learned to become a better partner, so as to secure better public services and better value for money for the taxpayer, and generally be more successful in delivering its objectives. This means, for example:

- taking a more sophisticated approach to the sale of state-owned businesses, for example using part sales to obtain long term value for the taxpayer;

- seeking to align the interests of management, employees and all other stakeholders with those of the Government in the run-up to the PPP;

- being a better shareholder for those businesses remaining in the public sector, looking to grow the value of such businesses into the medium and long term; and

- being a more educated client in PFI and procurement deals, so that these deals are structured to leave risk with the party best able to manage it and to deliver best value for money.

Safeguarding the public interest (Chapter 4)

28 The design of PPPs reflects the continuing public interest in key public services, and in state-owned businesses. This means:

- ensuring PPPs deliver demonstrable benefits to customers and users of those services;

- putting effective regulation in place to ensure that PPPs deliver value for their customers and maintain high safety and environmental standards; and

- maintaining Government involvement in those elements of PPPs where a strong public interest remains.

Recognising the contribution of staff (Chapter 5)

29 The Government believes that dedicated and committed staff are central to the long term success of partnerships. PPPs are being designed so as to recognise the contribution of staff, in particular by protecting staff terms and conditions and pension entitlements at the time of the PPP, and by seeing that employees share in the opportunities which partnerships create.

Developing new types of partnership (Chapter 6)

30 Finally, and consistent with the other key principles and themes, the Government is continually looking to develop new types of partnerships with the private sector. As the Government introduces private sector skills and finance into an ever widening range of public sector activities, so there are opportunities for new and innovative solutions. Chapter 6 sets out a Prospectus for Partnerships, as a guide to the opportunities and challenges associated with different types of partnership arrangements.

31 The remainder of this document expands on these common principles and themes, and demonstrates how PPPs will deliver real improvements to public services, for the benefit of customers, local communities, employees and the country as a whole.

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Annex A

ADDRESSING QUESTIONS OFTEN RAISED ABOUT PFI

PFI projects are often complex, involving the Government and the supplier adopting innovative approaches, and this often prompts questions about the policy. This annex addresses the questions most frequently raised.

Why does PFI offer value for money when the private sector's cost of borrowing is higher than that of the public sector?

First, it is important to put this into perspective: the difference between the private sector's cost of borrowing and that of the public sector is down to some 1-3%[2]; and this additional margin applies only to a relatively small proportion of the total cost of each PFI contract- capital expenditure forms on average just 22%[2] of the total cost of PFI projects.

Second, and as a result, the value extracted from the use of the funds raised is normally more important than the price paid for these funds. The private sector can compensate for the higher price of its borrowing in a number of ways:

- it can be more innovative in design, construction, maintenance and operation over the life of the contract;
- create greater efficiencies and synergies between design and operation;
- invest in the quality of the asset to improve long term maintenance and operating costs; and
- underlying all this, the discipline of the market place ensures the private sector can manage risk better - it has better incentives and is better equipped to deliver on time and within budget. As the Institute of Civil Engineers and the Faculty and Institute of Actuaries in their publication on risk management state: "The Private Finance Initiative has heightened awareness of project risks in ways that traditional procurement has hitherto not been able to do, so that the identification, allocation and management of risks has grown to become an essential part of the PFI process."[3]

Third, in reaching a judgment on whether a PFI contract will offer value for money, and therefore whether to proceed, the Government compares the contract with an assessment of the cost of alternative public sector financing and management - the Public Sector Comparator (PSC).

In July 1999, the Government commissioned Arthur Andersen and Enterprise LSE to carry out a study of Value for Money Drivers in the Private Finance Initiative. The report was published in January 2000,

[2] Value for Money Drivers in the Private Finance Initiative - Arthur Andersen and Enterprise LSE, (2000)
[3] Risk Analysis and Management of Projects - Thomas Telford Publishing, (1997)

and submitted as evidence to the Treasury Select Committee. It confirmed that PFI is delivering better value for money, and indicated that PFI projects are on average delivering savings of 17% over traditional forms of procurement.

Some examples of the better value obtained by PFI include the following:

- In the National Savings contract signed in January 1999 for the transfer of business operations, the PSC indicated that the traditional procurement option would be over 20% more expensive;
- The Falkirk school PFI deals are estimated to offer 15% better value for money;
- Defence projects average between 10 - 15% and in some cases up to 20% (for example, the project to train crew for the Medium Support Helicopter);
- Prisons averaged 10% for initial deals signed under the previous Government and an average 13% (assuming optimal public sector risk management) to 18% (assuming good public sector risk management) for recent contracts; and
- The first four Design, Build, Finance and Operate (DBFO) road projects are likely to deliver savings of around £100 million (10%).

Is value for money achieved by exploiting staff?

No. The terms of employment for staff transferred to private sector management are protected under TUPE in the vast majority of cases. In addition, the Government has announced measures to protect pension entitlements. Staff recruited by contractors benefit from the Government's general reforms of employment legislation covering issues such as pay and working hours.

Why not just relax the rules on public borrowing to allow more investment by public sector bodies?

The Government has already announced, in the 1998 Comprehensive Spending Review, a £10 billion increase in public sector investment over the following three years, consistent with the Government's fiscal rules.

The Government's approach is to use PFI where it would provide better value for money compared to public sector investment, as described above.

Doesn't PFI just mortgage the future?

PFI requires properly considered decisions about long-term service delivery requirements. The financial commitments entered into during the life of the contract not only provide a physical asset, but a guaranteed service to specified performance levels.

Under a conventionally-procured project, the public sector would still have to meet the cost of maintaining the asset and providing the service. In the past, capital has often been invested without a clear commitment to adequate future spending on maintenance, leading to poorly maintained assets, high running costs, inefficient service provision and premature replacement. In contrast, PFI invests in the future because it ensures that assets are maintained properly and can revert to the public sector at the end of the contractual period in good condition. This amounts to sound budgetary planning.

It is also worth noting that long term PFI contracts often contain break points or options at the half-way point and at regular periods thereafter to give the public sector flexibility over the service that is being delivered by the private sector party. Some NHS contracts are an example of this.

To make them affordable, don't PFI schemes lead to smaller facilities and reduced levels of public service?

It is sometimes suggested, particularly in the context of health projects, that PFI schemes are not affordable unless they are made smaller in size and scope than the facilities they replace, for example by reducing bed numbers in new PFI hospitals. However, the affordability ceiling and the level and mix of services to be delivered under any new capital investment project is determined long before the private sector is involved in negotiations.

To use the NHS as an example, the services to be provided at any new hospital - which in turn determine the number of beds needed to deliver them - are set out in an initial Outline Business Case (OBC). This is drawn up by NHS managers, clinicians and health experts and must be approved by the Department of Health before a decision is taken on whether to use public capital or the PFI route to fund the project. An affordability ceiling must also be determined for the OBC and, together with the number of beds required, be included in the first tender documents which go out to prospective private sector bidders under the PFI route.

The reductions in bed numbers at new hospitals have been driven by developments in medical techniques and practices such as the increased use of day surgery and shorter hospital stays. It is not a result of the introduction of PFI.

What is wrong with traditional public procurement?

There is a history of conventional projects which have overspent their original budget, or which have been delayed. Some examples include:

Trident Submarine Shiplift and Berth (Faslane, Scotland)

- Initial cost estimate £100 million, final cost £314 million
- Total Slippage in completion date - $2\frac{1}{2}$ years

Jubilee Line Extension

- Initial cost estimate £2.1 billion, final cost some £3.5 billion
- Total slippage in completion date - almost 2 years

The New En-Route air traffic control centre

- Total initial cost estimate £475 million, latest estimate £655 million
- Total slippage in completion date - 5 years

Guy's Hospital

- Initial cost estimate £36 million, final cost £160 million
- Total slippage in completion date - over 3 years

When to use PFI

Private finance can provide better value for money than conventional procurement. In deciding whether a particular capital project is suitable for PFI, the Government takes into account the following factors:

What is the scale and complexity of the project? Does it cover more than one location?	PFI offers the advantages of: • optimal overall risk allocation, with risk falling to those parties best able to manage it • integrated supply-chain management • commercial discipline leveraged into the deal through lenders' due diligence
How much scope is there to innovate in designing the infrastructure and operating procedures?	PFI focuses on specifying the outputs rather than retaining detailed control over inputs. So long as there is an effectively structured competition, PFI should encourage: • new ideas for the design of assets and operational systems • synergy between design and operation • a focus on the whole life costs of the operation of the asset • avoidance of costly over-specification in design
What is the value of the transaction?	PFI contracts are complex long-term arrangements, so there may be significant costs associated with the transaction itself. This tends to make them more suitable for the larger value projects. Nevertheless, it may be possible to justify small scale and low value schemes, particularly if they can be "bundled" with other PFI schemes.
Discrete nature of the services to be provided	As the risks and rewards for the contractor are much greater than conventional procurement, there must be clear differentiation between private sector responsibilities and remaining public sector accountability, so that the contractor is only exposed to financial penalties for his own performance.

1 Annex B

PUBLICLY-OWNED BUSINESSES – A TAILORED APPROACH

The Government believes that, in order to meet all three of its objectives - better services, better value and benefit for all stakeholders - it needs to devise solutions which are tailored to the particular circumstance of the public enterprise or public service concerned. As the privatisation programme of the 1980s and early 1990s demonstrates, trying to apply a single model to each case leads to a sub-optimal result. The starting point is therefore to define the specific outputs the Government wants to see delivered, and then to determine which elements are better provided by the private rather than the public sector.

The Government's policies for state-owned businesses provide an illustration of this approach, with differences in structure reflecting the different objectives and circumstances. Where new investment is central to the operation of the business (as with London Underground and NATS, for example), the investing part of the organisation is being transferred to the private sector to make best use of the private sector's ability to manage often large and complex capital projects. Where there are matters of public interest at stake, the Government is safeguarding these, for example by providing for economic regulation of the business alongside the comprehensive regulation of safety (as is the case for BNFL and NATS). The details are set out below:

NATS

The Government's objectives are to build on this country's enviable reputation for aviation safety and manage increasing volumes of air traffic (rising by an average of 5-6% per annum), with a solution which separates safety regulation from service provision, and provides the funding and management required to modernise the UK's air traffic control systems (an estimated £1 billion programme of investment in high technology infrastructure) and enable NATS in due course to exploit business opportunities around the world.

The PPP meets these objectives by:

- separating NATS from the CAA, with CAA remaining in the public sector as the body responsible for ensuring that NATS maintains, and where necessary enhances, high safety standards;

- introducing incentive-based economic regulation (which will also be the responsibility of the CAA). This will replace the existing "cost-plus" regulation which fails to encourage either timely and productive investment or value for money for airlines and their customers;

- transferring a controlling interest to a private sector strategic partner with the commitment, capability and skills that are required to manage large and complex investment projects to time and budget, and to take advantage of new business opportunities, in a framework which balances private sector shareholder scrutiny with commercial freedom from Government. The private sector will bear the risk of and provide the funding for NATS' capital programme and new business opportunities;

- the strategic partner will also help more generally to introduce commercial dynamism and innovation into what is a natural monopoly business;

- safeguarding national security and the public interest through powers of direction in primary legislation. The Government will also retain a special share in NATS; and

- allowing the taxpayer and employees to share in the long term success of the business by retaining in public ownership a 49% stake, and making 5% of the shares available to NATS staff.

CDC

The Government's objectives are to leverage CDC's position as an important investor in poor countries by drawing in additional private investment, while ensuring that CDC's unique investment and business principles are maintained. All CDC's investments are for the benefit of developing countries, with at least 70% for the poorest of these countries. CDC also aims to ensure that at least 50% of its investments are for the benefit of countries in sub-Saharan Africa and South Asia.

The PPP would meet these objectives by:

- transferring the company into the private sector so as to benefit from private sector funding, drawing on the disciplines of the private sector to ensure the extra investment is used to maximum effect, and using CDC's exposure to the private sector capital markets to help leverage in funds from third parties into CDC's target markets in the developing world;

- protecting CDC's business principles and investment policy through the partnership arrangement; and

- allowing taxpayers and staff to share in the long term success of the business by retaining in public ownership a substantial minority stake and by plans to develop an employee partnership scheme.

London Underground

The Government's objectives are to provide both the investment (an estimated £8 billion over the next 15 years) and the management required to modernise the tube infrastructure, against the backdrop of a rise in passenger journeys of around 70% over the last two decades, while safeguarding the public interest by maintaining safety and the unified network.

The PPP will meet these objectives by transferring the investing parts of the business into the private sector, through three infrastructure companies, in order to benefit from private sector disciplines and, in particular, the expertise of the private sector in managing large infrastructure projects so as to ensure they are delivered to time and budget. London Underground and its advisers estimate that the private sector should deliver the required investment programme significantly more efficiently than the public sector. This means that, within the resources available, the PPP will deliver a better tube infrastructure and hence a better service for Londoners than would be provided by the public sector alone.

A clear framework will be put in place to ensure safety. London Underground: will remain in the public sector to operate trains and stations; will be overseen by the Health and Safety Executive, which will remain responsible for the safety of the whole network; and will approve the infrastructure companies' safety procedures.

Other measures to safeguard the public interest include:

- keeping train operations in the public sector;
- transferring infrastructure companies under 25-30 year concessions rather than permanently; and
- introducing a clear performance regime for private sector concessionaires (contrasting with the weak incentives placed on Railtrack when it was privatised under the previous administration).

London Underground has recently sought expressions of interest in a public private partnership for the future management and development of their non-operational property estate (the "London Underground Property Partnership"). The proposed arrangements comprise (a) the outright sale of some surplus properties, (b) the future management of London Underground's non-operational property portfolio, and (c) an exclusive 20-year agreement covering future development opportunities. The transaction is taking place to the same broad timetable as that for the main tube PPPs.

BNFL

The Government's objectives are to provide a commercial framework which will enable BNFL to grow its global business in a competitive market, while ensuring high safety and environmental standards.

A PPP would meet these objectives by:

- selling a minority equity stake, which would introduce private sector capital market disciplines into the business, ensuring that proposals for new business ventures are thoroughly scrutinised for their commercial viability;
- retaining rigorous independent safety and environmental regulatory regimes; and
- the continuing Government shareholding in BNFL, and the employee partnership scheme which the Government intends to introduce in the run up to the PPP, will ensure that taxpayers and BNFL staff share in the long term success of the business.

The Government has set BNFL performance targets relating to the safety of its operations, the skill levels of its staff and the company's financial performance. A decision to proceed with the PPP will be taken in the light of the company's overall progress towards achieving these targets and in the light of further work by the Government and its advisers.

DERA

The Government's objectives, which would be delivered by a PPP, are to enable DERA to grow its commercial business for non-defence customers more quickly, and to encourage the 'spin-out' of its advanced technologies into civil applications, while ensuring that DERA continues to provide high quality, impartial advice to the MoD on the acquisition of new military systems of all types.

Some of DERA's more sensitive capabilities will need to be retained within MoD. However, for the majority of the organisation, a PPP will give DERA better incentives and greater freedoms than it currently enjoys to form joint ventures and spin-out companies, and to invest in developing its capabilities and extensive technical facilities, so enabling it to provide a more cost-effective service to MoD.

Kingston Communications

Until recently, Kingston Communications was the last wholly-owned local authority telephone company in the country. In July 1999, Hull City Council floated the company on the stock market, reducing its stake to below 50%. The main impetus for the sale was to fund investment in Kingston Communications' business telecoms subsidiary, Torch Telecom. While Kingston Communications' primary function is telephone services in Hull, Torch was recognised as the main driver of future growth. As a local authority, Hull Council concluded that, in the fast-moving telecommunications market, they could not satisfy the ambitions of the group. They faced growing at a rate that did not match the underlying rate of telecoms growth, unless the company could gain access to extra funding and participate in the commercial world.

As a result of the sale, effective control has passed from the local authority to the company. However, it is understood that Hull City Council will be consulted by Kingston if the future 'strategic direction' has a bearing on the economic well-being of the city.

Apart from the sums reinvested in the company, Hull City Council have benefited from a capital receipt of some £250 million from the flotation. They are currently considering how best to use the receipt to maximise the benefit to the city. Following the sale, the share value of the company rapidly increased, recently standing at around £1.2 billion. The Council are planning to divest themselves of their remaining holding at an appropriate time. This gives the Council the potential for a substantial further receipt.

Post Office

The Government's objectives for the Post Office, as set out in the Post Office White Paper, are to provide a commercial framework which should enable the Post Office to grow its business against the backdrop of an increasingly competitive and rapidly changing global market, while safeguarding the public interest in a key public service. In this case, however, the Government has made clear its intention that the Post Office will remain in the public sector.

The new commercial framework announced in the White Paper will achieve these objectives by combining new freedoms and new disciplines:

- the Post Office can fund its core investment programme from cash generated by the business, but the Government is allowing the Post Office to invest more of what it earns, enter into joint ventures and borrow for growth investment at commercial rates (subject to a fast track but rigorous Ministerial approval process for growth investments of more than £75 million a year);

- the Post Office will be allowed to enter into joint ventures with private sector businesses in order to compete in the rapidly changing market place, including the growing but highly competitive parcels, express and logistics markets; and

- the Post Office operates in an increasingly competitive market, and the Government is looking to enhance the commercial disciplines on the business by liberalising the UK postal market, and creating a new postal regulator to regulate prices in the Post Office's monopoly business, and to safeguard the interests of postal users.

2 LEARNING THE LESSONS OF THE PAST

1 Throughout the 1980s and 1990s, the UK has seen a number of initiatives to bring the private sector into activities once thought the sole preserve of Government - first through the programme of privatising state-owned industries and the contracting out of public sector activities, and then through the use of private sector management and funding for public sector projects through the Private Finance Initiative.

2 Too often, these early approaches were based on the assumption that the best solution to public sector problems was simply to transfer as much of the activity as quickly as possible to the private sector. The private sector was often brought in with insufficient competition, regulation and other requirements on service standards. This chapter sets out how the Government addressed some of the key deficiencies of the privatisation programme and the PFI when it came into office in May 1997.

PRIVATISATION

3 The UK's programme of privatisation began in 1979. Since then around 100 major businesses have been transferred to the private sector. Overall, privatisation had beneficial effects, with productivity improved and the economy better able to respond to change, but the record varied significantly industry by industry.

4 At its best privatisation, when combined with competitive markets, led to the creation of world class companies, reduced costs and prices and improved services to the consumer.

5 Elsewhere its record was more mixed, with certain stakeholders (in particular the new shareholders and the senior management) benefiting at the expense of others (most clearly, customers and taxpayers). Businesses were sold for less than their full value, prices have been higher than they should have been, services have not met consumers' expectations and yet shareholders and senior managers have done well.

6 Many of these deficiencies can be traced back to the way privatisation was implemented. In particular:

- too many assets were sold too quickly and too cheaply. The valuation at the time of sale did not take full account of the improvement in performance which could be achieved through commercial pressures and incentives in the private sector. A more phased approach to sale, involving the initial retention of public sector stakes, would have given a better return to the taxpayer;

- regulatory regimes were initially too lax because the potential for efficiency gains well in excess of those which had traditionally been achieved in the public sector was underestimated. Shareholders gained at the expense of consumers as mistakes were only slowly corrected through price reviews;

- not enough was done to create competition. Industries perform best in a challenging competitive environment. The rush to privatise too often left unnecessary elements of monopoly in place and regulation proved an imperfect substitute for the market;

- in some cases, the new structural arrangements and regulatory regimes did not provide enough incentives on the private sector to invest to provide better services;

- senior management were often enriched beyond any reasonable requirements for incentives to achieve commercial success and with insufficient direct link to performance. Where rewards were linked to performance, they were based solely on performance post-privatisation. There was therefore no consistency of interest with the public sector vendor in the run up to the sale;

- in contrast, employees often failed to benefit, and were not truly partners in the new enterprise. The limited opportunity for many of them to invest in shares meant that they received little of the gains to which they had contributed; and

- the proceeds, some £90 billion in current prices, were not used effectively. The asset base of government was run down to finance current deficits.

THE WINDFALL TAX

7 The Windfall Tax, introduced in July 1997, tackled the concern that the utilities were sold too cheaply, and that the initial regulatory regimes, which had been based in large part on information supplied by the companies themselves, were too lax. This one-off tax on the excess profits of the privatised utilities was levied in two equal instalments to raise some £5.2 billion to fund the Welfare to Work programme. The tax applied to the main privatised utilities, namely those companies privatised by flotation and regulated by statute.

IMPROVING REGULATION OF THE UTILITIES

8 Some of the weaknesses of privatisation were most evident in the utilities, where public sector monopolies were transferred to the private sector with significant monopoly characteristics in place. Experience has demonstrated that more competition should generally have been introduced at the outset. In some cases, the development of technology since privatisation has pushed back the frontiers of potential competition, for example in telecoms, gas supply and, most recently, electricity. In the meantime, greater weight has needed to be placed on economic regulation to restrain monopoly and protect consumers.

9 The UK's basic structure of economic regulation has stood the test of time. The RPI – x price control formula, which provides regulated companies with a genuine incentive to achieve efficiency gains, and the independence of regulators, have produced a climate favourable to investment and significant gains for consumers. But there is room for improvement. The Government's utility review concluded in July 1998 that changes could be made to:

- make protecting consumers, wherever appropriate through promoting effective competition, the principal objective of the regulators;

- establish strong and independent consumer councils to investigate complaints and champion consumer concerns;

- give the energy regulator powers to implement new electricity trading arrangements, so enabling the generation market to be more competitive;

- provide for greater transparency of decision-making; and replace individual regulators in the energy and telecoms sectors with regulatory authorities to improve consistency and predictability in decision-making; and

- require regulators to have regard to statutory guidance issued by Ministers on social and environmental objectives relevant to their sectors, while leaving economic regulation to the regulators acting at arm's length from Government.

10 The Government is legislating (through the Utilities Bill) to implement these conclusions for the electricity and gas industries. Arrangements for taking these conclusions forward for the telecoms industry will be set out in a Communications White Paper (due to be published later this year) and for the water industry in a Water Bill (due to be published in draft also later this year).

EARLY PERFORMANCE OF THE PRIVATE FINANCE INITIATIVE

11 Progress in the PFI in the early years was relatively slow. It became clear that many of the advantages that PFI was expected to have over traditional public sector procurement were not materialising. There were five main reasons for this:

- a requirement for universal testing of the suitability of PFI for all new capital investment, which overstretched resources in both public and private sectors, and meant that not enough attention was paid to the organisational issues that needed to be resolved if a timely flow of sound projects was to be achieved;

- inadequate project management skills for such a complex procurement process in the public sector;

- public sector clients had insufficient commercial knowledge and experience, in many instances even to select suitably qualified advisers;

- often inflexible input specifications reduced the scope for delivering better value for money through (for example) innovation and greater synergy between the design and operation of assets; and

- investment projects were poorly prioritised, which was illustrated most dramatically with the culling of hospital schemes in 1997.

ABOLITION OF UNIVERSAL TESTING

12 On coming to office in May 1997, the Government quickly ended universal testing, which had been a recipe for frustration and delay and which worked against the concept of prioritisation which the Government wished to build into the process.

THE 1997 BATES REVIEW

13 In addition, the Government asked Sir Malcolm Bates, Chairman of the Pearl Group, to carry out a review of the PFI. His main recommendations in June 1997 were:

- to create a Taskforce within the Treasury. The first appointments to the Taskforce were made in September 1997. Members with project management and financial skills and experience were recruited from the private sector on fixed term contracts. The Taskforce was charged with supporting departments to deliver good quality transactions, in particular by helping them test significant projects before procurement commenced. This was to include: checking that they were affordable for the public sector; that the output requirements were appropriately specified; that risk was allocated to the party best able to manage it; and that funding was likely to be forthcoming from the private sector. The Taskforce was also to advise on draft contractual terms and conditions, project resources and on whether proposed timetables were realistic, as well as then monitoring the progress of projects.

- to establish standard contract conditions. It was recognised that standardisation of tender documents would sharply reduce legal fees and other costs, and the time required for negotiation with tenderers and financiers. The Taskforce standard terms were published in July 1999;

- to prioritise projects better. Bates proposed that effort in the Treasury and elsewhere in the public sector should be focused on establishing quality transactions which would then become the basis for other deals. For local government projects, a project review group was set up to prioritise projects and agree to them proceeding to procurement.

- to learn lessons. Although it was accepted that public sector experience of PFI was growing, those with that experience needed to be encouraged to make available their expertise for the benefit of future projects.

14 With the changes made in the wake of the Bates Report, the flow of PFI projects increased from around 40 deals in 1997-98 to over 100 separate deals in 1998-99, which should lead to an investment flow of some £11 billion between 1999-2000 and 2001-02.

15 This chapter has set out the immediate action which the Government took to address the deficiencies of the privatisation programme and PFI. However, it was clear more generally that the Government needed to take a more sophisticated approach to its relationship with the private sector if it was fully to achieve its objectives from public private partnerships. The next chapter looks at how the Government is applying the lessons learned from the past to the development of new PPPs.

3 GOVERNMENT BECOMING A BETTER PARTNER

1 Following on from the lessons from the privatisation programme and the early years of the PFI, this chapter illustrates how the Government is becoming a more effective partner in its dealings with the private sector. It should be read in conjunction with the Cabinet Office's Better Quality Services.

BY LOOKING FOR LONG TERM VALUE

2 The Government's presumption is that the taxpayer should share in the benefits which exposure to the private sector can bring, and to this end the Government intends to retain a substantial equity share in each of the PPPs being taken forward for the major public enterprises. This approach is consistent with one of the conclusions of the PAC report Getting value for money in privatisations (July 1998) that those privatisations which involved a 100% sale of the equity in a single tranche often sacrificed long term value for the taxpayer. Examples of the Government's approach here include:

- NATS and CDC, where the PPP will transfer the businesses to the private sector, but the Government will retain a substantial minority stake; and

- BNFL, where the Government is looking to introduce a PPP involving a minority sale of the equity, subject to the company's overall performance against targets and further work by the DTI and its advisers, with the Government retaining a majority equity stake.

BY ALIGNING STAKEHOLDER INTERESTS

3 One reason why Government has not achieved full value in sales of state-owned businesses in the past is that key stakeholders saw this objective as running counter to their own interests:

- senior management had an interest in holding back potential improvements in the performance of the business until after the sale, so that more of the benefit would come to them, by means of their share options; and

- in contrast, many employees saw little scope for any of the benefits of the transfer to the private sector being passed to them - they were more concerned about the impact of the sale on job security and working practices.

4 This is a particular issue in the case of flotations, where potential investors will value the company on the basis of its recent performance and on the management's statement about strategy and future prospects. In contrast, in the case of trade sales or the introduction of a strategic partner, bidders can be given access to more detailed information on the company, and will base the price they are prepared to pay on the value they believe they (rather than the existing management) could extract from the business.

5 It is therefore particularly important in the case of flotations that (in addition to any incentive schemes that apply after the PPP) staff at every level in the organisation are motivated in the period

running up to the PPP in a way that aligns their interests with those of the Government as vendor. The Government is therefore:

- looking at the scope for setting performance targets for the business which would need to be achieved before a sale would take place. These targets relate to some of the key drivers of value, and can be cascaded down from a company level to an individual team or plant level. This is the approach being pursued in respect of a PPP for BNFL; and

- ensuring that staff have incentives to grow value in the run up to the PPP, for example in the way that employee partnership schemes are designed (see Chapter 5).

6 But more generally, the Government believes that the prospects for a successful PPP are best if all the main stakeholders are committed to the partnership's objectives. In each case therefore, the design of the PPP will take full account of the interests of the main stakeholders.

BY BECOMING A BETTER SHAREHOLDER

7 In the 1980s and early 1990s, the presumption within Government was that state-owned businesses should be transferred to the private sector. It was believed that difficult commercial decisions were often better delayed until after the change in ownership, and the Government's main focus in the interim was on controlling short term cash flows.

8 However, this Government's objectives of delivering better quality services and value for the taxpayer apply as much to businesses remaining in the public sector as to those where ownership is transferring to private sector investors. The Government is therefore considering how it can take a more long term view as shareholder, with the aim of growing the value of the businesses that it owns, drawing where appropriate on practice in the private sector and in other countries. The Government recognises that the public sector can never fully replicate the shareholder disciplines which exist in the private sector, but believes that it is possible to improve upon the short-term approach of the past. Some of the options being considered include:

- a more strategic approach. The Government is looking to step back from the day to day management of public enterprises, and instead focus on the drivers of long term value, setting targets and encouraging alliances and partnerships with the private sector. The Post Office is an example of this approach. The Post Office White Paper, in July 1999, announced a new commercial framework, in which the Government will agree the strategy for the business each year and set the Post Office a profit target. The Board will be responsible for delivering that target and paying a commercial dividend, but will have more freedom to invest. And alongside these greater commercial freedoms will be additional disciplines, in particular as the Post Office's traditional monopoly business is increasingly opened up to greater competition, and in the meantime the Post Office will face scrutiny from the new independent postal regulator;

- introducing greater transparency. The Government believes that greater openness about the financial performance and service delivery of public enterprises will be a useful discipline on managers within those organisations. Focusing on a few strategic targets will be a start. But a more sophisticated approach is for City analysts with experience of the industry sector to write and publish reports on the prospects for the business - much as they would for a listed company. The Government is considering whether this is an approach worth pursuing;

- introducing greater shareholder expertise. A key element of making the Government a better shareholder is to ensure it can draw on an appropriate mix of skills and experience to help it carry out this role. One option, which the Government is pioneering for the Royal Mint, is to create a shareholder panel to provide advice to Government on strategic issues faced by the business and on what needs to be done to enhance shareholder value. This would draw on City and relevant business expertise; and

- separating shareholder responsibilities within Government from public policy/consumer issues. This is a way of provider greater clarity in the Government's approach to businesses remaining in the public sector. One example is the Post Office where many of the consumer protection issues currently falling to the DTI (e.g. regulation of postal prices and monitoring the Post Office's performance against its service standards) will fall to the new postal regulator.

BY BECOMING A BETTER CLIENT

9 As noted in Chapter 2, following the creation of the Treasury Taskforce and the implementation of the other recommendations made by Sir Malcolm Bates in May 1997, the flow of PFI deals stepped up a gear.

10 The Government has been looking at how to build on this success, in particular by further enhancing the capability and expertise of the public sector as the client in PPP deals. In November 1998, therefore, the Government asked Sir Malcolm to carry out a second review of the PFI, to examine progress since 1997 and to identify changes that would further improve the Government's approach to PPPs.

11 Sir Malcolm had recommended in his first review that the Taskforce should have a limited life of two years. The intention was that, at the end of this period, the level of expertise within departments would be sufficient to set up partnerships with the private sector without any continuing need for a central co-ordinating capability. However, central to the analysis in his second report is the perception that partnerships with the private sector require a range of private sector skills which it has proved difficult to nurture within the Civil Service, such as commercial negotiating skills, project management and project structuring. In addition, he was concerned that insufficient resources were being devoted by public bodies in the development phase of privately financed projects, with consequent delays to investment projects and failure to secure best value for money.

12 Sir Malcolm recommended that the Government address these problems by creating a new public private partnership managed on private sector principles to support public sector PFI procurement and PPPs with a combination of project and financial skills. Responding to this recommendation, the Government announced in July 1999 that it would establish Partnerships UK.

Partnerships UK

13 Partnerships UK will itself be a PPP - a private sector company managed on commercial lines but with a public interest mission. Its aim is to accelerate the flow of value for money deals. Working for the public sector, it will help to make the public sector a more effective client, and ensure the best possible deal in privately-financed investment programmes. In effect, it will enhance the public sector's "intelligent client" capability.

14 For a particular project, Partnerships UK will align itself with the public sector procuring authority and inject more detailed examination of practical considerations into the decision-making process and drive forward the conclusion of deals. In this way, and by making available its experienced staff and resources to assist with the development of projects, it will help departments and other public interest organisations secure better value in PFI procurement.

15 Partnerships UK will have no monopoly or guaranteed market but will seek to win business on its own merits. It should offer benefits to the public sector and private sector alike:

- for the public sector, because it will help ensure projects are better structured from the outset, so boosting the flow of investment into the UK's infrastructure and helping the Government achieve better value for money in PFI deals; and

- the private sector will also benefit from better-structured projects, which will help bring about a reduction in the cost, delay and uncertainty experienced by bidders for PFI projects.

16 The Government is now engaged in a development period prior to preparation for the raising of private capital, which is expected to take place later this year. The enabling legislation was introduced into the House of Commons in December 1999.

Assessing the performance of PFI projects

The Government's policy is that all projects should be subject to post-implementation evaluation. This applies as much to PFI projects as to conventional forms of procurement. The Office for Government Commerce will play a key role in promoting best practice in this area, but the following points are central to the Government's approach:

- the evaluation process should be the responsibility in each Department of a central team with the necessary top level backing;

- the level of detail required normally depends on the amount of expenditure, and the policy interest (for example, importance, novelty and relevance to future activities);

- evaluation should be conducted even on activities which have gone well in order to identify ingredients for success, as well as those which have generated significant problems;

- the evaluation process should include arrangements to ensure that the necessary follow up action is taken; and

- departments' contract management and performance monitoring activities should be regularly audited.

The Government is also considering the benefits and practicalities of establishing a central system to collect information on project performance and provide a facility to benchmark performance against comparable PFI and other projects, as recommended by Arthur Andersen and Enterprise LSE.

Monitoring the long term expenditure implications of PFI schemes

PFI transactions lead to long-term spending commitments which will have an impact on future public spending plans. As a result, the Government has taken steps to ensure that Parliament is fully informed of the extent of the estimated commitments. This information is laid before Parliament at least twice a year.

The Treasury Taskforce has issued guidance, agreed with the NAO, on the arrangements for the reporting of information on PFI projects to Parliament. As well as requiring the provision of general information on future commitments, the guidance sets out the need for procuring authorities to inform Parliament of projects where contracts contain clauses which depart from those set out in Standardisation of PFI Contracts (Treasury Taskforce July 1999), in addition to those which give rise to reportable contingent liabilities.

BY BECOMING A BETTER PURCHASER

17 The Government strongly believes that many of the lessons learned from the Government's reform of the PFI are equally appropriate to other public sector procurement, and some of the key principles established through PFI should become standard practice within the public sector, irrespective of the source of finance. In November 1998, the Government therefore asked Peter Gershon, then Managing Director of GEC Marconi, to carry out a wide ranging review of civil procurement.

18 One of Gershon's key recommendations was that the Government needs to approach public sector procurement with a similar degree of due diligence as private sector partners would use in effectively structured PFI procurement. Rigorous expert scrutiny is required throughout the life cycle of public sector procurement projects.

19 Gershon therefore identified a need for radical change to make the Government a better purchaser across the full range of civil procurement. He recommended that Government create a central body to ensure consistency of strategy and promotion of best practice across the public sector, and take the lead in combining separate public sector projects where this is appropriate.

20 The Government is therefore creating an Office of Government Commerce (OGC), bringing together a number of bodies presently in the Treasury and the Cabinet Office - this is expected to include those parts of the Taskforce that will not become part of Partnerships UK, the Treasury Procurement Group, the Buying Agency, the Central Computer and Telecommunications Agency (CCTA), and the Property Advisers to the Civil Estate (PACE).

21 Peter Gershon was appointed OGC Chief Executive in February 2000. OGC should be operational from April 2000 when its remit as owner of the generic procurement process will include issuing guidance on PPP commercial matters, including PFI procurement (see Chapter 6).

22 More generally, public sector parties should benefit from innovative approaches developed by private sector partners in PFI deals. An early example is prisons, where the cost structure and service provided by private sector partners at ten contractually managed prisons provide benchmarks for the Prison Service at some 120 directly managed prisons.

23 The increasing use of PPPs will provide additional performance benchmarks for public sector managers engaged in modernising parallel or similar services that continue to be undertaken in the public sector, adding value above that yielded by the individual partnerships themselves.

Sophisticated deal structures

A clearer understanding of the risks and of the approach of the private sector parties has led to a more sophisticated approach to designing PPPs. Examples include:

- National Savings, where the PPP involves transferring the business operations to the private sector partner; and
- smaller health projects, where trusts have clustered a number of their projects together in order to obtain the scale of investment necessary to offer value for money.

In June 1998, the Government stepped in to rescue the Channel Tunnel Rail Link (CTRL) PFI project. The novel deal structure included an agreement by the Government to guarantee certain bonds issued by London Continental Railway. The Government concluded that this structure offered best value for the taxpayer, given the exceptional circumstances of the case - in particular (and following scenario testing by the Government's financial advisers) the low probability that these guarantees would be called.

However, in most cases, financing capital projects through the issue of bonds by state-owned businesses or bonds guaranteed by Government does not offer best value: the cost of raising the funds is greater than if the Government finances the project directly by issuing gilts; and the management of the project does not benefit from the same degree of risk transfer to the private sector as under a PPP (including the due diligence work of the private sector providers of finance). In addition, bonds issued by state-owned businesses represent public sector borrowing. The same is true of Government guaranteed bonds (unless, as with the CTRL, the probability of the guarantee being called is demonstrably low).

4 DELIVERING QUALITY SERVICES AND SAFEGUARDING THE PUBLIC INTEREST

1 A key test of the success of PPPs is whether the added value they generate is benefiting the users of public services, and the wider community as a whole. As this chapter illustrates, the Government has a vital role in monitoring and enforcing standards, and protecting the public interest, for example through regulation of safety and prices.

BETTER VALUE ALLOWS MORE INVESTMENT IN QUALITY SERVICES

2 As noted in Chapter 1, PPPs are making a valuable contribution to the renewal of Britain's public services by delivering better value for money and better management of capital spend. This means that, within the resources available, PPPs allow the Government to provide more public services, more quickly and to a higher standard.

3 The advantages are being seen across the public services. For example:

- in the NHS, since the Government overhauled the Private Finance Initiative, three waves of major projects comprising 35 major hospitals at a cost of over £3 billion have been agreed, with the first new hospital due to open later this year. This represents the largest investment in new hospital facilities since the NHS was established. The PFI scheme for the new Cumberland Infirmary in Carlisle has a timetable of 29½ months compared to the 54 month programme envisaged under the public capital option. The project is currently 6 weeks ahead of schedule and is due to be the first major PFI hospital project to become operational, in April this year;

- similarly, in the schools sector, eighteen individual schools projects and twenty-three grouped projects, covering 520 schools, are underway. Innovative projects in the schools sector include the provision of IT services to Dudley's 104 schools and the provision of catering services to Lewisham's 90 schools. Many of these projects have come forward by PFI much sooner rather than a conventional procurement could have achieved, and it is doubtful that some would ever have come about at all were it not for the scope for innovation that PPPs permit. Already the first PFI schools, in Bridport, Dorset and in Hillingdon have opened their doors to pupils; and

- PPPs are also making a difference on a smaller scale, for example projects to improve street lighting in Brent, North London and sewerage services in Kinnegar, Northern Ireland.

PERFORMANCE REGIMES AND ACCOUNTABILITY

4 However, if PPPs are genuinely going to deliver better quality services, it is vital that they are designed with the focus on outputs and performance. The private sector partner or partners need to be clear about what is expected from them, and the implications if they fail to deliver.

5 One example of this focus on outputs is the London Underground PPP, where the private sector partners will be subject to a rigorous performance regime. This will specify the capability that is

required from the infrastructure to allow London Underground to deliver steadily improving levels of service. The payments made to the private sector partners will depend on achievement of standards required by the performance regime. This gives the private sector a clear incentive to invest, in contrast to the funding arrangements designed for the national railways when they were privatised under the last administration.

6 More generally, the Government is committed to ensuring that all public services, whether provided by public or private sectors, are accountable to the customers and communities that rely on them, for example by monitoring levels of customer satisfaction and regular discussions between service providers and representatives of users. In the case of PPPs, it is also important to involve users, where appropriate, and indeed a wide range of stakeholders, at the time the contract specification is being drawn up, so as to ensure that services are shaped around the needs of users rather than providers.

DESIGNING FOR SAFETY

7 The Government is taking forward a number of PPPs in businesses and activities where safety is of paramount importance. In these cases, the objective of maintaining and enhancing safety standards is central to the way the PPPs have been designed. Examples include:

- air traffic control where, by separating NATS from the Civil Aviation Authority (CAA), the PPP will ensure that for the first time NATS will be regulated by a separate public body - the CAA - which will enforce rigorous safety requirements for NATS just as it currently does for the airlines. In addition, the PPP will provide the capability and project management skills of the private sector to deliver NATS' programme for modernising the UK's air traffic control systems, which is key to enhancing aviation safety;

- London Underground, where the PPP is designed so that London Underground, as the public sector operator post-PPP, will be accountable to the Health and Safety Executive for the safety of the entire network. Infrastructure Companies in the PPP will inherit existing contractual safety cases, and will be expected to take an active role in the maintenance and improvement of system safety. They will in turn be required to put in place similar arrangements for their contractors, which must be described in each infrastructure company's safety case, so that London Underground can be certain that safety is properly addressed throughout the supply chain. This hierarchy of safety leadership and control, with London Underground at the apex, and with single point accountability at each level in the chain, will provide the clarity of roles and responsibilities that is vital to good safety outcomes; and

- BNFL, where the company is already subject to safety and environmental regulation by the Health and Safety Executive and the Environment Agencies. These regulatory regimes will continue post PPP. The Government has made clear that one of the conditions BNFL must satisfy before a PPP will be taken forward is to improve the company's safety and environmental standards.

PRICE REGULATION

8 Price regulation is a key element in protecting the public interest in those businesses which, post PPP, will be operating in a non-competitive, or semi competitive environment.

9 In the case of the NATS PPP, the Government intends to introduce RPI-x regulation to the prices charged to the airlines. The economic regulation group in the CAA will be responsible for setting the price cap, performing a similar role for NATS as they currently do for BAA plc.

10 Details of the Government's approach to regulating utilities are set out in Chapter 2.

A CONTINUING ROLE FOR GOVERNMENT WHERE IT MATTERS

11 The Government recognises that it has a continuing role in the public service element of essential services. In some cases, this may mean retaining some elements of service delivery in the public sector; for example:

- in PFI hospitals, where the private sector constructs and maintains the building, but the medical and nursing staff are provided by the NHS, ensuring that clinical standards generally remain a public sector responsibility; and
- similarly, while the private sector will maintain and upgrade the London Underground infrastructure, the public sector will continue to operate the trains, signals and stations, so ensuring a unified service to the public.

12 Alternatively, the Government may retain control of key decisions affecting the service. In the case of PFI prisons, in addition to the constant monitoring of contract performance, decisions affecting civil liberties (such as punishments and withdrawal of association with other prisoners) and public safety (temporary release) are taken by Government officials on site.

13 Finally, there are cases where the private sector will be taking a controlling interest in the partnership, but where there is a public policy objective that needs to be retained. For example, through the Articles of Association of the CDC, safeguarded by a special share, the Government will protect the business' unique investment policy and ethical business principles, thereby ensuring that CDC continues to invest 70% of its funds in the poorest countries of the world, with 50% going to sub-Saharan Africa and South Asia. CDC will therefore remain a key element in the UK's overseas development effort.

5 RECOGNISING THE CONTRIBUTION OF STAFF

1 The Government recognises that staff are also partners in PPPs, and that the future success of the partnership relies on their dedication and commitment. The transition to partnership will inevitably cause uncertainty, and may require restructuring and changes in working practices. While the Government cannot give indefinite guarantees over job security (either before or after the PPP is established), it will ensure staff get a fair deal.

2 In particular, the Government wants all staff to feel that they have a personal investment in the future of the organisations in which they work. They need to be assured that their conditions of employment (including their pension entitlements) will be protected. But beyond that, they need to know they will be rewarded for their contribution to a successful PPP, for example by gaining new opportunities (as the business diversifies into new activities post PPP) and new skills.

CONSULTATION

3 First and foremost, the Government is committed to consulting staff, particularly on proposed PPPs that could see them transferred to the private sector. The TUC and CBI both welcomed the publication in October 1998 of Treasury Taskforce Policy Statement No 4 as evidence that the Government had listened to union concerns, by requiring:

- full, effective and continuous communication where such transfer could take place in order that staff and recognised trade unions can be engaged throughout the process;

- transparency during and after the procurement process, with commercial confidentiality only being accepted as justification for non-disclosure where this would cause real harm to the legitimate commercial or legal interests of suppliers, contractors, the public sector client or any other party.

4 This guidance, taken together with initiatives by departments and agencies, such as the NHS practice of making contractual details available in local libraries, means that PPPs are setting a benchmark for more open government in public sector commerce.

TUPE AND PENSIONS

5 The TUPE regulations[4] protect employees' terms and conditions (other than occupational pension arrangements) when the business in which they work is transferred from one employer to another. The Government's policy on the application of TUPE in PPPs was set out in the Cabinet Office document, Staff Transfers in the Public Sector: Statement of Practice, published in January 2000. The policy is based on the following principles:

[4] Transfer of Undertaking (Protection of Employment) Regulations (1981) as amended

- contracting exercises with the private sector and voluntary organisations will be conducted on the basis that staff will transfer and TUPE should apply, unless there are genuinely exceptional reasons not to do so;

- this includes second and subsequent round contracts that result in a new contractor, where staff originally transferred from the public sector; and

- there should be appropriate arrangements to protect occupational pensions, redundancy and severance terms of staff in all these types of transfers.

6 The Government's approach to the protection of staff pensions in PPPs was announced in June 1999 by the then Chief Secretary, Alan Milburn. His five point plan ensures that:

- staff are offered pension packages by the new employer under which they can earn pensions through their future service on terms which are at least broadly comparable to those available from the public sector employer. (Broad comparability involves a detailed assessment to ensure that no member of staff would suffer material detriment to their overall pension terms when they switch pension schemes on moving from the public sector - this may mean that some transferred staff will be better off under the new pension arrangements);

- this applies also to former public sector staff who are subsequently transferred to another private sector employer either because the contract for services from the private sector is re-tendered, or because of sub-contracting which is integral to the contract;

- there will be full consultation with staff and their unions about how pensions are being protected, including open disclosure of actuarial advice and an explanation of how the new pension arrangements satisfy the conditions for broad comparability set out in a published Statement of Practice by the Government Actuary's Department;

- there should be bulk transfer agreements which will give staff the option of transferring their accrued pension credits to the new employer's pension scheme on a fully protected basis; and

- business deals involving staff transfers will not be signed unless any unresolved employee concerns have been considered by the appropriate Departmental Minister.

7 The Government will also consider arrangements for staff transferring to the private sector to retain active membership of a public sector pension scheme where this can be done on the basis of the private sector partner becoming a "non-associated" employer within the public sector scheme. This is possible where the public sector pension scheme is funded, and is the arrangement announced for London Underground and NATS.

NEW OPPORTUNITIES AND NEW SKILLS

8 The transfer of public sector organisations into the private sector often increases the potential for growing the business, in particular through selling into wider markets or diversification. One example is the PPP for National Savings, where the partner has undertaken to create new job opportunities for staff no longer required in the National Savings business.

9 In addition, most commercial organisations recognise that their staff are the most important asset they have, and investment in the business includes investing in a skilled workforce. In the case of BNFL, one of the performance targets set for the company by the Secretary of State includes the commitment to monitor targeted improvements in skill enhancement and productivity levels. This not only emphasises to employees the key part they play in the future success of the business, but is also an important element in demonstrating that the future of the company is inextricably tied to the development of its staff and their active involvement as partners in the business.

EMPLOYEE PARTNERSHIP SCHEMES

10 In addition to the new opportunities and new skills that PPPs should bring, the Government will also consider what other mechanisms would be appropriate to provide the right incentives to staff, so as to involve them as active members of the partnership. There is a wide range of potential employee partnership schemes, from simple performance-related pay schemes, which for example may be appropriate for PPPs involving administrative activities, through to the type of schemes used in private sector companies for PPPs involving state-owned businesses (more details below). The particular arrangements need to be decided on a case by case basis, and it may sometimes be appropriate to invite potential private sector partners to make proposals as part of the bidding process.

Partners in the long term success of the business

11 In some PPPs, particularly those which involve the introduction of private sector ownership and other commercial disciplines into state-owned businesses, the Government is developing employee partnership schemes which provide staff with a financial stake in the long term success of the business. The key objectives for such schemes are to:

- recognise that all employees at all levels - not just management - are a key asset of the business;
- ensure that employees are long term partners in the economic benefits of the PPP;
- provide employees and management with incentives to improve the performance of the enterprise during the run-up to the PPP being established, to maximise the value realised from the introduction of the private sector partner;
- provide employees with incentives to improve performance and productivity of the PPP on an on-going basis, by aligning the interests of employees with those of investors, giving them a medium/long term interest in the company; and
- contribute to the Government's target of doubling the number of companies offering shares to all employees.

12 How these objectives are achieved will depend on the form of the PPP and the stage of its development:

- in a PPP involving a flotation, employees could be offered shares, for example within the structure of the Government's proposed new employee share scheme, announced in November 1999, which will provide for long term share holding and not short term sale. Share allocation may also be linked to the performance of employees and the business as a whole;

- in a PPP involving a trade sale or the introduction of a single private sector partner, an employee share scheme can still be used but, in the absence of a publicly-quoted share price, arrangements need to be put in place to ensure employees have clear incentives to grow the value of the business. Again, share allocation may be linked to the performance of employees and the business as a whole;

- furthermore, an employee partnership scheme could be put in place before the PPP, with employee allocations dependent on the performance of employees and the business as a whole during the run up to the PPP (for example by linking it to the achievement of performance targets). As noted in Chapter 3, this is particularly worth considering in the case of flotations where the recent track record of the business is a key factor in the value realised at the time of the PPP. However, prior to the flotation, such schemes would operate on a shadow basis, for example by allocating phantom shares;

- where part or all of the organisation will remain in the public sector, the Government will consider how employees may best be provided with incentives to improve performance.

6 DEVELOPING INNOVATIVE PARTNERSHIPS

1 Finally, the Government recognises that the concept of PPPs goes well beyond the traditional areas of public enterprises and the PFI. PPPs are about changing the way in which the Government does business and interacts with the private sector across the board. The Government has developed a number of innovative approaches to policy advice and implementation and the involvement of business in improving the efficiency of the public sector.

WIDER MARKETS

2 In November 1997, the Government published the National Asset Register, the first ever list of the Government's assets. At the same time, it announced incentives to dispose of assets it no longer needs and make better use of those it does, in particular by spreading best practice. These incentives are encouraging Government departments and agencies, where appropriate, to work in partnership with the private sector to exploit the surplus or latent potential of Government assets. These Wider Markets projects can cover physical assets such as land, premises and equipment, as well as the skills and know how of Government staff, and intangibles such as intellectual property. While it is still early days, the benefits of these projects will include the revenues which can help meet core departmental objectives (though in comparison with other PPPs, these projects are often quite small), and exposure to commercial disciplines through the partnering and contracting process.

3 Examples of public private partnerships in this area include:

- the Royal Parks Agency, which has a partnership with Cardington plc delivered through a company, Royal Parks Enterprises, to develop an extensive range of commercial activities using or based on the Royal parks in London including St James's Park, Hyde Park and Regents Park. These activities include concerts, such as Party in the Park and other open air activities, as well as sponsorship, publishing and licensing opportunities using the Royal Parks brand;

- the Medical Research Council (MRC) has established a venture capital fund, UK Medical Ventures Management, a partnership between the MRC and range of private sector organisations to provide commercial advice and financial backing for technologies originating in the MRC's in-house research programme. A number of investments have been made in start up companies arising from the MRC's technology and in which it holds a continuing equity stake;

- the Roslin Institute in Edinburgh established a spin out company 42% owned by the Institute into which were transferred the nuclear transfer (cloning) patents underpinning Dolly the cloned sheep. The Institute has capitalised on its initiative and on the investment from British venture capitalists who backed the venture initially by selling the company, Roslin Bio-Med, for around £17 million plus a further £12.5 million from the buyer to fund further research to develop cloning technology;

- the Defence Evaluation and Research Agency (DERA) has the potential to transfer technology developed for the military into the civil sector. Scientists at DERA played a major role in the development of Liquid Crystal Displays (LCDs). DERA has begun to develop a partnership approach to the exploitation of its intellectual property, for example through the licensing of its technology for producing flat loudspeakers to a British company, NXT. Most recently, DERA has entered its first equity joint venture (with the same company, NXT) to develop its speech recognition technology;

- the Foreign and Commonwealth Office's Global Purchasing Group has a partnership with the Australian Government for the supply of furniture and equipment for diplomatic residences around the world. The arrangement allows the FCO to reduce its own costs by spreading its overheads over a wider range of contracts; and

- more recently, the Baker Report on commercialising public science has given further impetus to wider markets projects involving intellectual property and know-how. The Government is currently looking at how it can support the development of public private partnerships to exploit public sector science.

POLICY FORMULATION

4 Business people have played an important role in advising the Government on policy issues over the years. However, the Government is now using the advice of business more proactively and more deeply in developing policy across a much broader range of policy areas than before:

- the New Deal programme has been formulated on partnership principles. The Government has been advised by a Task Force drawn from the private, public and voluntary sectors, chaired by Peter Davis of the Prudential. This Task Force has been supplemented by a wide range of working groups which have drawn heavily on business expertise. The partnership approach has been accompanied by strong and sustained support and participation by businesses in the New Deal's private sector option;

- the National Skills Task Force was set up in Spring 1998 to advise on the development of the national skills agenda, to ensure the UK has the skills necessary to sustain high levels of employment, compete in global markets and provide opportunities for all. Its members are drawn from a wide variety of backgrounds, but around a third of its members are business people or from bodies representing business such as the British Chambers of Commerce and the CBI;

- the Creative Industries Task Force established by the Secretary of State for Culture, Media and Sport, like the New Deal, has drawn heavily on the private sector which makes up around half its number. The Task Force has been instrumental in focusing the review around mapping the economic value of the creative industries. A number of specific initiatives are now under development, drawing on the expertise of private sector members, focusing on key issues such as the skills base, finance for creative ventures, export promotion and intellectual property;

- the DTI's Competitiveness Council was established in July 1999 to advise the Secretary of State for Trade and Industry on a range of issues related to the UK's level of competitiveness. The main role of the Council will be to provide comment and advice on the implementation of the Competitiveness White Paper and to identify follow-up work and areas for future policy development. The Council, which includes leading business people and entrepreneurs from a whole range of British industry and commerce, puts business at the heart of the Government's partnership approach to improving UK competitiveness; and

- the Public Services Productivity Panel was established late in 1998 to advise on raising levels of productivity and efficiency in the public services. The Panel consists mainly of leading private sector managers, is chaired by the Chief Secretary, and reports to the Cabinet Committee which oversees departments' progress against their Public Service Agreements. The Panel is in the process of publishing its first set of project reports: departmentally-based reviews of performance management practices. The Panel is also producing a report pulling together the lessons learned from its projects, which will be published in the summer.

POLICY IMPLEMENTATION

5 Partnership approaches to policy implementation extend beyond the PFI and capital projects described earlier in this paper. The Government is committed to finding the most appropriate means of meeting all of its policy objectives, and of allocating risk between the public and private sectors according to which is best placed to bear it. These principles can be applied across a wide range of policy areas. Innovative new public private partnerships are being developed as a result. For example:

- Education Action Zones (EAZs), area-based partnerships in areas of the greatest educational need, are based on the principles of partnership. It is early days for the EAZs. However, by involving all the stakeholders of the education process, including the employers whose businesses suffer from a poorly educated workforce, EAZs have a greater incentive and ability to focus on the key issues affecting education in deprived areas and to identify and deliver on the action necessary to improve performance;

- School-business link activities are another example of innovative public private partnerships. There is already substantial investment from businesses and schools in partnerships which stimulate pupils' interest in enterprise, improve pupil achievement and help with the professional development of teachers and business people. But there is much room for improvement in the current provision and quality of SBLs. Peter Davies, Managing Director of Business in the Community, completed a report in July setting out a new agenda for SBLs. He concluded that the Government should encourage more business involvement in effective school partnerships. A new £10 million package to boost SBLs was announced in November 1999 in the Pre-Budget Report, along with a national network of entrepreneurial ambassadors - business people who will act as role models and mentors; and

- Social Housing - Some of the Housing Action Trusts set up to revitalise former local authority housing estates have signed or are planning innovative partnership deals involving private investment by Registered Social Landlords (RSLs). Tenants are rehoused sooner than would be possible with public funds alone; less is spent on keeping habitable homes that are to be replaced; and the RSLs share some of the financial uncertainties that arise from tenants having a choice of future landlord. The involvement of RSLs and their funders broadens the range of agencies with an interest in ensuring that Trusts' achievements are sustained in the longer term.

6 In its support for enterprise, the Government is moving away from subsidies towards approaches based on partnership. Some projects involve shared Government and private sector objectives such as increased investment, research and development or improved productivity. Here

Government funding is being tied to the achievement of milestones. Elsewhere, the Government is pump-priming investment through repayable loans. Examples of these approaches include:

- the DTI's Enterprise Fund which includes proposals for a series of regional venture capital funds and a national high technology fund. The Government's approach here has been to act as a catalyst, by investing first in venture capital funds which will be backed by City institutions and other investors and managed by private sector venture capitalists on investors' behalf; and

- recent loans from the Launch Investment programme, which provides repayable finance for major civil aerospace investments, have been awarded on terms that provide a real return to Government.

7 These new approaches to industrial assistance seek to allocate responsibilities appropriately between the public and private sectors. They recognise and reward the risk involved and produce a stream of future revenue payments to facilitate further industrial assistance in the future. But the public sector's contribution can only be delivered by effective partnerships which give the private sector the scope and incentive to manage the larger share of the financial risk.

THE FUTURE: A PROSPECTUS FOR PARTNERSHIPS

8 In his Foreword to the Better Government White Paper, the Prime Minister described the modernisation of Government as:

> "a vital part of our programme of renewal for Britain. The old arguments about Government are now outdated - big Government against small Government, interventionism against laissez-faire. The new issues are the right issues: modernising Government, better Government, getting Government right."

9 Partnerships have a key role to play. As the culture of partnership working extends further throughout Government, innovative solutions are being developed all the time. The range of opportunities is as wide as the range of Government business itself.

10 But partnership is not a panacea. In the future, as in the past, it is vital that partnerships are not seen as a formulaic approach - a new dogma - but are used where it is right to use them, where they add value.

11 The Government's approach is therefore to deliver partnerships that are:

- appropriate. Using the approach that works best is a key part of the modernisation agenda. This applies as much to partnerships as anything else, so that partnership arrangements reflect the circumstances in which they are to be implemented and the objectives which they are intended to serve;

- imaginative. Whether in traditional areas such as PFI and asset sales, or in newer areas such as joint ventures and policy partnerships, innovation is crucial. At this early stage in the development of the partnership approach, creating new ways of working - learning by doing - is key, particularly where there is no existing best practice; and

- holistic. Effective partnerships occur where there is synergy, not just between the public and private sectors, but where different Government activities are combined and delivered more effectively. In practice it means an holistic approach: joined-up thinking, reflecting the needs of customers, potential partners and providers, as well as joined-up Government rather than the narrow defence of departmental territory.

Partnership Models

12 This paper has considered a wide range of partnership models. Each is appropriate in certain circumstances; none is appropriate in all. Partnerships bring opportunities, but they also bring challenges which must be addressed if they are to fulfil their potential within the modernising agenda.

13 The remainder of this chapter sets out different broad types of partnerships and the opportunities and challenges posed by each. There is clearly some overlap, with a number of existing PPP projects fitting into more than one category, and some of the same opportunities and challenges apply to a range of PPP types.

(i) Asset Sales

Definition: the sale of surplus public sector assets.

Opportunity: to release the potential of public sector assets by exploiting private sector finance and management, and other private sector skills and capabilities.

Challenge: to safeguard any continuing public sector interest in such assets, and to ensure the taxpayer receives value for money, both at the time of the sale and by sharing in any future growth in the value of the asset.

(ii) Wider markets

Definition: introducing the skills and finance of the private sector to help make better use of assets (both physical and intellectual) in the public sector.

Opportunity: to exploit the potential of public sector assets (both physical and intellectual) which cannot easily be sold, and to share in the returns.

Challenge: to identify assets where such potential exists, and to ensure that the taxpayer receives a fair share of the returns.

(iii) Sales of businesses (by flotation or trade sale)

Definition: the sale of shares in state-owned businesses, by flotation or trade sale, with the sale of a minority (e.g. BNFL) or majority (e.g. CDC) stake.

Opportunity: to lever-in private sector investment, capital market disciplines and therefore improved management performance, to release the potential of state-owned businesses.

Challenge: to ensure that the benefits of the PPP are shared fairly with employees, customers and the taxpayer, for example by linking the timing of the PPP to the progress of the business in meeting targets set by Government which are associated with growth of shareholder value; setting up employee partnership schemes which provide incentives to improve performance in the run up to the PPP and beyond; and by ensuring there is effective competition or regulation in place, and other mechanisms as appropriate, to protect the public interest and deliver a better service for customers.

(iv) Partnership companies (e.g. NATS)

Definition: introducing private sector ownership into state-owned businesses, while preserving the public interest and public policy objectives through legislation, regulation, partnership agreements, or retention by Government of a special share.

Opportunity: to bring in the benefits of private sector ownership described above, including private sector investment and management skills, while safeguarding the continuing public interest in the business.

Challenge: as with sales of businesses described above. In addition, the Government will ensure that arrangements to safeguard the public interest are targeted, so as not to restrict unnecessarily the scope for private sector management to add value.

(v) Private Finance Initiative

Definition: the public sector contracts to purchase quality services, with defined outputs, on a long-term basis from the private sector, and including maintaining or constructing the necessary infrastructure. The term also covers financially free- standing projects (e.g. the Second Severn Bridge) where the private sector supplier designs, builds, finances and then operates an asset and covers the costs entirely through direct charges on the private users of the asset, with public sector involvement limited to enabling the project to go ahead through assistance with planning, licensing and other statutory procedures.

Opportunity: to benefit from private sector innovation, to generate radical new synergies between the design and operation of assets, and to take advantage of private sector commercial discipline, so helping to modernise public services and obtain better value.

Challenge: to define clearly the requirements on the private sector partner from the start (for example through a robust performance regime), and to ensure there is a proper and appropriate allocation of risks between the public and private sectors, so as to deliver real improvements in the quality of service provided, and value for money for the taxpayer.

(vi) Joint Ventures

Definition: partnerships in which public and private sector partners pool their assets, finance and expertise under joint management, so as to deliver long term growth in value for both partners.

Opportunity: to exploit the latent potential of Government assets, and to share the risk of delivering policy objectives and, where appropriate, commercial objectives as well, while enabling the public sector partner to retain on-going involvement and a share in the financial benefits of the project. Joint ventures can include contractual agreements, for example licences, profit and revenue sharing agreements, or formal corporate joint ventures with one or more public or private sector partner.

Challenge: judging when to use joint ventures rather than more conventional partnerships, and how to create the right balance of risks and rewards for the public and private sectors. Structures need to work commercially, and be sufficiently robust to withstand public scrutiny.

(vii) Partnership investments (applies to certain Regional Selective Assistance and Launch Investment cases)

Definition: Partnerships in which public sector contributes to the funding of investment projects by private sector parties, so as to ensure that the public sector shares in the return generated by these investments.

Opportunity: the original rationale for these programmes was to try to overcome market failure by providing finance for projects with commercial potential but where the size, risk, or timescale of the investment, or the political context, mean that the capital markets are unable fully to fund the costs. Redefining these programmes as partnership investments allows the taxpayer to share in the future returns from the project.

Challenge: to ensure that such investments offer value for money, and in particular that the terms of the investment provide the public sector with returns commensurate with the risks it is taking on.

(viii) Policy Partnerships

Definition: arrangements in which private sector individuals or parties are involved in the development or implementation of policy.

Opportunity: to introduce new thinking and relevant experience in the resolution of long-standing policy problems and in meeting the innovative challenge of modernising Government.

Challenge: the challenge here is one of culture and specifically of openness to change. Developing policy through partnership means challenging traditional ways of doing things and traditional assumptions of what needs doing. For any organisation, public or private, this is a difficult, painful but valuable process.

Modernising Government through partnership – The next steps

14 Too often in the past, change in Government has been implemented inflexibly from the centre. This, combined with inertia and unwillingness to embrace reform found in some parts the public sector has weakened the value of the partnership approach. But there is now a range of policy drivers, both through the Treasury-led spending review process and through the Cabinet Office's policies, to encourage Departments to review their businesses, and to take steps to develop them in the best interests of service consumers.

15 The drivers of change include:

- the 2000 Spending Review which will provide a framework for the further modernisation of public services in general;
- the Cabinet Office's Better Quality Services initiative, which encourages the development of partnerships for public services, whether alone or as part of PFI and other partnership arrangements (see box below).

16 These drivers will be underpinned by greater transparency through:

- the Review of the National Asset Register, the results of which will be published, and which will benchmark how well Departments have performed in reviewing their assets and the use they make of them. This should stimulate further opportunities for partnership; and

- this in turn will feed into Departmental Investment Strategies. These will be submitted as inputs into the Spending Review, which will report in the summer, and will be published after the conclusion of the Review. Building on last year's exercise, DISs will provide an opportunity to review how partnerships can be used in relation to capital assets, both new and existing.

17 In addition, there are on-going opportunities through prior options reviews, further use of benchmarking and other business process reviews which should be used as much and as far as possible.

18 This concluding chapter has set out the principles which will underpin the future of public private partnership policy. It has also considered the range of partnership options available, some of the ways in which they can be used, and the issues which need to be addressed when implementing them. In addition, it has looked at the policy drivers which provide the opportunities for Departments to take the next steps. Ultimately, however, the challenge of modernisation lies with Government Departments. It is now up to them to rise to it.

Better Quality Services

The focus of Better Quality Services (BQS) is on improving what is delivered, rather than taking a dogmatic line about whether this is best achieved through private, public or partnership solutions. BQS is a comprehensive programme across central Government. It covers all activities in departments, agencies and executive NDPBs. All services and activities, including policy and headquarters functions, are reviewed over a five year period.

What is a Better Quality Service review?

Individual reviews generally cover a specific service or part of a department (eg HQ personnel function) rather than the whole organisation. The aim of each review is to re-consider what service is needed, in consultation with users, and then identify the best supplier to deliver both cost and quality gains year on year. Each BQS review considers the following five options:

- abolition;
- introduction of private sector ownership;
- strategic contracting out;
- market testing; or
- internal re-structuring.

Under contracting-out or market testing, competitive tendering is required. Under internal re-structuring, benchmarking is used to set improvement standards.