PFI : meeting the investment challenge

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INTRODUCTION

I.1 This document explains the PFI programme's small but important role in the delivery of the Government's investment plans for public services. It explains the Government's approach to PFI based on clear limits on its appropriate use and a rigorous assessment of value for money with no bias in favour of any particular procurement route. It presents the results of research conducted into the performance of PFI, and outlines the steps already taken to improve the programme through building the partnership between public sector client and private contractor. It also outlines the steps the Government has taken to ensure that PFI's value for money is not obtained at the cost of employees' terms and conditions. Finally, it proposes further improvements to the Government's process for assessing value for money, its systems for delivering projects and its ability to capture efficiently the benefits of private finance. This document is concerned only with the Government's PFI programme, and not other forms of public private partnership (PPP). Its policy proposals have direct effect only in England, as policy on PFI is devolved in Scotland, Wales and Northern Ireland.

MEETING THE INVESTMENT CHALLENGE

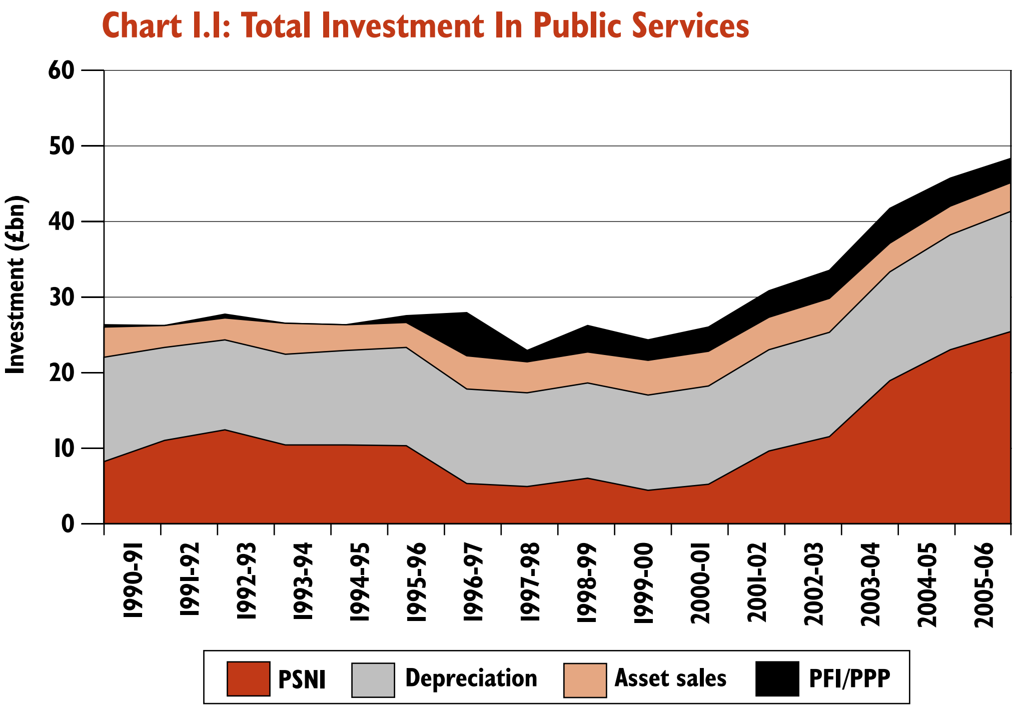
I.2 The Government's objective is to deliver world class public services. To achieve this, sustained increases in investment and matching reforms are needed to deliver efficient and responsive services, which meet public expectations throughout the country. Strong and dependable public services lay the foundations for a flexible and productive economy. They also promote opportunity and security for all, helping to tackle poverty and social exclusion and improving the quality of life. Chapter 2 contains detailed information on the Government's extensive programme of capital investment in the public services, and PFI's place within that programme.

I.3 A prerequisite for delivering high quality public services is having the right public service infrastructure in place. In 1997, Public Sector Net Investment (PSNI)stood at just £4.9 billion – 0.6 per cent of GDP – the lowest level for more than a decade. Investment in public services had been on a declining trend since the 1970s, resulting in falling standards in schools, hospitals and other public service assets.

I.4 The Government is committed to reversing this legacy of under-investment in public service infrastructure. Public Sector Net Investment will rise to 2.1 per cent of GDP by 2005-06, while total investment – which includes PSNI, depreciation, recycled proceeds from asset sales and estimated private sector investment in public services through PFI and PPPs – is set to rise to more than £47 billion over the same period. This is the largest sustained increase in public sector investment in over twenty years.

I.5 The vast majority – over 85 per cent – of this increased investment is conventionally procured public investment, with the proportion of estimated private sector investment in public services through PFI remaining relatively constant over the period 1998-9 to 2003-4 at between 10 and 13.5 per cent of total investment. This overall picture does not change when looked at for individual departments.

I.6 This investment programme is beginning to deliver extensive new and modernised infrastructure to public services. PFI investment has now delivered over 600 operational new public facilities, including 34 hospitals and over 200 new and refurbished schools. The decision to undertake PFI investment is taken on value for money grounds alone, and whether it is on or off balance sheet is a subsequent decision taken by independent auditors and is not relevant to the choice of procurement route. Almost 60 per cent of PFI projects by value are on balance sheet.



Source: Budget 2003. PFI figures are for deals signed to date and report capital investment expected under signed contracts in the year that investment takes place.

THE GOVERNMENT'S APPROACH TO PFI

1.7 The Government only uses PFI where it is appropriate and where it expects it to deliver value for money. In assessing where PFI is appropriate, the Government's approach is based on its commitment to efficiency, equity and accountability and on the Prime Minister's principles of public service reform. PFI is only used where it offers value for money, where it can meet these requirements, and where the value for money it offers is not at the cost of the terms and conditions of staff. The Government is committed to securing the best value for its investment programme by ensuring there is no inherent bias in favour of one procurement option over another. Chapter 3 lays out in more detail the Government's approach to PFI, and its analysis of where it is appropriate and effective.

1.8 Evidence to date suggests PFI is appropriate where there are major and complex capital projects with significant ongoing maintenance requirements. Here the private sector can offer project management skills, more innovative design and risk management expertise that can bring substantial benefits. Where it is effective, PFI helps ensure that desired service standards are maintained, that new services start on time and facilities are completed on budget, and that the assets built are of sufficient quality to remain of high standard throughout their life. These are some of the value for money benefits which PFI can provide. They are outlined in more detail in paragraph 3.14.

1.9 However, PFI is unlikely to deliver value for money in other areas, for example where the transaction costs of pursuing PFI are disproportionate compared to the value of the project or where fast paced technological change makes it difficult to establish requirements in the long term.

Box 1.1: PPPs and PFIs

In 2000, the Government published "Public Private Partnerships – the Government's Approach" which defined public private partnerships (PPPs) into three categories:

- **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.**

This document is concerned only with the Government's PFI programme, and does not relate to or include information about investment undertaken by other kinds of PPP.

1.10 To be effective, PFI needs to be managed as a mature relationship between the public and private sectors that recognises their mutual responsibilities. PFI relationships are very different from privatisation, in which the market and price mechanism defines the service provided. The private sector has always been involved in the building and maintenance of public infrastructure. PFI ensures that contractors are bound into long-term maintenance contracts and shoulder the responsibility for the quality of the work they do. With PFI, the public sector defines what is required to meet public needs and remains the client throughout the life of the contract. The public sector also ensures, by contract, delivery of the outputs it sets and has rights under those contracts to change the output required from time to time. Consequently, with PFI the public sector can harness the private sector to deliver investment in better quality public services while maintaining frontline services in the public sector.

1.11 While an effective client relationship with the private sector is important to ensure PFI is a success, the Government places equal importance on working with both employees and the private sector to ensure staff are protected. Equally there needs to be an optimal sharing of risks between the private and public sector. There are certain risks that are best managed by the Government and to seek to transfer these risks would either not be viable or not offer value for money for the public sector.

1.12 Where this sharing of risks is done appropriately and effectively, it is the key to ensuring that the value for money benefits in PFI projects are realised. The benefits PFI can offer, in terms of on time and on budget delivery and whole-of-life costing, all flow from ensuring that the many different types of risks inherent in a major investment programme – for example construction risk or the risk associated with the design of a building – are borne by the party who is best placed to manage them. In this way, the private sector is incentivised by having its capital at risk to perform well, and takes responsibility for the work it undertakes. Paragraph 3.29 gives an overview of the Government's approach to risk-sharing.

1.13 While the private sector takes on the major project performance risks, like cost overruns and delay, key risks in an investment project are retained by the public sector in both conventional procurement and in a PFI scheme. These include the need to make alterations in the delivery of services necessary to reflect changing needs of the public sector in the future. The Government also needs to protect the ongoing delivery of public services. For those services provided through PFI, the contract entered into with the private sector builds in major protections for the public sector to safeguard the standards of delivery by PFI schemes in public services, and their flexibility in future.

PFI – AN ASSESSMENT

1.14 The Government is committed to ensuring that decisions on investment, whether through conventional procurement routes or PFI, are informed by a sound evidence base and meet its requirements of equity, efficiency, and accountability.

1.15 Research conducted by the Government and others, particularly the National Audit Office (NAO), confirms the largely positive impact of PFI to date and highlights areas where there is scope for further improvements. Chapter 4 provides details of HM Treasury research of 61 PFI projects. The key findings were:

- 89 per cent of projects were delivered on time or early;
- all PFI projects in the HM Treasury sample were delivered within public sector budgets. No PFI project was found where the unitary charge had changed following contract signature – other than where user requirements changed;
- 77 per cent of public sector managers stated that their project was meeting their initial expectations; and
- there is scope to reduce procurement times, although there is evidence that new intiatives to tackle this problem are having an impact.

1.16 As outlined in Box 1.2, the NAO undertakes a rolling review of all Government procurement and procurement policy, including PFI procurement. In many cases the NAO's findings have been positive. For example, its investigation into PFI's construction performance demonstrated that over 75 per cent of PFI projects were delivered on time or early, and in no case did the public sector bear the cost of construction overruns, a significant improvement on previous non-PFI experience.

1.17 Equally, the NAO's critical review function has been demonstrably beneficial in highlighting areas of PFI procurement policy that required attention. For example:

- the NAO's recommendations on refinancing contributed to the Government's issuing of guidance on refinancing in future PFI projects and to the drawing up of the refinancing Code of Conduct; and
- the NAO's emphasis on the proper use of the Public Sector Comparator in the procurement process has provided support for the need for reforms to the value for money appraisal process laid out in Chapter 7 of this document.

1.18 Research has also provided valuable evidence on project performance in low capital value schemes and in IT, the results of which have informed decisions on when PFI may not consistently deliver value for money and where other procurement routes could offer a better alternative in future. This research is outlined in paragraphs 4.27 to 4.56.

Box 1.2: The National Audit Office, Public Accounts Committee and other audit bodies

The National Audit Office (NAO) is the primary body charged with assessing the Government's PFI programme. In this capacity it audits procurement policy, the conduct of procurement, and the value for money of selected individual projects, for both PFI and non-PFI procurement routes. In its capacity as auditor of central government Departments' accounts, it also audits the balance sheet treatment of Departments' PFI projects.

The Public Accounts Committee (PAC) frequently follows up reports produced by the NAO with hearings and reports of their own, placing Government policy and activity under Parliamentary scrutiny, and making recommendations on policy areas. Individual Departments are accountable for projects they procure. HM Treasury is accountable for overall PFI policy.

The NAO and PAC not only investigate, report and make recommendations based on significant individual PFI projects, but also conduct systematic reviews of important PFI policy areas or other aspects of the programme. Recent examples include the NAO's reports on construction performance in PFI and public sector contract management, and the PAC's overview report on securing value for money in PFI procurement.

The NAO have published 31 reports to date on PFI, and the PAC has published 24 further reports. The majority of NAO reports (26) have investigated individual projects such as the redevelopment of the West Middlesex University Hospital. Five reports have looked at sector or general PFI issues, for example construction performance and PFI prisons. The full text of the NAO's reports is available on their website at www.nao.gov.uk. Reports published by the PAC are available, along with the Government's response to each report, on the House of Commons website at www.publications.parliament.uk/pa/cm/cmpubacc.htm

The NAO now produces a database of its recommendations and those of the PAC on PFI policy – and also on PPPs and aspects of privatisation – which can be searched by topic area. It is available on the Internet at www.nao.gov.uk/recommendation.

A number of other audit bodies have areas of PFI procurement within their remit, including the Audit Commission and Audit Scotland. The Audit Commission is responsible for auditing public money spent by local authorities, NHS bodies and others in England and Wales and has published reports on PFI in these areas. Audit Scotland plays a similar role for the Scottish Executive and public bodies in Scotland.

IMPROVING THE PARTNERSHIP

1.19 Strong procurement skills are vital for delivering quality investment on time and in a way that secures value for money for the public sector. It is important that authorities have the capacity and the support needed to pursue both conventional procurement and PFI effectively. PFI requires relevant expertise – like other large and complex procurements – because it involves long-term options appraisal, significant use of specialist advisers and what can be complex contract negotiations reflecting the Government's approach to risk sharing. The steps that the Government has already taken to raise the skills level across public procurement are set out in Chapter 5.

1.20 The Government has therefore already introduced a number of measures to support the public sector in its role as a client in PFI and other procurement. To ensure that strong procurement skills are developed across the public sector, the Government has established Partnerships UK. Partnerships UK is a public private partnership whose principal objective is to support all parts of the public sector, including the devolved administrations, by providing specialist procurement expertise. Procuring authorities are able to call upon Partnerships UK to help them identify and remove obstacles to the successful and timely implementation of particular projects. The Office of Government Commerce has also introduced the Gateway process as a performance management tool to ensure successful delivery. The Gateway process provides the framework for a rigorous assessment of the deliverability of projects, including PFI schemes, throughout the procurement process. In this way it helps ensure that any potential problems in the procurement process can be identified and addressed at an early stage. These measures are outlined in more detail in Chapter 5

1.21 In recognition of the particular needs of local authorities, who may only be engaged in 'one-off' procurements the Public Private Partnership Programme (4Ps) was established. This provides support to local authorities through the provision of advice and guidance notes on PFI projects and is working with the Government to increase the standardisation of local authority contracts. The Government also introduced the Project Review Group to review the progress of local authority projects so that best practice can be shared more effectively.

1.22 The Government is also committed to ensuring that bid costs for both private and public sectors are kept as low as possible, and that the PFI procurement process runs smoothly and without delay. High costs or long delays in the PFI bidding process slow delivery and impact on value for money for the public sector and, if unchecked, may reduce competition for PFI projects. Similarly, high bid costs may influence the returns sought by the private sector from PFI projects. Improving the public sector's ability to procure PFI projects plays a key part in helping reduce bid costs and deliver more effective projects. The importance of partnership between the public and private sectors in PFI procurement is highlighted in paragraphs 5.27 to 5.35.

EMPLOYEE PROTECTION

1.23 The Government is committed to ensuring fair and reasonable treatment for workers in PFI projects. The value for money that PFI provides should not be achieved at the expense of staff terms and conditions. Chapter 6 sets out the Government's approach to ensuring fair and reasonable treatment for staff in PFI projects, and the principles which lie behind it. It goes on to outline the steps taken since 1997 to protect employees in PFI schemes, including:

- the Fair Deal for Staff Pensions, announced in June 1999, which stated that staff who transfer from the public sector should continue to have access to a good quality broadly comparable occupational pension scheme, with options for handling benefits they have already earned;
- the Cabinet Office Statement of Practice which sets out how staff compulsorily transferred should be treated;
- Retention of Employment in the NHS recognises the specific needs of the NHS. Staff who fall under this agreement remain employed by the NHS and are then seconded to the new service provider; and
- the Best Value code of practice, which came into effect from March 2003 across England. It applies to all new staff employed on PFI, PPP and outsourcing contracts that are covered by Best Value. The code ensures new employees terms and conditions that are "overall, no less favourable" than their transferred colleagues, and requires that employers proved a pension to a given standard.

I.24 Going forward, the Government is also committed to monitoring the implementation and performance of measures taken to avoid new joiners to PFI workforces receiving worse terms and conditions than do transfered staff, as this will be key to establishing future best practice. It is important that the principles behind the code, workforce protection and adequate flexibility to deliver high quality public services, are achieved.

I.25 To ensure that the value for money delivered by PFI does not come at the expense of employees' terms and conditions, Departments have the option of not transferring soft services staff in a PFI project, where they believe their transfer is not essential for achieving the overall benefits of improved standard of service delivery specified by the procurer, and where not transferring staff is consistent with delivering the Prime Minister's commitment to flexibility in public services provision.

ASSESSING VALUE FOR MONEY

I.26 The Government's commitment to PFI rests on its ability to deliver value for money in public investment that is not at the cost of the terms and conditions of employees. The Government's procurement decisions must be based first on its approach to considering where particular procurement options are appropriate and second on an unbiased and rigorous assessment of which of the available options represents the best value for money. It is therefore vitally important that the process of assessing value for money is robust – that it takes place at key stages of the procurement process and that there is the budgetary flexibility to pursue alternative procurement routes if PFI does not prove value for money. This is in order to ensure that there is no inherent bias between procurement routes. Chapter 7 sets out the Government's approach to assessing value for money and outlines measures to ensure its effective use in the procurement process.

I.27 In order to better ensure that investment is always procured through the best value for money option, the Government will be consulting on reforms to the appraisal process including the Public Sector Comparator (PSC), an important tool used in assessing the value for money of PFI projects. The result will be a value for money appraisal process that adopts a comprehensive and analytically rigorous assessment of all the costs and benefits of PFI and builds in the option to pursue alternative procurement routes at any stage if they offer better value for money. The changes proposed are:

- instituting a new test of the potential value for money of procurement options when overall investment decisions are made, to ensure PFI is used only in those sectors where it is appropriate and has a good value for money case;
- reforming the Public Sector Comparator into an early rigorous economic appraisal of an individual project at the stage an outline business case is produced, prior to the procurement of the project, to allow projects to proceed down alternative procurement routes where they offer better value for money; and
- instituting a final test at the procurement stage of a project that would evaluate the competitive interest in a project and the capacity of the market to deliver it effectively.

I.28 In sectors where the evidence and analysis now suggests that PFI procurement does not offer the benefits that had been expected, specifically in the IT sector, and in individually procured projects with small capital values, the Government is reassessing the use of PFI. The evidence on deals with a low capital value, presented in Chapter 7, suggests that they can offer poor value for money because of high pre-contract transaction costs relative to their overall value. Where small individual projects are bundled together, however, value for money can be secured through increased efficiences in procurement. In the IT sector, structural characteristics have proven to be at odds with the principal benefits of PFI, and PFI has not been able to deliver the step-change in performance the public sector requires as outlined in paragraph 7.39. The research showed that in those IT projects which were more successful, contracts had been negotiated to accomodate improved structures, susggesting a move in practice away from a PFI model. The Government will therefore consult with Departments on a level of capital expenditure below which alternative means of procurement will be pursued. The Government will replace PFI in IT with a range of procurement models, better able to deliver, on which it will consult.

1.29 Where PFI has proven and continues to prove to be value for money the Government will use PFI procurement for new investment, for example in delivering vital new infrastructure for schools and hospitals. The Government will also investigate with departments and other stakeholders potential new areas where PFI investment could offer value for money. If there is evidence that these new areas exhibit potential for benefiting from PFI procurement, investigation and consultation would be followed up with a pilot stage to provide further evidence to judge performance in practice. Areas under consideration include moving in the prisons sector from the construction and management of new build prisons to management of the existing prisons estate, urban regeneration, waste management and social housing.

1.30 The Government is committed to transparency in monitoring and reporting on the progress of the PFI investment programme. Since 1997, the Government has increased the information disclosed in the Financial Statement and Budget Report to include:

- a record of future payments contracted for by each PFI scheme; and
- the capital value of contracts signed to date and in procurement.

1.31 The Government plans to build on this by publishing, on an annual basis, a comprehensive statement on the progress of the PFI programme. This will include a complete record of transactions committed to in the previous year, a record of projects that have been completed in the year in question and their performance against expectations, and a statement on potential future transactions by sector.

IMPROVING DELIVERY

1.32 Assessing where PFI could offer value for money is only part of the process in ensuring there is the delivery of quality public services. It is important that the public sector is able to manage the procurement process efficiently, intelligently and in a timely manner in order to maximise the benefits of PFI and other sorts of public procurement, and to be consistent with the need to secure value for money. A lasting step-change in the quality of public services in the UK can only be achieved if the public sector has the skill set necessary to translate increased public investment and facilities fit for modern public services.

1.33 The Government is therefore introducing measures that will help the public sector become a better client and harness the benefits that can be achieved by helping to coordinate public sector activity and be treated as an important client. These measures are detailed in Chapter 8.

I.34 The process of standardising PFI contracts helps spread best practice, improving PFI procurements across the public sector, and reduces the length and cost of PFI procurement. At the same time, the standard contracts maintain flexibility for an individual project to set its needs and requirements, while providing standard terms for those elements of PFI that are common to all procurement processes. To maximise these benefits, a new approach will be taken on the enforcement of standardised contracts by the Project Review Group and by HM Treasury in the future. To help with this process, HM Treasury has agreed with Partnerships UK that it will increase the resources it will make available to support the adoption of standardised contracts.

I.35 Alongside increasing procurement skills within the public sector, it is important to ensure that public sector managers have access to high quality advice. The Government is therefore proposing to put in place over the next 12 months a single information resource, accrediting specialist advisers who have demonstrated their expertise and the quality of their advice in PFI projects in fields such as law, commercial structuring and finance. By implementing this information resource and promoting its use by procuring authorities, the Government will be able to:

- ensure that the public sector is able to act like a single, important client for advice in PFI;
- benchmark the price and quality of advisers, based on evidence of their past expertise and performance, to help authorities secure the best advice and value for money from their advisers; and
- provide positive incentives for advisers to ensure that they give the best advice to Government, utilising their most skilled personnel and full resources, as the accreditation system will provide an effective means for the public sector to reward excellence.

I.36 The Government is also introducing new models of PFI delivery that should provide procurement expertise and support to the public sector in its own assessment and delivery of local public service investment needs. Bundling projects together offers the benefit of increasing the involvement of PFI experts in the procurement process from the earliest stages through to the operational phase of projects and ensures that the timing of projects maximises market interest. Another route is the establishment of public sector procurement bodies specialising in structuring and delivery of PFI projects, which work with local public sector managers to procure projects, to increase the quality of specifications and reduce delays in the process and the procurement burden on local managers. Chapter 8 gives a number of examples of where these models are now being pursued in practice.

I.37 Chapter 8 also outlines where the Government intends to carry out further research on the public sector's ability to identify and secure value for money in practice. In particular, the Government intends to examine the way in which PFI bids are evaluated, and the public sector's record in managing PFI contracts to ensure their flexibility in delivering the requirements of public services in practice.

PRIVATE FINANCE

I.38 The involvement of private finance in taking on performance risk is crucial to the benefits offered by PFI, incentivising projects to be completed on time and on budget, and to take into account the whole of life costs of an asset in design and construction. Private finance in PFI, particularly third-party finance, takes the risks in a project and allocates them to the party best able to manage them. The lenders to a PFI project, as they have significant capital at risk, have a powerful incentive to identify, allocate and ensure the effective management of all the risks the private sector assumes in a project. Private finance therefore plays an important part in PFI's ability to deliver value for money benefits, and will continue to be integral to its success. Paragraphs 3.54 to 3.64 outlines the role of private finance in PFI.

I.39 By involving private finance in PFI, the Government seeks to ensure that it receives the best value for money in securing the benefits it brings, and that its involvement is on a sustainable basis. To facilitate this, as outlined in Chapter 9, the Government intends to:

- maintain a variety of sources of funding for PFI projects to ensure competitive tension, a sustainable spread of investment programme risks across different funders, and a minimal Government exposure to systemic market risks;
- explore the provision of framework funding, particularly in bundled small PFI schemes, to provide a faster, cheaper funding solution for these kinds of schemes; and
- explore through pilot projects the potential role of a form of credit guarantee finance as an additional means of funding PFI projects. This means of financing would retain the private sector lender's risk premium and its benefical role as risk-taker and risk-allocator, but improve overall value for money by utilising the Government's ability to secure funds more cost-effectively.

I.40 The Government also seeks to ensure that the involvement of private finance does not lead to unnecessary inflexibility in privately financed projects. In a standard PFI contract, the public sector has built-in safeguards to ensure it retains the same levels of flexibility as in a conventionally procured project, including the ability to hold competitions for work to implement changes. However, in the extreme case where, because of a wholesale change in public sector requirements, a PFI contract needs to be terminated by the authority, the Government will explore further measures to ensure that termination costs do not limit this flexibility. The measures under consideration are outlined in paragraphs 9.24 to 9.37.

KEY MEASURES

Box 1.3: Summary of key measures from Chapters 7 to 9

To improve the assessment of value for money, and provide for greater transparency, the Government will:

- embed value for money appraisal at three key stages of the procurement process;
- reform the Public Sector Comparator as the second stage of that process;
- reassess the role of PFI, given the evidence, in projects with small capital values and in the IT sector;
- investigate potential new areas where PFI could offer value for money – such as the management of the existing prisons estate, urban regeneration, waste management and new application in social housing; and
- confirm that to ensure that value for money in PFI does not come at the expense of employees' terms and conditions, Departments have the option of not transferring soft services staff in a PFI project, where they believe their transfer is not essential.

To improve delivery in PFI and other procurement routes, the Government will:

- rigorously enforce contract standardisation to reduce bid costs;
- enhance the role of the Project Review Group in monitoring PFI procurement by local authorities;
- set up a system of accreditation of public sector advisers and introduce an information resource accessible to all public authorities to ensure quality in external advisers;
- create vehicles to coordinate procurement in particular areas to put in place, support and share best practice; and
- research the public sector's record in bid evaluation and securing contract flexibility, to ascertain whether and what steps may be required.

To ensure value for money and flexibility in privately financed projects, the Government will:

- explore the provision of framework funding, to make available a faster, cheaper funding solution for bundled small schemes;
- pilot an additional means of funding PFI projects that combines the benefits of private sector risk-taking with the Government's comparative advantage in securing funds; and
- help ensure that the involvement of private finance does not lead to unnecessary inflexibility by consulting on the role of the Spens clause in the termination of bond-funded PFI projects and the continuing value in the private sector hedging interest rate risk.

2 PFI – Meeting the Investment Challenge

The detailed information presented in this chapter on the current place of PFI investment in Government expenditure demonstrates how private finance is contributing to the modernisation of public infrastructure.

The main points are:

- **PFI currently plays a limited but important part in public sector capital investment. Investment under PFI is projected to make up 11 per cent of total investment in public services in 2003–04. The majority – over 85 per cent – of public investment is still carried out through conventional forms of procurement;**
- **investment in public services has increased significantly since 1997, and the PFI programme has expanded in proportion. Both the number and the total capital value of PFI projects has increased, from nine projects with a total value of £667 million in 1995 to 65 projects with a total value of £7.6 billion in 2002. Over the same period, public sector gross investment rose from £17.3 billion in 1997–98 to an expected total of £33.4 billion in 2003–04. However, the proportion of investment made up by PFI has remained steady at between 10 and 15 per cent over this period;**
- **this investment programme is delivering extensive new and modernised infrastructure to public services. A total of 451 PFI projects have now completed construction across a broad range of sectors, delivering over 600 new public facilities including 34 hospitals and 119 other health schemes, and 239 new and refurbished schools; and**
- **the decision to use PFI is taken on value for money grounds alone, and whether it is on or off balance sheet is not relevant. Almost 60 per cent of PFI projects by value are reported on Departmental balance sheets and fully reflected in the Government's national accounts. The Government publishes a complete statement of the costs of PFI facilities, which are fully covered by annual unitary payments, in the Budget document.**

Background

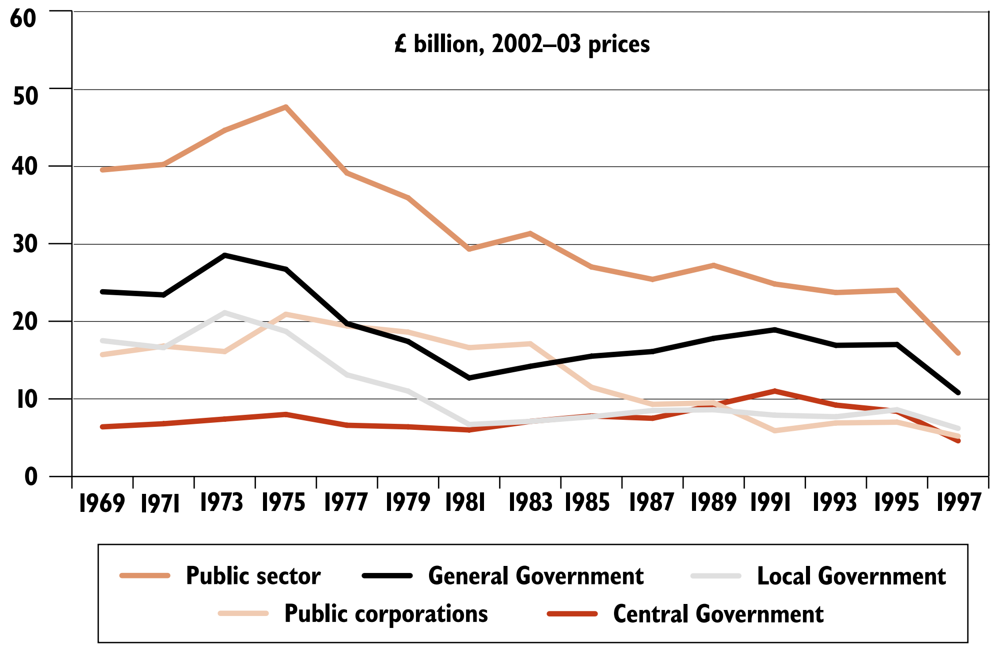
2.1 This section focuses on the scale of the Government's investment plans for public services, and on the size and scope of the PFI programme within that in particular. It illustrates the significant increases in the flow of public investment to the UK's public services, and the historical growth of the PFI market and of private investment in public infrastructure, in line with that increased investment. In reporting the PFI programme, it excludes investment by the private sector in public services not undertaken under PFI-type contracts. It therefore does not include investment by private sector businesses like London and Continental Railways (CTRL) or under Public Private Partnerships (PPPs) like the National Air Traffic Services (NATS), where the Government owns an equity stake in a business. (See Annex B for technical details of the reporting of PFI and PPPs.)

PRIORITISING PUBLIC INVESTMENT

2.2 The UK's public services have suffered from a legacy of under-investment. A repairs and maintenance backlog built up on existing assets, and plans for new investment projects were subject to flaws in the budgeting system which encouraged short termism and a bias against capital spending. Public Sector Net Investment fell by an average of more than 15 per cent each year between 1991–92 and 1996–97, and represented 0.6 per cent of GDP in that year – the lowest level for over a decade.

2.3 This fall in public sector investment translated into a marked decline in general government capital spend, in both central and local government, since the start of the 1990s. Chart 2.1 sets out gross fixed capital formation, the acquisition less disposal of fixed assets, by government sector. These figures show the decline in public corporation and local government capital spend caused by the shrinkage of the public sector over the 1970s and 1980s, and also the downturn in capital investment between 1990 and 1997.

Chart 2.1: Gross domestic fixed capital formation in real terms



Source: HM Treasury

2.4 This record of under-investment in assets produced a damaging backlog of repairs and maintenance that has hampered the ability of public servants to deliver high quality services to taxpayers:

- in 1997 the backlog of repairs in schools was estimated at around £7 billion;
- the backlog of maintenance in NHS buildings in 1997 was over £3 billion; and
- the transport sector had suffered from consistent neglect, and a highly damaging lack of investment in infrastructure.

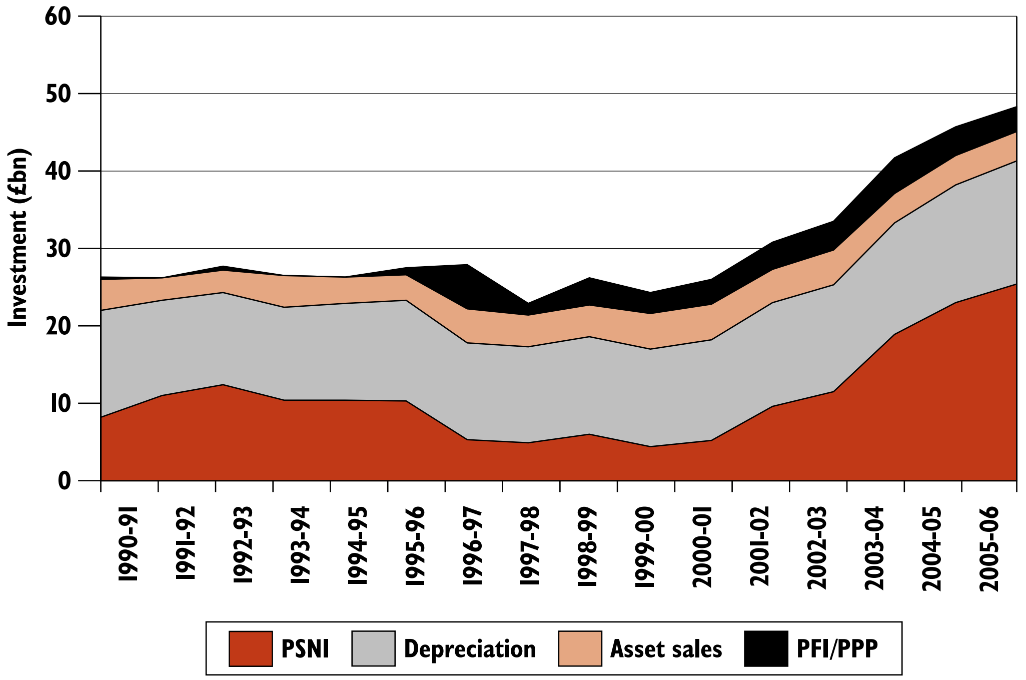
2.5 In order to secure the long-term future of the public services, the Government has significantly increased the total investment flowing into them. By the end of 2005-06, Public Sector Net Investment will be 2.1 per cent of GDP, more than trebling since 1997 as a proportion of GDP and funding sustained investment in the infrastructure of public services.

2.6 To ensure that this increased investment translates into the maximum improvement in public service delivery, it has been matched by reform of the budgeting framework to protect capital investment programmes and to give new incentives for managing the public sector asset base more effectively. PFI represents one option for infrastructure and facilities investment in particular that, in some circumstances, enables the Government to secure value for money for the extra investment it is undertaking.

PFI'S PLACE IN PUBLIC EXPENDITURE

2.7 The Government only uses PFI where it is appropriate, and where it will deliver value for money. Not all investment will be suitable for PFI. This is why PFI accounts for a limited proportion of the Government's capital spending, as illustrated in Chart 2.2. The majority – over 85 per cent – of public investment is still carried out through conventional forms of procurement.

Chart 2.2: Total investment in public services

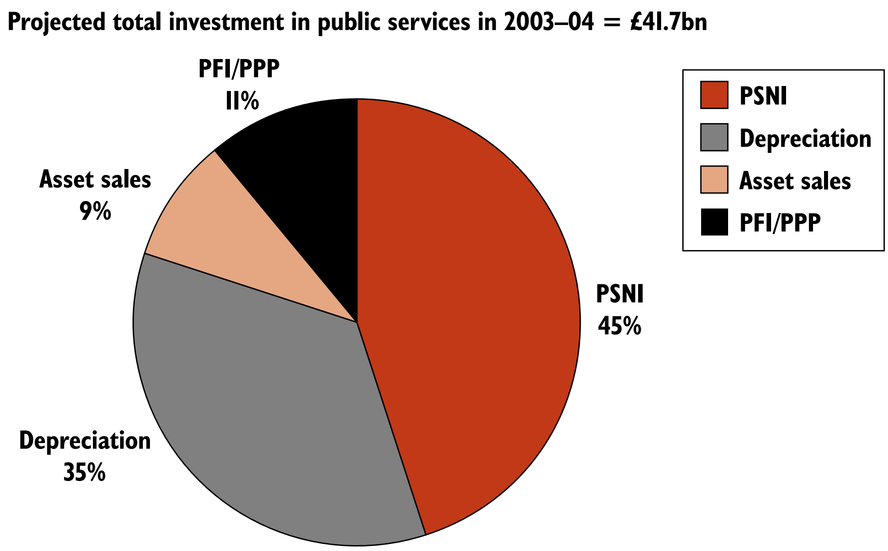


Source: Budget 2003. PFI figures are for deals signed to date and report capital investment expected under signed contracts in the year that investment takes place.

2.8 Total investment in public services will rise to over £48 billion in 2005-06, compared with £23 billion in 1997-98, a 7 per cent average annual increase after inflation. Total UK investment in public services includes: Public Sector Net Investment, reflecting conventional capital spending undertaken within departmental budgets; recycled proceeds from asset sales which are re-invested in capital on top of the budgets already available to departments; depreciation, to reflect the ongoing capital investment in existing assets to repair buildings and carry out maintenance; and investment carried out by the private sector on public service assets under PFI (including maintenance).

2.9 The vast majority of this increased investment is conventionally procured public investment, with the proportion of government investment represented by estimated private sector investment in public services through PFI remaining relatively constant between 1998-99 and 2003-04, at between 10 and 13.5 per cent of total investment. PFI is expected to account for an estimated £4.6 billion this year, or 11 per cent of total investment, as shown in Chart 2.3.

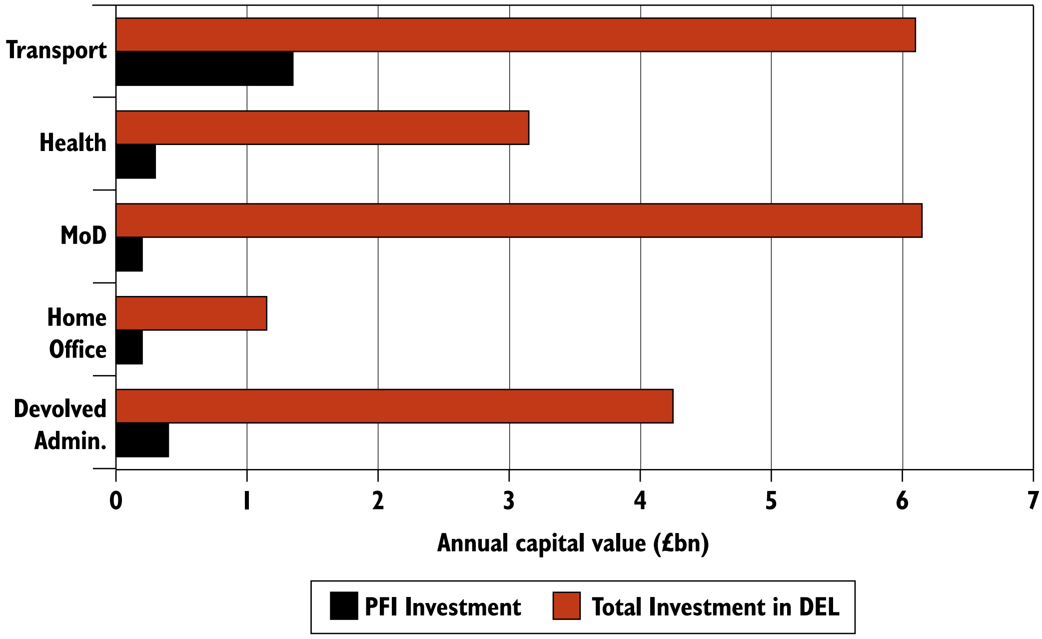
Chart 2.3: PFI investment as a proportion of total investment in 2003–04



Source: Budget 2003. PFI figures are for deals signed to date and report capital investment expected under signed contracts in the year that investment takes place.

2.10 PFI remains a limited proportion of government investment within any particular sector. Chart 2.4 shows PFI investment compared with total capital investment undertaken within departmental budgets for key spending departments (excluding investment funded by asset sales), and for the devolved administrations. In no case does PFI represent more than around a quarter of investment being undertaken in a sector.

Chart 2.4: PFI investment by Department as a proportion of total investment within Departmental Expenditure Limits (DEL)



Source: Budget 2003. PFI figures for deals signed to date. "Total Investment within DEL" includes Capital DEL and capital grants to the private sector within Resource DEL. Plans at Budget 2003 – final figures are subject to departmental decisions about the allocation of capital grants, and decisions by the Devolved Administrations about the allocation across their Resource and Capital budgets.

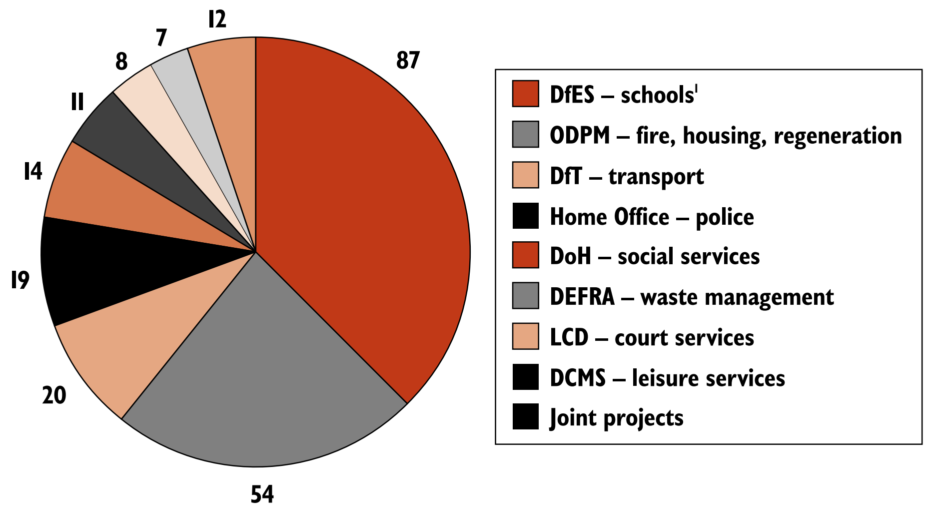
2.11 The same is true for investment undertaken through local government. Investment through PFI in local government is expected to be £1.9 billion in 2003–04, compared with capital spending on local government supported through departmental capital budgets expected at £10 billion. PFI investment in schools, which is undertaken by local education authorities, is included in this local government figure.

Box 2.1: PFI in local authorities

Much of the PFI programme is delivered by local authorities, largely with revenue support provided by sponsoring departments. So far, 119 local authority projects have been signed, 97 of which are now operational, and a further 119 schemes are in various stages of procurement.

The chart below, which shows all the local authority PFI projects, signed and unsigned, by sector, illustrates how PFI is helping authorities meet local priorities.

Number of projects supported by departments



Source: HM Treasury.

1. PFI schools projects, sponsored by DfES, typically cover a group of schools with a single project.

Completed Infrastructure

2.12 451 PFI projects have now completed construction and are in operation. These projects have delivered new facilities including:

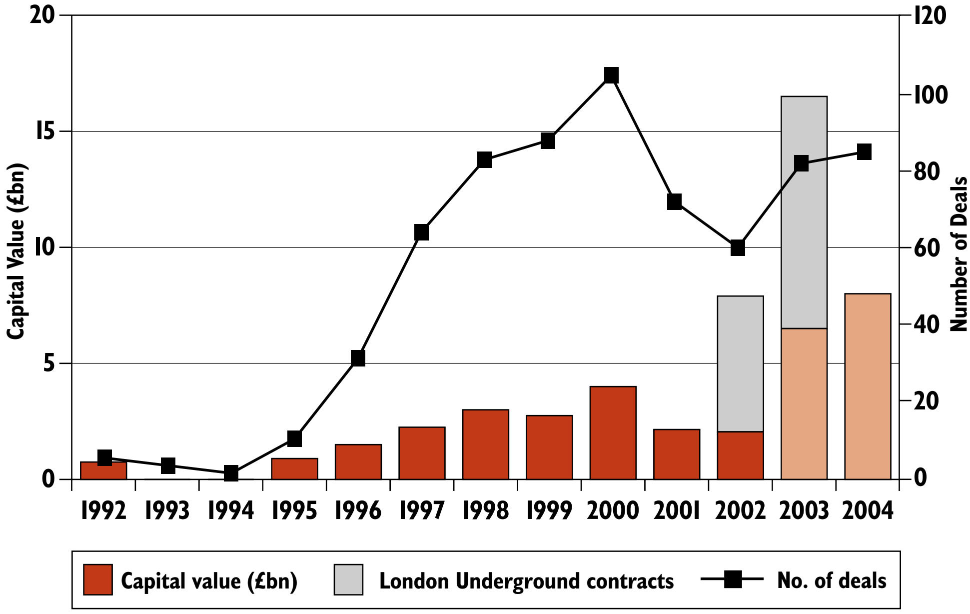
- 34 hospitals, and 119 other health schemes;
- 239 new and refurbished schools;
- 23 new transport projects;
- 34 new fire and police stations;
- 13 new prisons and secure training centres;
- 12 waste and water projects; and
- 167 other projects in sectors including: defence, leisure, culture, housing and IT.

THE DEVELOPMENT OF PFI

2.13 Total government investment has increased significantly since 1997, and the development of the PFI programme has gathered pace in line with it. Government investment is planned to continue to grow in the future, and PFI is expected to grow in proportion. Chart 2.5 illustrates the capital value of PFI projects signed in each calendar year since the programme's inception.

Aggregate number and value of PFI projects by year

Chart 2.5: Number and value of PFI projects by year



Source: HM Treasury.

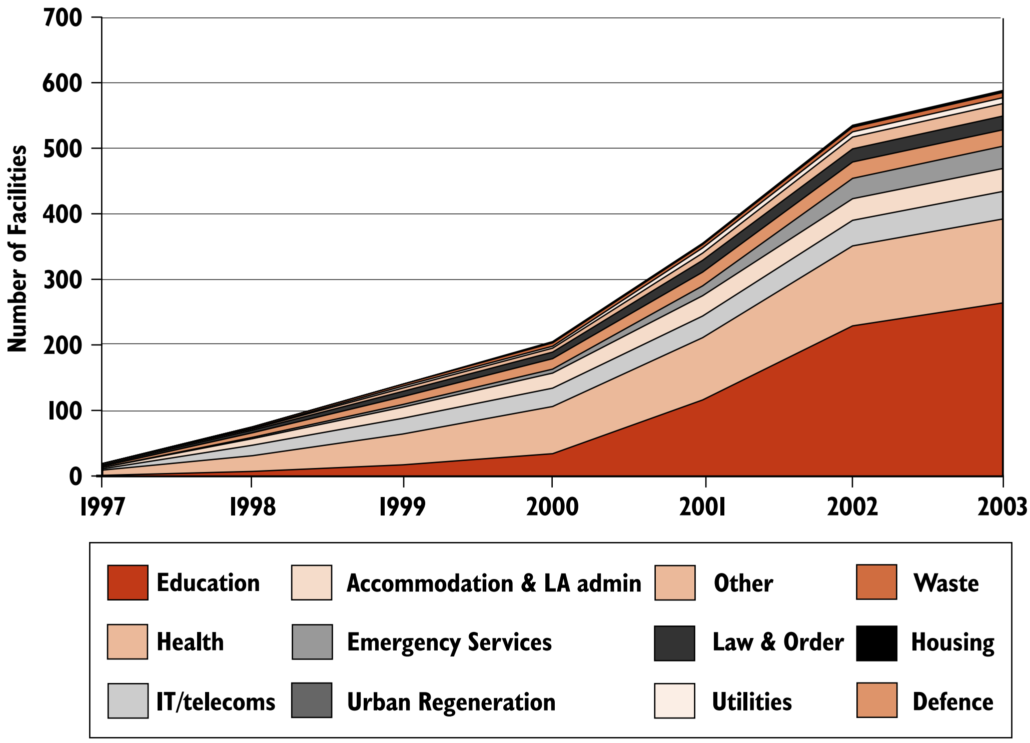
2.14 A total of 563 PFI transactions reached financial close by 4 April 2003, with a total capital value of £35.5 billion. Over £32.1 billion of the total has been signed since 1997. Chart 2.5 also provides projected figures for the capital value of PFI investment under projects signed or expected to be signed in 2003 and 2004. (A more detailed breakdown of planning for future PFI projects can be found in Chapter 7, paragraph 7.21 onwards.)

2.15 The number and total capital value of PFI projects has increased in recent years. In 1995, projects amounting to £666.8 million were signed, whereas PFI investment from 1997 to 2001 has averaged £2.6 billion a year. With the London Underground contract signed in December 2002, the capital value of PFI contracts in 2002 is more than double the comparable figure for 1997 – comparable growth to that in PSNI. As detailed in paragraph 2.9, PFI has remained a relatively constant proportion of increasing total investment since 1997, at between 10 and 13.5 per cent. The PFI contracts with the Tubelines and Metronet consortia to modernise London Underground, signed in 2002 and 2003 represent the most significant PFI contracts signed to date by capital value, and consequently a very high proportion of the market of PFI contracts in those years. Nevertheless, even if the London Underground contracts are set aside, the total value of PFI projects due to close in 2003 is, at over £5.5 billion, expected to be the highest to date.

2.16 The construction and investment undertaken through these PFI projects has already delivered, through the 451 completed projects, over 600 operational facilities, as Chart 2.6 illustrates. These are the public facilities which have opened and are in use. More are under construction or in procurement. The increase in the pace of government investment since 1997 is reflected in the acceleration in the delivery of operational PFI facilities around 2000, as the construction phase of these projects is completed.

PFI's contribution to public infra-structure

Chart 2.6: Number of operational PFI facilities



Source: HM Treasury.

2.17 Of course, although there are now a large number of PFI projects operational, they are all in an early stage in their operation of what are typically 20 to 30 year contracts. The operational performance of PFI contracts, and in particular their ability to maintain a consistent quality of service over the long term, will need to be assessed in later years.

Breakdown of Projects

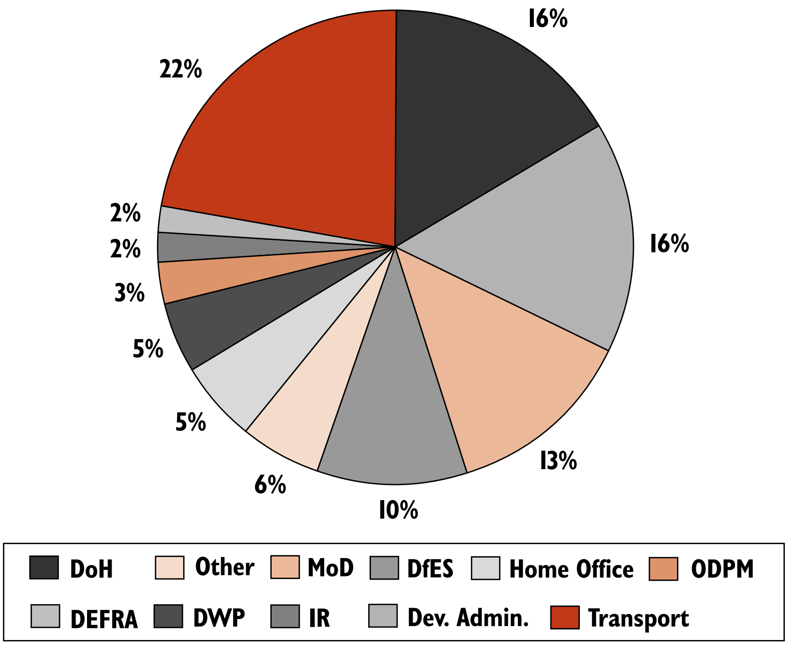
2.18 PFI investment has been used across the range of sectors. PFI transactions have been signed in over 20 different sectors, and by over a hundred different departments and local authorities. Chart 2.7 shows the largest users of mainstream PFI by value have been:

- the Department for Transport, which accounts for 22 per cent of projects by capital value. Large capital investment projects such as the M6 Toll Road (£485 million) account for the high value in this sector;
- the Department of Health, which has seen a total capital investment of £3.2 billion with 117 PFI projects signed to date;

- the Department for Education and Skills, with a total of 96 transactions worth a total capital value of £2 billion; and
- the Ministry of Defence, with 46 projects and a total value of £2.5 billion.

Total number and capital value of projects by sector

Chart 2.7: Total capital value of projects by department

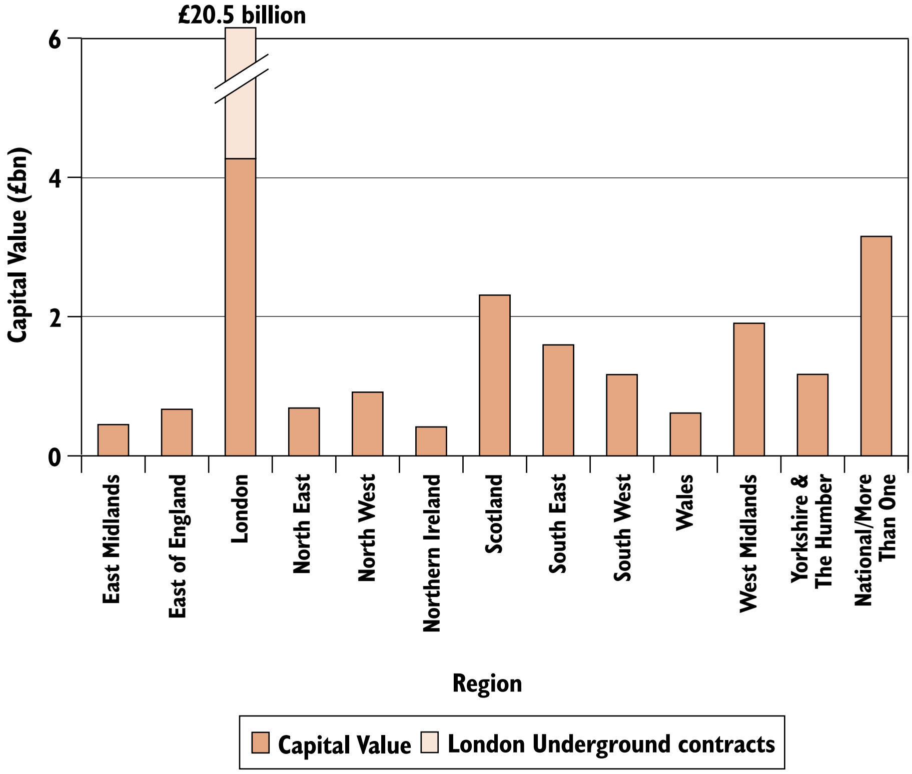


Source: HM Treasury
Other Departments with signed projects are: FCO, LCD, DCMS, Customs, DTI, DWP, GCHQ, HMT, IR, and the OGC. Figures exclude LUL contracts.

Geographical Breakdown

2.19 Chart 2.8 shows signed PFI projects broken down by region. All the regions of the United Kingdom have signed at least 20 PFI projects. Every region will receive capital investment under PFI signed projects worth at least £400 million. Information about the extent of PFI investment being undertaken in each English region is available in HM Treasury's regional map publications. Information about these publications is available at www.hm-treasury.gov.uk.

Chart 2.8: Capital value of projects by region



Source: HM Treasury.

2.20 As Chart 2.8 shows, the Devolved Administrations are also seeing significant investments in public services through PFI, with 143 projects signed worth a total capital value of £3.3 billion between Scotland, Northern Ireland and Wales.

- Scotland has a total of 84 signed projects amounting to a total capital value of £2.3 billion. Signed projects include schools and healthcare projects.
- Northern Ireland has signed a total of 29 PFI projects with a total capital value of £416 million. This involves projects in areas such as schools and health.
- Wales has a total capital value of £615 million from 30 PFI projects signed. Energy management, healthcare and road projects are typical examples of projects procured.

FINANCIAL REPORTING OF PFI CONTRACTS

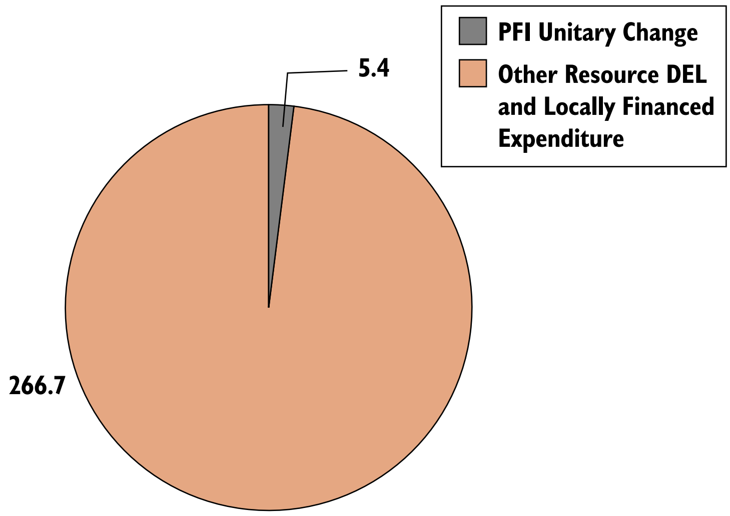
2.21 The Government only uses PFI where it offers value for money, considered over the long term. Its approach to the use of PFI is detailed in Chapter 3. The financial reporting and balance sheet treatment of projects are subsequent and irrelevant to the decision whether to use PFI, but the monitoring and reporting of financial commitments made under PFI is an important part of managing the public finances.

2.22 The Government publishes its estimates of the unitary charge payments – single annual payments made by the procuring authority to the private sector which cover all the costs, both capital and service, of PFI projects – to be made under all signed PFI contracts in the Financial Statement and Budget Report. These payments represent the full price of the specified facility being made available and cover all costs over the life of the contract. These Departmental commitments of future revenue are monitored by Government, included in consideration of future budgets, and therefore taken into account by Departments in deciding how much PFI investment to undertake.

2.23 PFI unitary charges include payments to cover the cost of capital expenditure (money to repay the debt and interest charges, including hedging costs, incurred in building a large capital asset), the services needed to run and repair that asset, like maintenance work and supporting soft services like catering, cleaning and hospital portering. In a typical PFI hospital, payments for services make up 40-50 per cent of the unitary charge. For a typical PFI schools project, around 30 per cent of the unitary charge goes toward caretaking, maintenance and other services. If a project is built using conventional procurement, these future costs for services are not automatically covered, monitored or disclosed. Reporting estimated payments under PFI contracts therefore provides a fuller picture of future commitments than would be possible under conventional procurement, and provides better information for the management of future budgets.

2.24 These annual payments under PFI unitary charges make up a very small proportion – just over 2 per cent – of total annual resource budgets, as illustrated in Chart 2.9. Consequently, they represent very little threat to the flexibility of the Government's budgets, and a small commitment of future revenue.

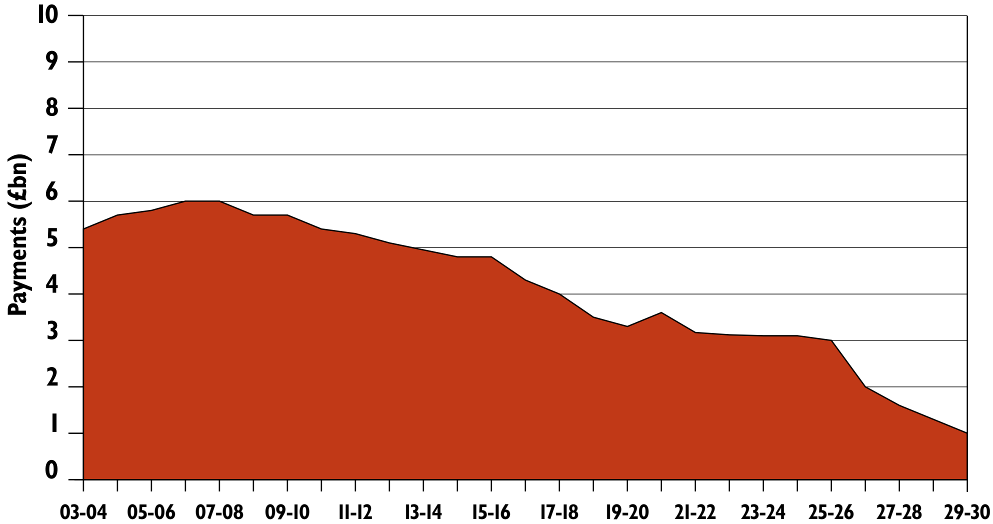
Chart 2.9: PFI unitary charge payments in 2003–04 as a proportion of Departmental and locally financed annual resource expenditure (£bn)



Source: Budget 2003.

2.25 This conclusion, that PFI presents little threat to overall budgetary flexibility, remains true into the future. Because the cost of PFI unitary charges in the future is clear, and transparently reported, the Government is able to take it fully into account in future budgeting. In fact, as illustrated in Chart 2.10, the estimated payments under signed PFI contracts begin to fall after 2007-08. These figures obviously do not take into account unitary charge payments under future PFI contracts, however, if PFI investment remains the limited proportion of total investment it currently is, there is no reason to believe that these payments represent a long-term threat to overall budgetary flexibility.

Chart 2.10: Estimated payments in real terms under signed PFI contracts

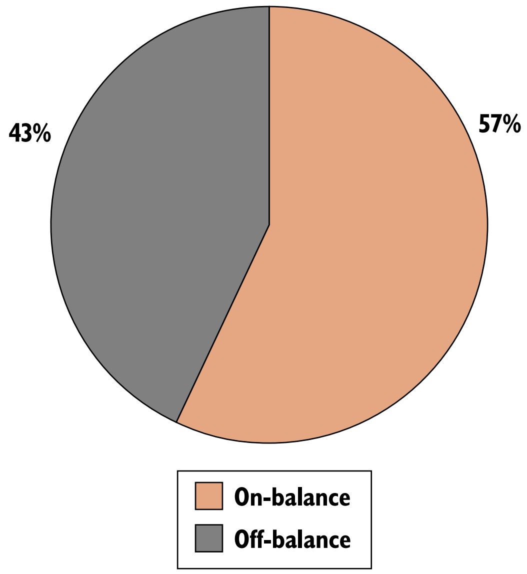


Source: Budget 2003. These figures represent the estimated payments that the public sector expects to make to the private sector for services delivered under PFI. The payment mechanisms of PFI contracts contain provision for performance deduction – which reduce payments if the service is unavailable or to a poor standard to incentivise contractor perfomance – and may therefore be lower than these figures. These figures include estimates of the first 15 years of LUL PFI contracts, as these contracts are reviewed periodically and payment levels may change. These payments also include tax payable by the private sector in respect of profits earned on the PFI scheme.

Accounting treatment of PFI

2.26 The accounting treatment of a PFI project on a Departmental balance sheet, and its reflection as an asset in the national accounts, is not material to the Government's decisions about when to use PFI. These are based on value for money alone. In fact, the majority – 57 per cent – of PFI projects by capital value are reported on Departmental balance sheets, as illustrated in Chart 2.11. Accounting and reporting treatment follows rules set by a series of independent national and international organisations, and is decided by independent auditors. (See Annex B for details.)

Chart 2.II: Balance sheet treatment of PFI projects by value



2.27 It is important to note that, simply because a PFI asset is reported on Departmental or Authority balance sheets, that does not mean that there has been no effective sharing of risks with the private sector, or that the PFI project has secured value for money gains by doing so. As outlined in Chapter 3, the appropriate sharing of risks in a PFI project, leading to their better management, is an important source of its value for money benefits. However, the accounting treatment of PFI assets depends only on a subset of the risks involved in a project, in particular the risks of ownership. For example, accounting treatment does not take into account whether a party bears the risks involved with building a property – a very important subset of risk in major capital projects.

3 The Government's Approach to PFI

The Government is committed to securing, over the long term, the most cost effective infrastructure for the public services. To achieve this, it seeks to ensure that investment uses the appropriate procurement option which can offer the best value for money, and that there is no inherent bias between procurement options. Consequently, its approach to PFI is based on an objective assessment of where it can offer value for money, where it can meet the Government's requirements of efficiency, equity and accountability, and where the value for money it offers is not at the cost of the terms and conditions of staff. The Government continues to work closely with employers and trade unions to ensure that the rights, conditions and pensions of employees in PFI are properly safeguarded.

The Government's analysis of where the PFI model is likely to be applicable, based on evidence of its delivery in practice, suggests that it is most likely to offer value for money in major capital projects where there are significant ongoing maintenance requirements, where the structure of the service allows the public sector to appropriately define its needs as service outputs, and where the nature of the assets to be procured allows them to benefit significantly from whole-of-life costing. It is less likely to represent value for money where very fast-paced change makes a long-term contract structure inappropriate; or where the costs of pursuing PFI procurement are disproportionate to the benefits it brings.

Private sector expertise and experience has always been utilised in public sector procurement, but, where in traditional procurement private companies built and then walked away, PFI seeks to ensure that the private sector takes responsibility for the quality of design and construction it undertakes, and for long-term maintenance on an asset, so that value for money is achieved. PFI projects can capture the benefits of having the private sector incentivised to perform by having its own capital at risk, while safeguarding and advancing the public interest in the best public services for all.

In effective PFI procurement:

- **the public sector specifies the outputs it requires** and a private sector consortium then contracts to meet those requirements;
- **the risk involved in the project is shared between the parties, with each party managing the risks they are best able to.** This approach to risk-sharing provides powerful incentives for the private sector to perform, and ensures value for money for the public sector; and
- **the public sector ensures the quality and continued effective delivery of public services is maintained,** with the ability to make deductions for poor performance, the flexibility to make necessary changes in future, provisions for the consortium or funders to replace poor service providers, and ultimately the right to terminate the contract.

BACKGROUND

3.1 The Government uses PFI where it is appropriate and where it expects it to deliver value for money. In assessing when PFI is appropriate, the Government's approach is based on its commitment to efficiency, equity and accountability and on the Prime Minister's principles of public service reform. The Government seeks to ensure that there is no inherent bias in favour of one procurement route or another. It explains the benefits PFI can offer when used appropriately and certain key aspects of the PFI programme, such as the Government's approach to partnership, risk sharing, flexibility and the public sector safeguards incorporated in PFI contracts to ensure that key services continue to be delivered even when PFI contractors fall into financial difficulty.

MODERNISING PUBLIC SERVICES

3.2 As outlined in Chapter 2, the Government has significantly increased total investment in public services. To ensure that this increase in investment will have maximum impact on the public services delivered to users, it must be accompanied by reform, and delivered in a way that provides value for money.

The Prime Minister's Principles of Public Service Reform

3.3 The Prime Minister has set out the Government's four principles of public service reform[1]:

- **national standards,** which means working with hospitals, schools, police forces, and local government to agree tough targets, with performance independently monitored so that people can see how their local services compare;
- **devolution**, whereby central government has to give successful frontline professionals the freedom to deliver;
- **flexibility**, which means removing artificial bureaucratic barriers which prevent staff improving local services; and
- **choice**, acknowledging that customers should increasingly be given the kind of options that they take for granted in other walks of life.

THE ROLE OF PFI

3.4 There are a number of ways the Government is delivering increased investment. When it comes to procurement, Office of Government Commerce (OGC) and HM Treasury set out in May 2000 three recommended approaches for improving delivery:

- **prime contracting**, where a single party acts as the sole point of responsibility between the public sector client and the supply chain, bringing together all of the parties necessary to meet public sector requirements effectively;
- **design and build**, where a supplier is responsible for both the design and construction of a facility to meet the public sector's output specifications; and
- **PFI**, where the public sector contracts to purchase quality services, with defined outputs, from the private sector on a long-term basis, and including maintaining or constructing the necessary infrastructure so as to take advantage of private sector management skills incentivised by having private finance at risk.

[1] Reforming our Public Services, March 2002.

3.5 For each project or programme of new investment, the Government seeks to identify which of these options will deliver the best value for money. Specifically, in modernising the infrastructure needed for public services such as hospitals, schools and other facilities the Government seeks to avoid the weaknesses of past procurement (see Box 3.1) and ensure its procurement choice will deliver:

- buildings of high quality, maintained to a high standard throughout their life;
- effectively-managed services for the public, while protecting staff; and
- new investment which is completed on time and within budget, so that facilities are available when the public sector needs them, and for the expected price.

3.6 Each of the procurement options set out in paragraph 3.4 have been designed to improve value for money and avoid past difficulties with conventional procurement. Each will offer best value for money in different circumstances. The key for public sector procurement professionals is to judge which project suits which procurement option.

3.7 PFI is characterised by a long-term, whole-of-life commitment by the private sector to deliver and maintain new public infrastructure. This approach will only be suitable for certain types of investment, naturally limiting the use of PFI as laid out below. These constraints have limited the use of PFI to around 11 per cent, or £4.6 billion, of total investment in public services this year (see paragraph 2.9). Historically PFI has not exceeded 15 per cent of total investment for any year since 1997.

3.8 The analysis set out in Chapter 4 of this report suggests that PFI can offer significant advantages for certain major capital projects – such as the construction and maintenance of hospitals or schools, or the provision of major capital assets for defence or transport infrastructure – but has not offered the same advantages in information technology (IT) or for small capital projects. (See paragraphs 4.3 to 4.12 and 4.27 to 4.56.)

3.9 The PFI model is only likely to be applicable where:

- the private sector has the expertise to deliver and there is good reason to think it will offer value for money;
- the structure of the service is appropriate, allowing the public sector to define its needs as service outputs that can be adequately contracted for in a way that ensures effective, equitable and accountable delivery of public services into the long term;
- it can be demonstrated that PFI offers greater value for money for the public sector compared with other forms of procurement; and
- the nature of the assets and services identified as part of the PFI scheme are capable of being costed on a whole of life, long-term basis. Investment with a time horizon of 5-10 years is unlikely to benefit from the PFI approach.

3.10 For example, the use of PFI would be inappropriate where:

- the pre-conditions of equity and accountability in public service delivery could not be met, as in most forms of frontline service delivery;
- the transaction costs of pursuing PFI were disproportionate compared to the value of the investment a project was delivering, impairing its value for money (see paragraphs 4.27 to 4.40); or
- the fast pace of technological change in a particular sector made it too difficult to establish requirements in the long term, or high levels of integration make enforcing systems risk allocation difficult (see paragraphs 4.41 to 4.56).

PFI and Value for Money

Overview **3.11** The Government's approach is to use PFI only where it can offer the best value for money. Public procurement cannot choose the short-term, least-cost option, but must instead concentrate on the true value and whole-of-life costs of capital expenditure to secure the long-term quality of the public services. The public sector needs the skills, at all levels, to identify the true benefits of good design and quality construction and maintenance, and take into account all the costs associated with major investment projects. Value for money benefits in PFI should not come at the expense of employees' terms and conditions.

3.12 The Government defines value for money as follows: "the optimum combination of whole-life cost and quality (or fitness for purpose) to meet the user requirement".[2] In seeking value for money for PFI, the Government seeks to ensure that:

- the evaluation of which procurement option to use is undertaken with no inherent preference for one option over another. There should be no dogmatism in this choice. Decisions should be made on the best evidence available;
- value for money is not taken to be least cost. There is a need to ensure that quality standards are maintained, for example in the design of public infrastructure, and the long-term viability of the PFI contractor is assured;
- the commitment to value for money should not be at the expense of the terms and conditions of employees transferred or subsequently employed by a PFI contractor; and
- a full evaluation of the costs and benefits on a whole-life basis is always undertaken, including an assessment of risk. (See paragraphs 7.2 to 7.20 for further details of the appraisal process and proposed reforms.)

3.13 The Government in the Green Book[3] and guidance on Public Sector Comparators (PSCs)[4] has set out extensive guidelines on how to assess value for money in PFI. Paragraphs 7.2 to 7.20 of this document set out further proposals to improve the procurement and appraisal process. Although assessing value for money will always involve a significant quantitative analysis of the merits of different procurement approaches, the emphasis on optimum whole-of-life cost and quality requires that objective professional judgement based on the best available evidence be brought to bear in determining the best procurement option.

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[2] Government Accounting.

[3] The Green Book: Appraisal and Evaluation in Central Government, 2003.

[4] Treasury Task Force Technical Note 5 – How to Construct a Public Sector Comparator.

Box 3.1 Addressing the weaknesses of past public procurement

The historical record of Government procurement shows that too often new assets have been delivered late and over budget. Furthermore, where projects experienced difficulties, the financial costs have been borne by the taxpayer. For example:

- **the initial cost estimate of Guy's and St Thomas' Hospital rose by £124 million to £160 million and the completion date slipped by over three years;**
- **the cost of the Trident submarine shiplift and berth at Faslane rose from an estimate of £100 million to a final cost of £314 million, and was delivered two and a half years late;**
- **the London Underground Jubilee Line extension was delivered two years late and cost £1.4 billion more than original estimates; and**
- **the top twenty five equipment projects in the MOD experienced cost overruns amounting to £2.8 billion with average delays of three and a half years.**

A 1999 NAO study found that only 30 per cent of non-PFI major construction projects were delivered on time and only 27 per cent were within budget, whereas the NAO's report on PFI construction performance showed that over 70 per cent of PFI projects were delivered on time, and no construction cost overruns were borne by the public sector.

This record reflects a number of weaknesses that have beset public procurement in the past. In particular, the full costs of projects have not been calculated accurately beforehand, risk management procedures have not been implemented, and there have been insufficient incentives, for management or organisation-wide, to ensure that projects are driven forward successfully.

These factors have helped establish PFI as an effective public procurement mechanism where it can be properly and effectively employed. The NAO's 2002 report into PFI's construction performance found that 76 per cent of PFI projects were delivered on time or early and Treasury research on a larger sample found 88 per cent on time or early. Both the NAO's construction survey and HM Treasury's research reported in Chapter 4 found that 78 per cent of PFI projects were within public sector budgets – and in each case, price changes were driven by changes in public sector requirements, not construction cost overruns. This result demonstrates that construction risk transfer has been effective, as cost overruns were not borne by the taxpayer. (See Chapter 4 for more detailed results of HM Treasury research.)

The Government, through the OGC and other initiatives, is taking steps to ensure improvements in all types of procurement, including both conventional procurement and PFI. The OGC expects to deliver £3 billion worth of value for money gains in civil procurement through better public sector skills, value for money testing and other efficiency savings, by 2005-06.

The Benefits of PFI

3.14 Where PFI is effectively utilised, it offers a number of advantages in delivering public sector infrastructure. These advantages stem from the sharing of risk in public projects within a structure in which the private sector puts its own capital at risk to delivery and performance. In the right circumstances, PFI can help ensure:

- **desired service standards are maintained.** Since under PFI the private sector's capital, not just its profit, is at risk depending on private sector performance, there is a very strong incentive for the private sector to maintain high and reliable service standards throughout the life of the contract;

- **new services are more likely to start on time**, since the private sector contractor does not get paid until it delivers. The record of conventional procurement is poor in this respect, with frequent delays before public assets become operational;

- **more efficient use of public money**. In the past, some conventional public procurements have gone heavily over budget, consuming funds which could otherwise have been invested in other public services (see Box 3.1). Under PFI, the public sector only pays for the service it has contracted for, at the price it has contracted for, and only when that service is available. Under conventional procurement the public sector is forced to fund cost overruns, and pays out whether or not the service it needs is actually available; and

- **contractors are incentivised to deliver the required service over the whole life of the asset**. The private sector partner only gets paid if it maintains standards throughout the length of the contract (for example 25 years in the case of new PFI hospitals). This means that in designing, building and maintaining a PFI hospital or school the private sector has a strong incentive to ensure high standards are built in and maintained across the building's whole life, as it would be forced to remedy defects and make repairs in the future.

3.15 Furthermore, when used properly, PFI offers other advantages to the public sector, over and above providing high quality, well-maintained assets over the life of the contract. In particular PFI helps the public sector by providing:

- **a better understanding of the total costs of providing the required service**. In PFI procurement, the public sector client can clearly define at the start the service it requires, and the private sector partner gives a price for the total cost of that service – covering both the up front cost of new investment but also ongoing recurrent costs such as maintenance. This helps to avoid short-termism by focusing on the long-term needs of the public sector; and

- **new ways of working, and new approaches to the delivery of the service**. The public sector defines the service to be delivered, but it is for the private sector partner to decide how to deliver it, drawing on its own innovation and experience. This provides the private sector with an incentive to develop innovative ways to meet requirements, and allows the public sector to harness the efficiency that can come from contestability, helping improve standards across the public sector. To bring out these benefits from innovation, it is important that the public sector has available the skills to act as an effective client in PFI procurement. Chapter 7 details Government measures designed to spread effective procurement expertise across procuring authorities, and so improve the value for money it can secure through PFI.

3.16 Where it can be effectively utilised, PFI helps to ensure that money invested flows through into improved public services. Chapter 4 lays out the findings of recent HM Treasury research designed to help evaluate how far PFI has delivered the benefits expected of it in major capital projects, and also examines two specific areas – projects with a small capital value and information technology (IT) projects – where further research was conducted.

HOW PFI WORKS

Overview **3.22** In PFI, the public and private sectors enter a contract which shares between them the risk of undertaking an investment project, typically to provide a major capital asset for the public services such as a school or a hospital and related support services like repairs and maintenance. The public sector retains some of the risks it would bear in a conventionally procured project, like demand risk or the risk that it has not adequately assessed its requirements, but transfers the remainder to the private sector. Furthermore, the public sector underwrites the public service, but not the private sector service provider, ensuring that safeguards are in place in event of failures in the private sector. The private sector takes on those risks it is best able to manage, like design, construction and maintenance risks, so that it is better incentivised to perform. The financial cap to the risk assumed by the private sector is the full value of the debt and equity it provides to a project.

PFI Contracts

Specification of Outputs **3.23** The centre of any PFI project is a concession contract within which the public sector specifies the outputs it requires from a public service facility, and the basis for payment for those outputs. The level of outputs required by the public sector is typically drawn up in close consultation with the public sector workers – doctors, teachers, firemen or policemen – who will be using the asset and support services provided through the PFI contract. This contract is the key document that sets out the risk-sharing arrangements between public and private sectors in a PFI project and is the subject of extensive guidance.

3.24 Public service requirements would normally be framed not as precise input specifications and designs for a particular asset, but as an output specification defining the service required; for example, supported hospital beds for a certain number of patients, or prison accommodation for a specific category of inmates. This approach helps utilise the private sector's ability to provide innovative solutions to meet these requirements. Once the public sector has determined the level of outputs it requires to run the public services, the private sector is then invited to submit proposals which meet the desired output objectives using best private sector expertise and know-how to deliver the service.

3.25 When the private sector has submitted bids to fulfil the public sector's requirements, the public sector evaluates these proposals, selecting the option which represents the best value for money. In making this evaluation the public sector should take advantage of the empirical evidence available, both qualitative and quantitative, and exercise objective judgement in selecting the best option, using appraisal and evaluation criteria, and a PSC to determine whether the PFI option offers better value than conventional procurement. It is vital that the public sector is equipped with the skills to do so. Chapter 5 discusses steps the Government has taken to ensure these skills are in place, and Chapter 8 lays out further measures to improve the quality and effectiveness of public sector clients. Chapter 7 discusses reform of the appraisal process to further ensure that all the relevant benefits and disbenefits of PFI procurement are taken into account at the earliest appropriate stage and throughout a procurement.

Performance Regimes **3.26** Also contained within the PFI contract is a payment mechanism and performance regime which outlines how service delivery levels against the public sector's desired outputs – supported hospital beds, pupil places or prison accommodation – is measured. The public sector undertakes to make a unitary charge payment, covering both the availability of the asset and the support services provided along with it. Deductions are then made from this unitary charge to penalise poor performance by the private sector or lack of availability. While Chapter 4 contains some preliminary indications of the operational performance of PFI projects in practice, it is not possible to assess PFI's operational performance as a whole at this early stage in the life of projects.

3.27 This process of setting performance measurement and penalty mechanisms in the PFI contract ensures that the private sector delivers the specific outputs the public sector intends to purchase. It also means the public sector only pays if those services are delivered. For example:

- if an operating theatre in a PFI hospital were unavailable, a deduction would be made from the unitary charge paid to the private sector until that theatre was again in full working order;
- if the pipes in a school burst, flooding it and causing damage to its fabric, the private sector would be responsible for fixing the pipes and returning the school to its proper condition, and in the meantime it would not be paid unitary charges for those parts of the school that were unavailable; or
- if there is an electrical fault in an office's lighting, and the conditions in the office therefore fail to meet the project's output requirements, then the private sector – and in this case typically a specialised facilities management firm that was a part of the private sector consortium – would have a set time period to remedy the fault. If it failed to do so, it would incur a financial penalty until the fault was remedied.

3.28 Once public service requirements have been set, the contract goes out to tender and companies in the private sector compete to fulfil those requirements. In order to produce the most competitive bid, the private sector must:

- build a consortium which is best qualified to meet the specified requirements. This would typically involve an experienced construction contractor forming a joint venture with a facilities management company capable of running and maintaining the asset and with other contractors best qualified to deliver other outputs to be specified in the contract. Increasingly, the consortium would also include specialised investors, who ensure appropriate sub-contract structures and perform a 'due diligence' role, evaluating the project's assumptions and exploring its risks; and
- produce a bid which takes into account the whole-of-life cost of the asset, incorporates the proper level of repairs and maintenance, and reflects the cost of the services provided and the cost of third party finance. Competitive tension between bidding consortia helps ensure value for money, while consortia would also have no incentive to place artificially cheap bids. Such bids, which compromised on design or construction quality, or underestimated required maintenance, would seriously damage the profitability of the consortium and place its equity at risk because any failure to deliver in the future would mean unitary charge performance deductions. Equally, the third-party lenders to the consortium would eliminate any such optimism bias in the bids to ensure the safety of their investment.

Risk Sharing

3.29 The appropriate sharing of risks is the key to ensuring value for money benefits in PFI projects are realised. The benefits described above all flow from ensuring that the many different types of risks inherent in a major investment programme, for example construction risk or the risk associated with the design of the building and its appropriateness for providing the required service, are borne by the party who is best placed to manage them. This section goes on to outline how risks are typically allocated within a PFI project between the public and private sectors, and within the private sector between the various parties involved.

Approach to Risk

3.30 The Government's approach to risk in PFI projects does not seek to transfer risks to the private sector as an end in itself. Where risks are transferred, it is to create the correct disciplines and incentives on the private sector to achieve a better outcome. The general principles behind the Government's approach to risk-sharing in PFI are:

- the Government underwrites the continuity of public services, and the availability of the assets essential to their delivery; but
- that the private sector contractor is responsible, and at risk, for its ability to meet the service requirements it has signed up to. Where it proves unable to do so, there are a number of safeguards for the public sector and the smooth delivery of public services in place, but the contractor is at risk to the full value of the debt and equity in the project; and
- the full value of that debt incurred by the project, and the equity provided by contractors and third parties, is the cap on the risk assumed by the private sector.

3.31 Successful PFI projects should therefore achieve an optimal apportionment of risk between the public and private sectors. This will not mean that all types of risks should be transferred to the private sector. Indeed, there are certain risks that are best managed by the Government; to seek to transfer these risks would not offer value for money for the public sector.

Retained risks

3.32 The key risks that the Government does not seek to transfer in entering a PFI scheme, and which it retains in the same way in conventional procurement, are usually:

- **the need for the facility on the date given and the adequacy of its overall size to meet public service needs.** So for example, if an NHS trust underestimates the number of beds required to meet demand, it must pay the costs of expanding the available facilities just as it would had it built a conventional hospital;
- **the possibility of a change in public sector requirements in the future.** If the needs of public services change, the Government retains the responsibility to make alterations in both conventionally built and PFI facilities. Provisions for flexibility to cover changing requirements in PFI are covered in more detail below;
- **whether the standards of delivery set by the public sector sufficiently meet public needs.** The public sector retains the risk involved in planning the provision of public services, and specifying a procurement of facilities that meets those requirements, in both PFI and conventional procurement;

- in most cases, **the extent to which the facility is used or not over the contract's life**. For example, if the demand for school places in an area drops significantly, the Government would continue to pay unitary charges for a PFI school, in the same way as it would continue to own and maintain a conventionally procured school. In some cases, where it is value for money, this risk is passed to the private sector, so in some office accommodation, should the Government decide it no longer needs full usage of the building, the private sector would take on the risk that it could let the remainder of the floor space; and

- **general inflation risk**. Unitary charges are typically linked to inflation, and so are subject to the same inflation risk as future maintenance or other costs in a conventional procurement.

Transferred risks

3.33 In a PFI, the risks which the Government usually seeks to transfer by contract to the private sector over the term of the contract, typically 15-30 years, are specifically identified and limited. In a typical PFI, these would involve the following:

- **meeting required standards of delivery**. So if, for example, the project's design was unable to provide the required service needs, the private sector would need to pay the cost of rectifying the design to meet those requirements and receive payments;

- **cost overrun risk during construction**. If, for example, ground conditions are discovered to be unstable after construction begins, and the building requires considerably more extensive foundations, the private sector would need to cover those extra costs in order to complete the building to the required standard. There would be no increase in the Government's unitary charge payments. In conventional procurement, the Government would be forced to cover these costs;

- **timely completion of the facility**. If, in the example of unstable ground conditions cited above, the facility was completed and delivered late to the public sector, no payments would be made to the private sector until it was available. Chapter 4 details research demonstrating the impact of this risk transferral on construction performance;

- **underlying costs to the operator of service delivery, and the future costs associated with the asset**. For example, where the private sector takes on an existing building in a PFI project, it takes the risk of any latent defects in the building requiring remedy. The private sector would need to make these remedies, and cover the cost of them, to continue to receive payments for the building's availability;

- risk of **industrial action** or **physical damage** to the asset; and

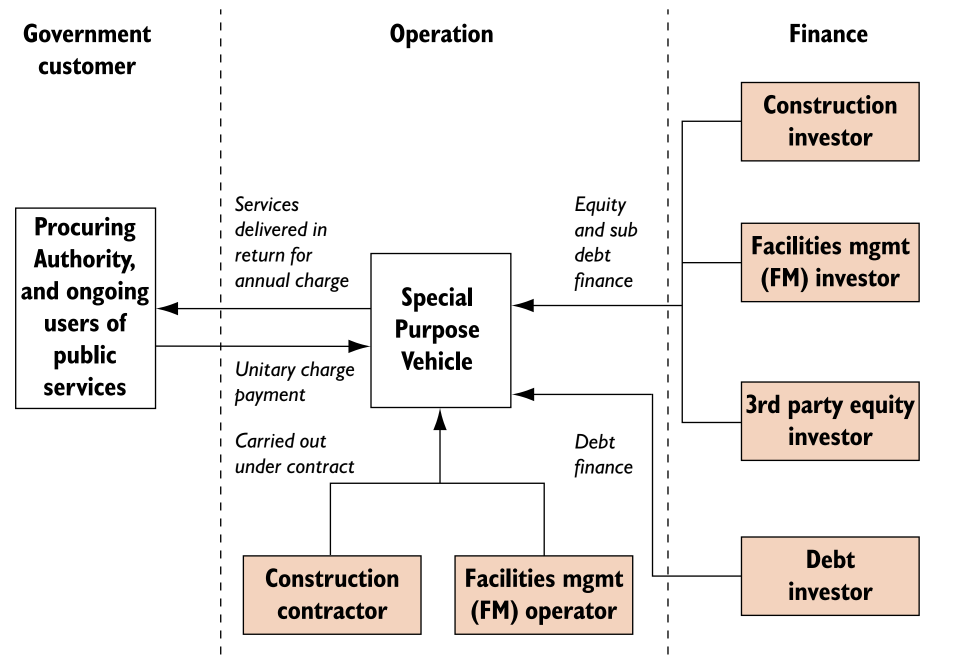
- **in limited cases, certain market risks** associated with the scheme (for example, in some road schemes, the actual traffic which uses the road).

Risk Sharing within a PFI consortium

3.34 With most PFIs the risks transferred by the public sector to the private sector are then reallocated between the different private sector parties participating in the PFI project, using a central consortium company with subcontracts as a means of distributing these risks amongst the private sector participants.

3.35 The consortium company is owned by one or more equity investors. Some of these shareholders may also be contractors to the central consortium company, who undertake to carry out construction, design or facilities management work in the project for a fee from the central consortium company. Others may be financial investors. The consortium will also raise debt finance, in the form of bank debt or bonds, to pay for the construction and operation of the project. It is at risk if the consortium is unable to meet its debt service obligations. Chart 3.1 illustrates the typical commercial structure of a PFI project.

Chart 3.1: The consortium company joint venture model



3.36 Within this structure, the private sector reallocates risk to the most appropriate parties. Typically:

- the construction contractor, under a subcontract with the consortium company, takes the design, construction and completion risk;
- the service provider, under a subcontract with the consortium company, takes the risk of timely and cost effective service provision;
- insurers provide protection for risks of damage and business interruption; and
- the consortium company, its lenders and investors are therefore left with a series of residual risks, some of which are credit risks on the subcontractors' performance.

3.37 The benefits of this consortium joint venture structure are that it permits different parties to become involved in the PFI scheme and share the risks effectively. It also permits the involvement of third party funders who must assess the strength of the contractual arrangements and the level of support offered as they rely on these when it comes to repayment of their loans.

Flexibility

3.38 It is important for the public sector to retain flexibility in delivering services. For example, if there is new technology which could improve service delivery, a desire to change the service configuration of the facility such as a shift from in-patient to out-patient care or an expectation that the volume of support services required may change, the public sector needs to retain the flexibility to manage such changes efficiently.

3.39 There will always be constraints on the public sector in facilitating such changes whichever procurement method is employed in delivering new infrastructure. Once complete, a new building inevitably presents a degree of inherent inflexibility by its very design. Similarly, it may be difficult to change service delivery quickly given the management and personnel arrangements put in place at the outset. Any change is also likely to require new funds to finance any new construction work needed, so affordability could also constrain.

3.40 With PFI, the contract entered into at the outset recognises that there will be a need for changes over the 15-30 year life of the contract. The key flexibility rights given to the public sector are:

- the public sector has a right to change any aspect of the building or service provision, subject to agreement with the PFI contractor on cost;
- to ensure that value for money is maintained, for changes over £100,000 in value the public sector can require a competitive tender for any works; and
- where there is a requirement to change service configuration, there is a similar right for the public sector to change any aspect of service provision, subject to agreement on costs, with the ability to require a competition as set out above. This is in addition to their rights to re-tender service provision regularly throughout the contract's life.

3.41 When the public sector wishes to make changes to the PFI building or services it bears the cost as it would in conventional procurement.

3.42 If a dispute arises concerning this process, there is a dispute resolution procedure which is binding, involving an independent expert agreed by both parties. However, if the public sector remains dissatisfied, or the scale of change required goes beyond what can be accommodated by the change mechanisms set out in the contract, the public sector can voluntarily terminate the full contract, as distinct from termination due to private sector default. Futher detail on voluntary termination by the public sector can be found in paragraph 9.27.

3.43 Evidence to date suggests that the flexibility provided by the PFI contract has already been used by the public sector during the construction period in early PFI transactions. The research set out in Chapter 4 identifies 22 per cent of PFI contracts during the construction period being adjusted to facilitate changes in scope required by the public sector. Given that most operating PFI contracts have only been in operation for a short period, evidence on how well the change mechanism works in practice for any changes which the public sector requires in respect of service delivery is not extensive.

3.44 The Government will continue to monitor whether PFI in practice delivers the flexibility which PFI contracts offer and which public services will need, whilst preserving value for money. Chapter 8 sets out proposals for monitoring the public sector's management of these change mechanisms in practice. The Government is also concerned to reduce the costs of voluntary termination where it is required to meet a public sector need to terminate in the rare cases where changes cannot otherwise be achieved, and has set out proposals to achieve this in Chapter 9.

Public Sector Safeguards

3.45 Ultimately, the Government reserves the right to protect the ongoing delivery of public services. For those services provided through PFI, the contract entered into with the private sector provides major protections to the public sector should the private sector fail to meet requirements, ranging from payment deductions to termination for default.

Deductions for poor performance

3.46 In the first instance, if a PFI contractor fails to deliver the project on schedule or the services provided fall below the standard originally specified, deductions and penalties will be withheld from payments made by the public sector.

3.47 The loss of revenue resulting from deductions and penalties provides a powerful incentive for the PFI contractor to remedy any shortcomings in service delivery. Shareholders will see a decline in their returns, third party credit providers will be concerned that this loss of revenue will increase risk that the PFI contractor will be unable to meet its debt service obligations. In these circumstances credit providers have contractual rights over the other private sector participants in the project, which can enable them to enforce performance against contractual obligations. Credit providers can replace the private sector participants in the PFI with other companies better able to deliver to the required standard.

3.48 Furthermore, even in circumstances where there is not default, under a PFI contract the Government retains the right to step in to take over the operation of the services being provided by the PFI contractor:

- if the Government determines that there is a serious risk to the health or safety of the public;
- if the Government determines that there is a serious risk to the environment;
- where the Government is required to exercise its statutory responsibilities; or
- if the Government determines that the project may have implications for national security.

Default and Termination

3.49 Where a PFI contractor consistently fails to deliver the services to the standard originally specified and the private sector has failed to remedy this deficiency, the PFI contract will fall into default, giving the public sector the right to terminate the contract and step in to ensure continuity of service delivery. In these circumstances:

- with rare exceptions, projects will revert to public ownership, including the assets and staff necessary to continue to deliver the service;
- compensation is only due to the private sector for the true value of assets taken over by the public sector less any rectification costs. In extreme circumstances this could result in no payment; and
- the public sector is then able to take ownership of the project itself or re-tender the opportunity to take over the project to other private sector contractors.

3.50 Given the 564 PFI projects signed to date and the long term nature of the PFI contracts it is likely that a small proportion of the PFI projects will fall so far short of their contractual requirements that they will be terminated by the public sector.

3.51 It is impossible to predict with accuracy the percentage of PFI projects which may fail, but it is important to understand that in these extreme circumstances of failure, after all reasonable attempts have been made by all parties to resolve any difficulties which may emerge, the Government will be prepared to terminate such contracts in accordance with its legal rights, even if at a loss to financial participants in the scheme. Where this happens, it will also act within its legal right to ensure that public services will be maintained.

Public sector monitoring

3.52 It is important for the public sector to regularly monitor the performance of PFI projects, and ensure they have the access to the professional skills they will need to take advantage of these public sector safeguards if necessary. Chapter 5 and Chapter 8 discuss steps already taken or planned to ensure the public sector has this expertise in place.

Contract expiry

3.53 Upon expiry of a standard PFI contract, with rare exceptions the key assets needed to continue to deliver public services revert to the public sector free of charge.

The Role of Private Finance

3.54 The providers of private finance to a PFI project, both providers of equity and debt play a series of important roles in the overall success of the project.

Equity

3.55 The shareholders in a PFI project provide it with equity capital, by investing in ordinary shares or subscribing for long term subordinated debt. Typically this investment will comprise approximately 10 per cent of the project's up-front costs and is the element of the financing most at risk to loss. This equity capital is usually provided by those providing services to the PFI project, whether they be the construction contractor or long term facilities manager and increasingly, specialised financial institutions.

3.56 An equity investor only benefits from its investment in a PFI project after it is complete and successfully in operation as unitary charges are only paid once an asset becomes available. Also, the value of the project to the investor is determined by the expected performance of the project over its whole life. This incentive to create a public asset with long-term value enables construction contractors to take a long-term interest in the project, even after they have completed their construction task. This also enables the various contractors to the PFI project and investors to work together with a common interest in creating an optimum, whole-of-life, cost-effective project and provides the right incentives to seek the best performance in the form of the performance regime set out in the PFI contract and actively remedy deficiencies.

Senior Debt

3.57 Typically, third party credit providers are more risk-averse than equity providers and provide the majority of the funding. The PFI approach and process thus leads banks and other financial institutions who lend to PFI projects to play a important role in ensuring that proper due diligence is performed, all important risks are identified and properly addressed and allocated to the appropriate parties. They will seek to have robust and rigorous contractual undertakings from private sector participants in the PFI scheme and this is one of the reasons the PFI process delivers projects to time and to budget.

3.58 Private financiers usually provide a significant component of the project funding for a PFI project. It is recognised that the funders who provide this finance play an important role in developing the project scheme, and provide many of the benefits outlined in paragraphs 3.14 to 3.16 above. Typically, areas where funders perform key roles are:

- **due diligence.** When funders consider financing a project, they will carry out extensive due diligence work, aided by independent advisers, on all aspects of the project plan including its technical, insurance, legal and financial aspects. This due diligence is intended to ensure that the plan is robust based on the project assumptions and to eliminate any identifiable 'optimism bias' in the consortium's plans. Funders are incentivised to ensure as far as is possible that all potential project risks are taken into account;

- **risk allocation.** Funders ensure that all the risk identified in a project is allocated to the party best able to manage it. As funders are potentially exposed to all of the debt provided to the project, they ensure that the project's contractual structure properly incentivises and apportions risk to the appropriate parties to the contract. Ultimately funders remain exposed and will assess the residual risks of, for example, not achieving a watertight contract structure, or the inherent risk that a failing or failed project will not have sufficient funds to repay its debt;

- **contract enforcement.** Where a project has experienced problems, the private sector funders ensure that the contract structure they have created through the due diligence and risk allocation process is properly enforced, and that parties who have assumed risks are accountable. This enforcement role helps ensure that projects are nevertheless completed so that the public sector client can enjoy their benefit and the private sector receive whatever payments follow; and

- **taking overall project risk.** Although the credit providers ensure that the great majority of project risk rests with the consortium and its sub-contractors, they hold the overall risk that their debt is not repayed. To manage this risk, they hold step-in rights to take over failing projects and bring in new contractors who can meet public sector requirements.

3.59 The involvement of private finance in a project therefore brings with it many benefits, over and above taking on the risk of the project to the value of debt and equity provided. Annex C contains the results of a study conducted into the cost of private finance in PFI projects.

Comparing Costs of Finance

3.60 Discussion of the role of private finance in PFI projects must take into account the benefits which it brings to PFI projects, outlined above, and it should also ensure that the costs of securing finance from both public and private sources are assessed on a consistent basis. A balanced approach to consideration of the costs and benefits of private finance is essential for developing future policy.

3.61 The cost of private sector finance in PFI is often cited as greater than the cost of funds available through public finance. A simple comparison of the combined returns on debt and equity earned by the private sector with the non-risk rate on gilts would show that the cost of public debt was lower, but this single cost comparison does not adequately capture the different methods of costing for risk in the public and private sector, nor does it reflect the value for money benefits which whole-life costing and appropriate risk-sharing in PFI bring to projects. There is a cost to the Government's use of private finance, involving the extra cost of the private sector securing funds in the market, but a great part of the difference between the cost of public and private finance is caused by a different approach to evaluating risk.

The price of risk – private sector

3.62 Typically, the private sector takes account of risk by discounting future cash flow at a higher rate. A risk premium is therefore made explicit in the private sector cost of capital, and the level of return on capital is competitively determined according to the risks assessed in the project. In PFI, the project discount rate, or expected rate of return for the private sector, takes into account the costs associated with procuring private capital and also seeks to price the wider risks associated with lending to the project.

3.63 The gilt rate, on the other hand, does not make any attempt to calculate risks. This does not mean that the Government is able to borrow and spend money free of risk. Instead it means that, with publicly financed procurement, the taxpayer underwrites the associated risk, and this is reflected in a lower price of capital to the public sector. The taxpayer takes on the risk attached to the project, and where it materialises, bears the cost as a result. It is therefore inappropriate to compare a "risk free" cost of gilts with the cost of private finance: PFI projects provide value for money through the private sector taking on, pricing, and managing more effectively these project risks.

The price of risk – public sector

3.64 Instead of reflecting risk in a risk premium on capital, Government investment decisions reflect risk by calculating the present value capital sum it regards as the necessary contingency for the risks inherent in a project. For example, when deciding between procurement options, project managers calculate an expected value of all risks for each option, and consider how exposed each option is to future uncertainty. They then discount the cost of these options in future years at 3.5 per cent per year to a present value, which purely reflects society's preference for consumption now over consumption in the future, rather than discounting the value of project cash flows at a higher rate to make a compensation for risk. (A further explanation of this process is contained in the Green Book.[5]) Risks are therefore priced individually, for each project option. The discounted costs of these risk-adjusted options can then be compared with each other, or with the cost of a PFI project, in a PSC, to determine which procurement option represents best value for money taking account of risk and uncertainty. This approach is consistent with the fact that in conventional procurement the public sector pays for risk not in its borrowing – which for the public sector is at non-risk rates – but when risks crystallise and must be covered in publicly funded projects.

[5] The Green Book: Appraisal and Evaluation in Central Government.

4 PFI – AN ASSESSMENT

The Government is determined to ensure that a sound evidence base informs the rigorous investigation of where PFI is delivering better facilities and value for money benefits in practice. The PFI programme has progressed to a point where, with 451 projects operational, sufficient evidence is available to assess many aspects of the early performance of the programme. This section summarises the findings of new HM Treasury research into completed major capital PFI projects. It also presents the findings of research into two particular areas of the PFI programme: projects with a small capital value, and information technology (IT) projects.

The main findings of this new research are:

- **PFI projects are being delivered on time and on budget. HM Treasury research into completed PFI projects showed 88 per cent coming in on time or early, and with no cost overruns on construction borne by the public sector. Previous research has shown that 70 per cent of non-PFI projects were delivered late and 73 per cent ran over budget;**
- **there is scope to reduce procurement times, although there is evidence that new initiatives to tackle this problem are having an impact. Procurement times averaged 22 months, but the first scheme signed under the NHS LIFT initiative, a new form of PFI joint venture designed to bring procurement expertise directly into primary healthcare projects, closed in just 14 months; and**
- **the operational performance of PFI has met with approval from public sector clients. Over three quarters of clients surveyed reported their PFI projects performing as expected or better. Further research into operational performance is required, to assess projects once they have had longer periods in operation. Moreover, it is still early for the expected long-term operational benefits of PFI procurement, in terms of whole-of-life costing and locked-in standards, to have become apparent.**

Two previous independent reports by the NAO into aspects of the PFI programme further support many of these findings, providing evidence of improved construction performance over non-PFI projects and of public sector client satisfaction.[1]

In HM Treasury's research focused on PFI projects with capital values below £20 million, the main findings were:

- **construction and operational performance were good, in line with larger projects. Over 80 per cent of projects were delivered on time or early, and over 90 per cent met with client expectations; and**
- **the procurement process for small projects was of comparable length to that of major capital schemes. This indicates that, in relation to the level of capital investment undertaken by the schemes, procurement times are disproportionately long, and procurement costs disproportionately high.**

For IT projects, the main findings of research were that:

- **IT PFI projects were moderately successful, but the majority of more successful projects renegotiated their contracts after signature to achieve ongoing flexibility, moving away from the mainstream PFI focus on contractually defining outputs; and**
- **this finding was in line with qualitative research on IT PFI, which identified a number of important differences with PFI in other sectors, including a greater need for project flexibility, a higher level of integration with public sector business systems, and little or no market for third party finance.**

The policy implications of these findings are explored in Chapter 7.

[1] PFI: Construction Performance, NAO, 2003; and Modernising Construction, NAO, 2001.

BACKGROUND

4.1 With 451 projects now operational, it is possible to take stock of the performance of the PFI programme to date. This chapter outlines new research carried out by HM Treasury on the track record of PFI in major capital projects, which tests its performance particularly against its expected benefits of on time and on budget delivery. It also reports on research into two particular areas of the PFI programme, small capital value projects and IT projects, to examine the value for money that PFI is actually delivering in these sectors.

4.2 By concentrating on operational projects, this research gauges how PFI has performed in practice, both in construction and the early years of operation. However, such projects were inevitably commissioned in the early years of the PFI programme, before a number of initiatives designed to establish and spread best practice had been implemented. The dynamic nature of the PFI programme, and the Government's commitment to further improving PFI's application, means continuing appraisal in the future is essential. In particular, it is important to monitor the effectiveness in practice of PFI's operational benefits and contractual protections, including contract flexibility, the ability of authorities to manage contracts, and the maintenance of quality standards into the medium and long-term. Areas for further investigation are laid out in more detail in Chapter 7.

PFI DELIVERY SO FAR: PUBLIC SECTOR RESEARCH

Sources

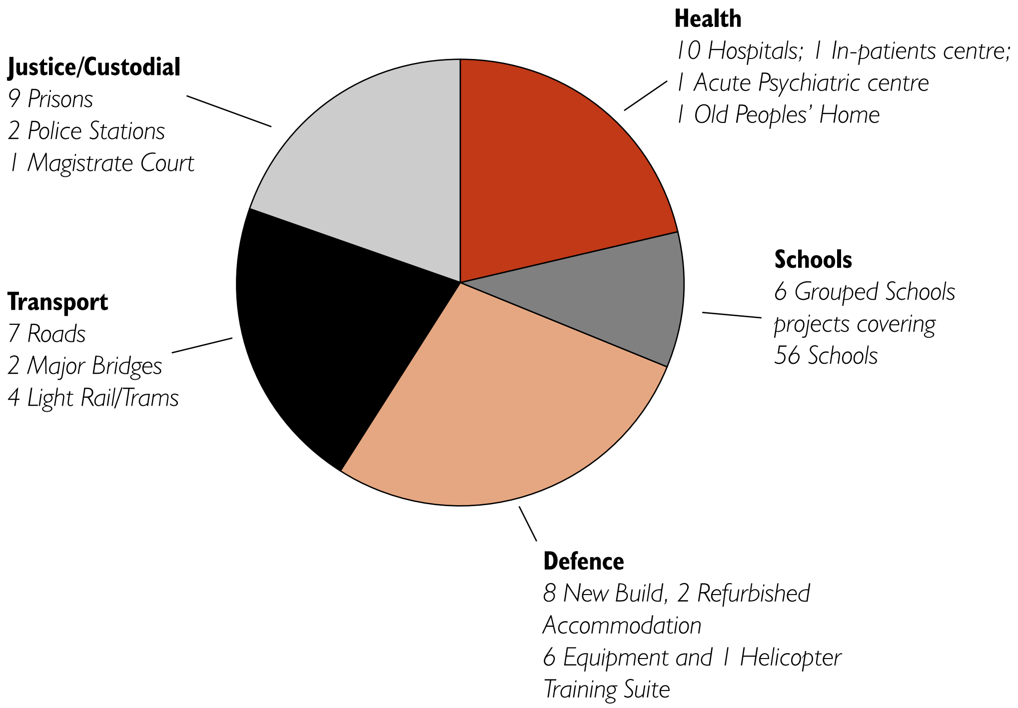
Researching PFI: substantial capital assets

4.3 In September 2002, HM Treasury conducted research to investigate whether PFI had delivered the benefits expected from it in completed procurements. Specifically, the research project examined information held on individual projects by procuring authorities and asked that additional data be sought from project managers across a range of sectors. Chart 4.1 sets out the project sample used to provide a picture of:

- construction performance;
- delivery against budgets;
- bidder selection;
- procurement times; and
- operational performance.

The project sample

Chart 4.1: PFI delivery project sample



Source: HM Treasury.

4.4 The scope of the research was restricted to the use of PFI as a procurement tool for substantial capital assets that were currently operational. IT or smaller projects, both the subject of separate research programmes were excluded from the sample.

4.5 Nine of the 70 projects in the sample were found to fall outside the scope of the research, leaving a sample of 61 operational projects covering a wide range of service areas. This sample represents about 10 per cent of all completed PFI projects. This information combined both objective data on the procurement process itself as well as more qualitative aspects concerning how far the schemes were matching up to the expectations of the public sector clients. The research will be published on the HM Treasury website in the Autumn.

Research Outcomes

Overview

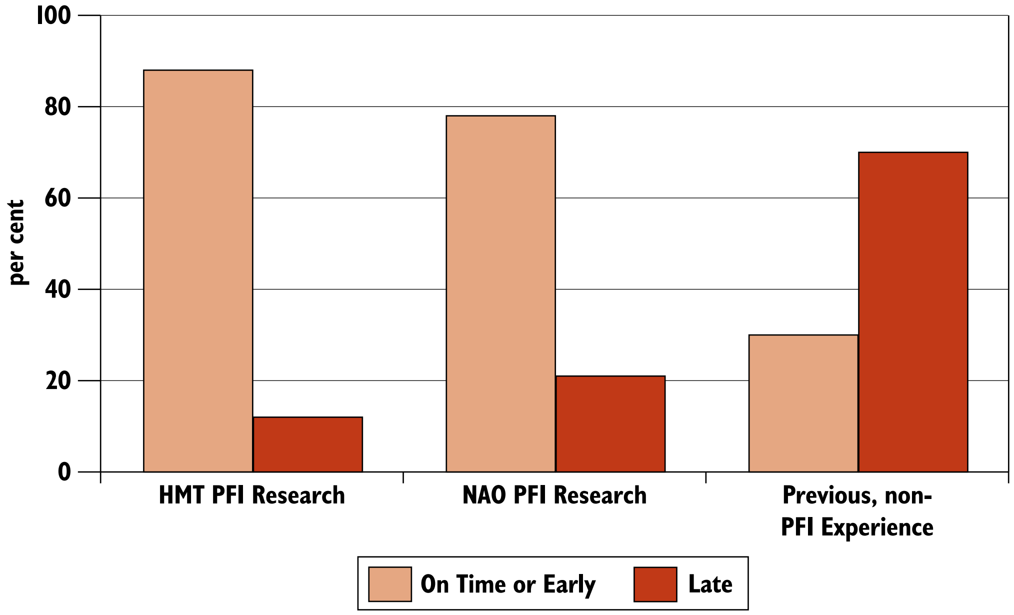
4.6 The research into completed PFI projects provided good evidence of PFI's successful performance in major capital projects. It showed PFI delivering new assets on time, within budget and meeting the expectations of public sector clients. The strength of current PFI performance in major capital projects provides a solid base for the continuing use of PFI to provide substantial capital investment in public services where it is appropriate to do so.

Delivering New Assets: Construction Performance in PFI

Delivering on time

4.7 A key focus of the research was to assess how far PFI delivered new assets on time. The sample suggested that PFI was delivering new assets on time across the public sector. 88 per cent of projects were built on time or early. This strong track record of PFI is borne out by a comparison of the HM Treasury findings with those of the National Audit Office (NAO). A recent NAO report[1] found that of a sample of 37 projects, only 8 per cent of PFI schemes were delayed by more than two months.

Chart 4.2: Delivering on time



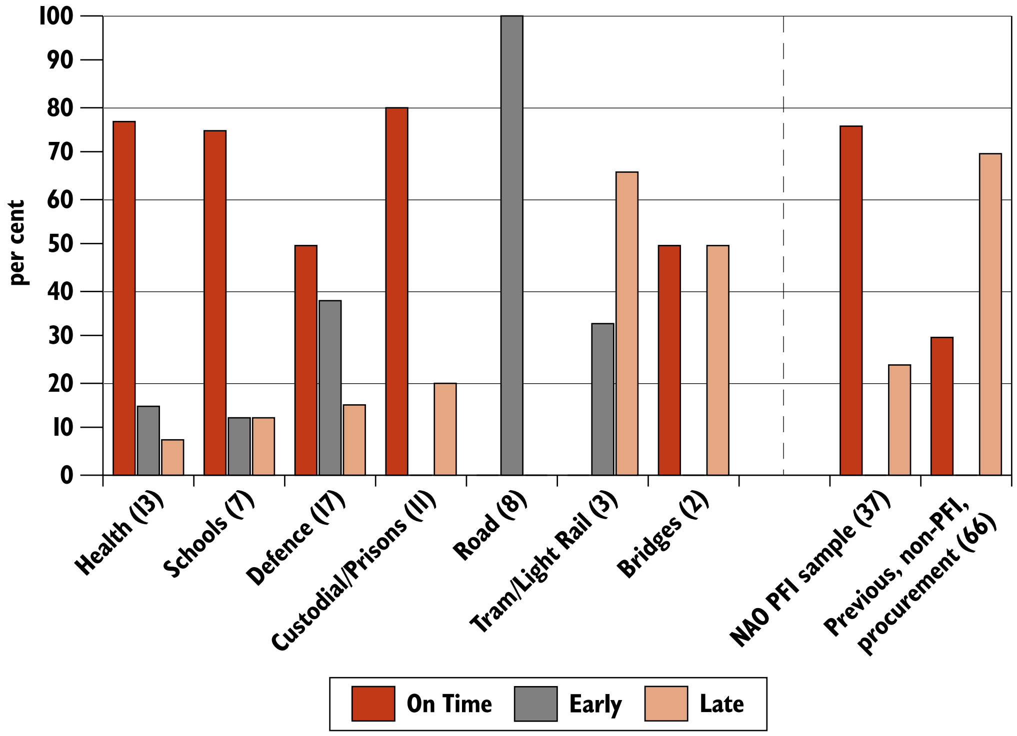
Source: HM Treasury; NAO: PFI Construction Performance 2002 HC 371, Session February 2002–03; NAO: Modernising Construction, 2001, HC 87, Session 2000–01.

4.8 The track record of conventional Government construction projects has been considerably worse in this respect. Other research into previous non-PFI construction performance has shown that around 70 per cent of conventional construction projects came in late[2].

[1] PFI: Construction Performance, NAO, 2003.

[2] Modernising Construction, NAO, 2001.

Chart 4.3: Construction performance by sector



Source: HM Treasury; NAO PFI: Construction Performance 2002, HC 371, Session February 2002–03.

4.9 Chart 4.3 shows PFI construction performance by sector. For school, hospital and defence projects (of which a high proportion were accommodation projects), very few schemes experienced delays. No prison and road projects surveyed were delivered late. In some sectors, such as light railways, the planning difficulties in densely populated urban areas and inherent inflexibilities in the schemes mean that PFI has been less successful in meeting initial delivery timetables. However, unlike conventional procurement, the direct financial costs associated with these delays were not borne by the public sector and payment only began to flow to the private contractor once the asset was complete and the service was underway.

Delivering to Budget

4.10 HM Treasury research assessed how far PFI was delivering new assets within the budgets originally agreed with the contractor. Under PFI, the public sector only begins to pay for an asset once it is built and the flow of services associated with it begins. As discussed in Chapter 3 from paragraph 3.22, this means that the costs involved in developing and operating an asset are at risk to the private sector.

4.11 In order to determine whether there were budget overruns on projects in the public sector, HM Treasury therefore sought to assess whether the unitary charge payment the pubic sector makes had changed following contract award. Construction cost overruns borne by the private sector would not, of course, be reflected in these data. There are situations where the unitary charge payment could increase during construction, not due to project cost overruns, but due to the public sector altering the specific requirements it wanted, and the private sector varying its price to reflect that. In fact, all cases in the research sample where the cost to the public sector increased were due, not to construction overruns, but to changes in public sector requirements.

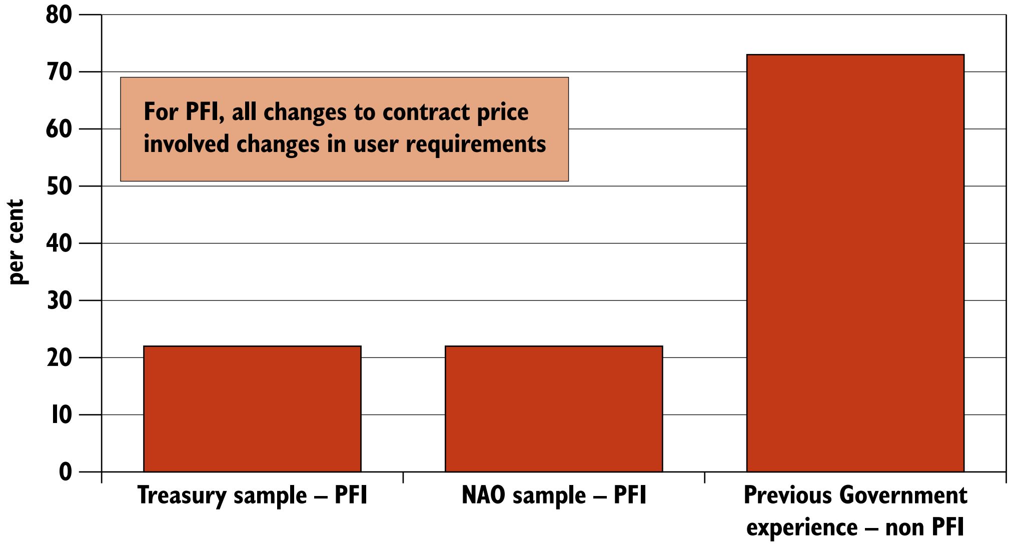
PFI is delivering new assets within budgets

4.12 Overall both HM Treasury research and the earlier NAO sample suggest that PFI provides high levels of price certainty for the public sector, particularly in comparison to the budget overruns experienced in traditional procurement, demonstrating that construction risk had been effectively transferred to the private sector:

- in the HM Treasury sample, changes to the unitary charge were experienced in only one fifth of projects, and all were driven by changes in the requirements of the public sector client; and
- in the NAO sample, 21 per cent of projects surveyed involved a change in price for the public sector after contract award[3] – and all were driven by a change in requirements by the public sector client.

PFI is therefore delivering very high levels of price certainty for the public sector for construction and operation, although of course at an early stage of the contract's life.

Chart 4.4: Delivering to budget – price uncertainty in public procurement



Source: HM Treasury; NAO: Modernising Construction, 2001, HC 87, Session 2000–01; NAO: PFI Construction Performance 2002 HC 371, Session February 2002–03.

Level of Competition

Competition

4.13 PFI allows the public sector to harness the efficency that can come from contestability in public procurement. It is important then that the PFI market retains the capacity to deliver healthy competitive tension.

4.14 Data on PFI competitions from the HM Treasury research showed that deals averaged four bidders each. This figure was relatively consistent across sectors. Four bidders represents strong competition for these contracts, and any significantly greater number of serious bids would probably be difficult to manage effectively enough to drive competition any further.

4.15 Although this research provides some evidence of healthy competition, the Government intends to continue to take steps to improve public sector procurement skills, give greater certainty for deal flow and so, as well as improving value for money in the public sector, ensure a healthy market of PFI in the private sector. Measures intended to strengthen public sector procurement and encourage private sector bidders are detailed in Chapter 8.

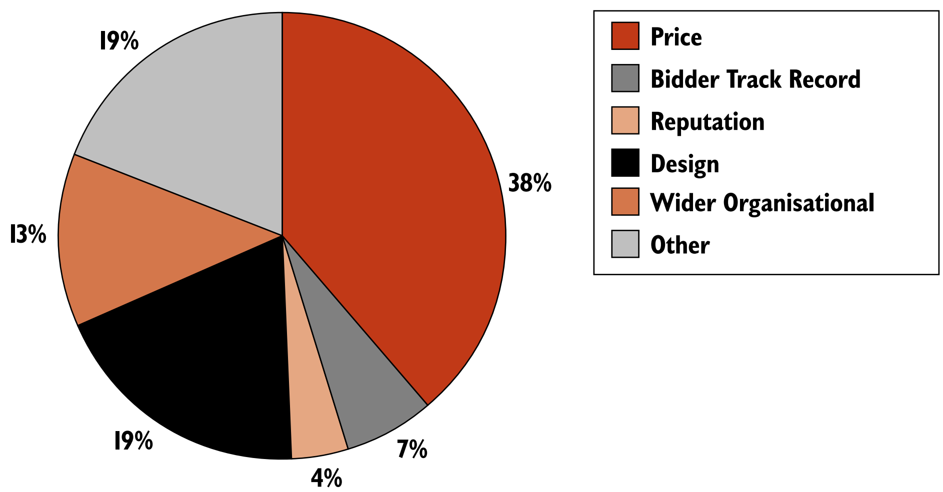
[3] PFI : Construction performance, NAO, 2003.

Bidder Selection

4.16 The HM Treasury research also sought to identify what project managers presented as the primary factors underpinning their selection of bidders. Project managers were asked to list those factors that were particularly important in awarding contracts (Chart 4.5). Overall, procurers said that price followed by design had been the dominant factors affecting their bidder selection.

4.17 The Government is clear that value for money should not be equated with the lowest cost option, but should instead identify the optimum combination of whole life cost and quality. Chapter 8, paragraphs 8.42 to 8.44 outline the Government's plans to investigate further bidder selection in PFI. Box 8.1 outlines the Government's approach to encouraging good design in public procurement.

Chart 4.5: Bidder selection in PFI



Source: HM Treasury.

Procurement Times

4.18 Procuring through PFI can be complex and can involve lengthy negotiations before contracts are signed, although after signature construction periods tend to be shorter than in conventional procurement and delays are significantly reduced as the private sector's own capital is at risk and payments from Government do not start until the service is available. The Government is concerned that investment be delivered to public services as quickly as possible, while ensuring the necessary safeguards and due diligence are in place to prevent public money being wasted. Futhermore, procurement delays and associated costs incurred by the private sector can damage competition and value for money in PFI. Chapter 5 outlines private sector concerns regarding the procurement process, and measures already in place to improve the efficiency of procurement. As a result, reducing procurement delays in PFI prior to contract signature, without compromising on achieving value for money, is a Government priority. Further steps to improve procurement in the public sector in PFI are outlined in Chapter 8.

4.19 Table 4.1 sets out the procurement times for the operational projects examined by HM Treasury from the point where first invitation to tender is published in the Official Journal of the European Communities (OJEC). Average procurement times were about 22 months, although average times were greater in the health sector. It is hard to compare this figure with non-PFI procurement times as aggregate information for the public sector is not presently available. However, this is a long lead time which may in part reflect early difficulties experienced at the outset of the PFI programme, such as unfamiliarity with the process, the absence of standard form contracts and uncertainty regarding the legal powers of public sector clients.

4.20 Long lead times are a result of a number of factors, some common to all procurement, and some associated with PFI. Furthermore, some of this time is taken performing tasks that are highly beneficial to the overall project, but in some areas progress to reduce procurement times is possible. Extended procurements have broadly been the result of:

- the increased complexity associated with procuring a PFI project, including securing the necessary technical, legal and financial advice and conducting contract negotiations;
- the need for the public sector to carefully specify its actual service requirements from a procurement, rather than provide a prescriptive design specification. The scope for improving the quality of public service outputs, which this rigorous procurement process provides, make this a very beneficial factor and one that should be present in all procurement; and
- legal issues surrounding the right of NHS Trusts to enter into PFI contracts in the early stages of the Department of Health's PFI programme. This problem has now been overcome and procurement times in the Health sector have fallen as a result.

4.21 The Government has taken a series of practical steps to overcome these difficulties, detailed in Chapter 5, which have met with success. For example, the first scheme under the NHS LIFT initiative, which uses a joint venture structure to inject procurement expertise into the public sector client, reached financial close in just 14 months. Improving the public sector client's general skills, and particularly its capacity to specify public service requirements and properly manage a PFI procurement process, continues to be a major concentration of the Government. Chapter 8 sets out measures to streamline the procurement process and boost public sector client capacity in more detail.

Table 4.1: Procurement times in early PFI

	Procurement Dates (OJEC issued)	OJEC to Financial Close (months)	Upper/Lower bounds (months)
Health	December 1994–December 1998	40	22–60
Schools	March 1997–December 1999	23	15–25
Defence	November 1994–September 1999	23	18–32
Custodial/Prisons	March 1997–November 1999	21.4	14–25
Road	March 1986–November 1995	18	15–20
Tram/Light rail	March 1986–November 1995	22.3	13–30

Operational Performance

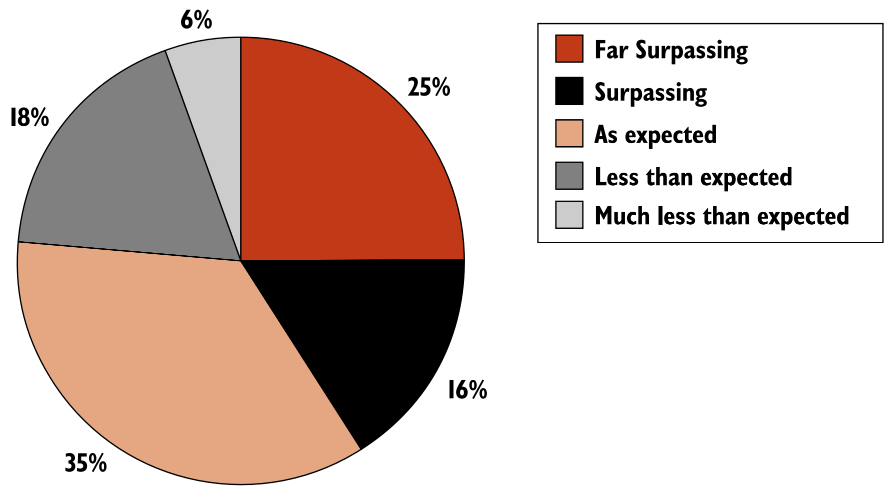
4.22 It is difficult to assess the operational performance of PFI projects at this stage. The fact that all operational schemes are in the early years of long-term agreements of up to thirty years means that it is too early to draw far-reaching conclusions on this point.

4.23 Research by HM Treasury, and also by the NAO, has sought to gain some initial indication of operational project performance by surveying the opinions of public sector managers. HM Treasury asked respondents to indicate how far "overall performance of the private sector partner" was "matching up to expectations at the time of contract close".

4.24 Of the project sample:

- over three quarters of public sector clients described the performance of the project as 'as expected' or 'better' and one quarter of respondents said the project was 'far surpassing' their expectations; and
- 24 per cent of respondents reported performance as less than expected. Further research is being conducted into projects viewed as poorly performing to ascertain the factors involved and determine remedies.

Chart 4.6: How far is the private sector partner meeting up to initial expectations?



Source: HM Treasury.

4.25 These findings are in line with a November 2001 survey of 98 projects by the NAO, which focused more specifically on the Public Authorities' perception of value for money. Of those sampled, 81 per cent of public bodies involved in PFI projects believed that they are achieving satisfactory or better value for money from their PFI contracts. Only 4 per cent described value for money as 'poor'.

Project evaluation in the future

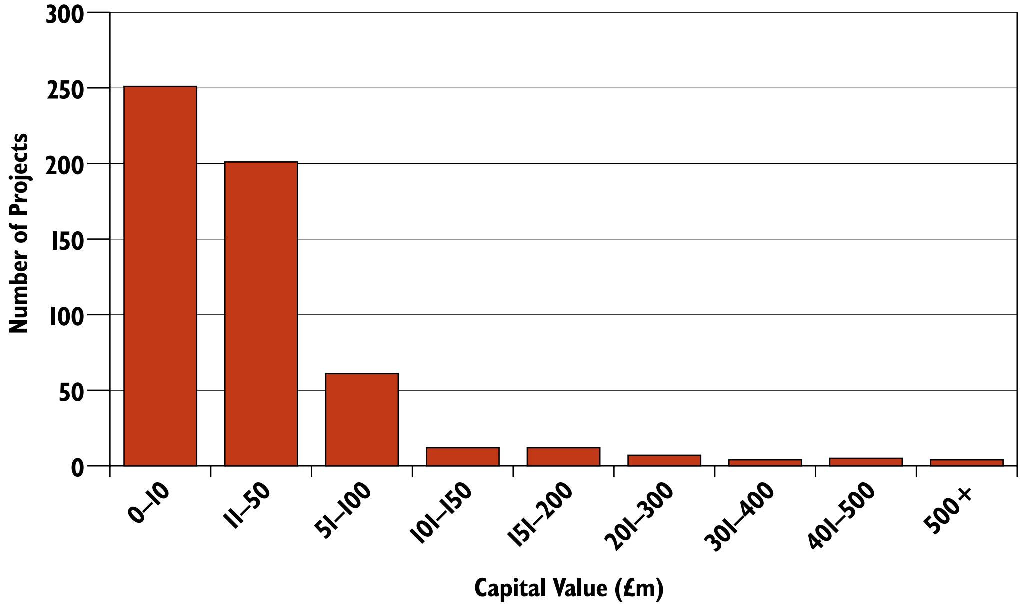
4.26 PFI involves long-term contracts in which private sector contractors are bound to deliver a clear level of service at a fixed price over the whole life of the asset. A primary motivation behind this structure is to ensure value for money over the long term. As the experience of service delivery under PFI increases, and particularly as the assets procured under PFI begin to age, the Government will seek to evaluate how far the long-term benefits of PFI are realised, and establish and pass on best practice in the public sector's management of these contracts. Future steps to be taken in this area are contained in Chapter 8.

PROJECT PERFORMANCE IN LOW CAPITAL VALUE SCHEMES

Background

4.27 One important area where research has recently been conducted to determine whether PFI is delivering in practice, and providing value for money overall, is in individually procured PFI projects with a low capital value, which, for the purpose of this research, was defined as less than £20 million. Historically, the number of small PFI projects has been high, as illustrated in Chart 4.7.

Chart 4.7: Number of projects grouped by Capital Value



Source: HM Treasury.

4.28 Because of a recognition that the development and transaction costs involved in PFI could be disproportionately high if it was utilised in those projects with small capital values, the Government sought to assess the performance of PFI in these projects and the value for money represented by its benefits. HM Treasury therefore commissioned Partnerships UK to survey projects which:

- were operational;
- involved the provision of a new capital asset under £20 million; and
- were identifiable as PFI, involving unitary charge payments for both the availability of an asset and services associated with it, so as to eliminate from the sample other common forms of procurement in small projects such as outsourcing.

4.29 A sample of 35 projects was selected. Of these, ten were the subject of additional, in-depth interviews.

Overview of Results

4.30 The performance of PFI in small projects has been good, with the proportion of projects completed on time and on budget, and operating to client expectations, in line with the results for larger projects. However, average procurement times were similar – at around two to two and a half years – meaning that times were disproportionately long for the projects with a small capital value. Small schemes also typically faced similar transaction and bid costs as major capital schemes, again indicating that these were disproportionately high.

Construction performance in smaller projects

4.31 Partnerships UK's research showed that projects with a lower capital value do deliver new assets on time and to budget. Of the sample of 35 projects, 83 per cent were delivered on time or early. Of the 17 per cent delivered late, the longest delay was four months.

Operational performance in smaller projects

4.32 The projects sampled also suggested that subsequent operations are satisfactory and in line with the public sector clients' expectations:

- 32 projects delivered met initial expectations or surpassed them;
- for one project, performance was 'as expected' but with certain elements 'below expectations'; and
- for two projects, performance was 'below expectations' in terms of facilities management services, but 'above expectations' in terms of build quality.

4.33 This record of satisfactory performance, with over 90 per cent of projects fully meeting client expectations, even surpasses that of larger PFI projects, where the figure was 75 per cent.

Procurement times in smaller projects

4.34 For the 35 projects sampled, procurement times ranged from 14 months to five years, with an average duration of two and half years. Subsequent interviews with ten project managers found that the duration of the procurement for all ten projects was longer than expected and, in many cases, considerably so. The periods ranged from just two months longer to a delay of four years in one case.

4.35 The two most prevalent reasons for delay, certainly once the PFI procurement had started, were: first, issues related to the availability of the appropriate sites (for example, acquisition, title, town planning); and second, protracted contractual negotiations once the preferred PFI partner had been selected.

4.36 Whilst PFI's record of performance has been similarly good for major schemes and for projects with a capital value of less than £20 million, there is however also evidence that smaller projects face a number of difficulties that need to be addressed to ensure that this success is not obtained at disproportionate cost.

Costs of third-party finance

4.37 All PFI schemes face the cost of using third-party finance and small schemes typically face the same level of legal and technical documentation, complex due diligence requirements and financial modelling that lenders require for much larger projects. As a result, the costs of private finance are relatively higher for small schemes.

Bid costs in small schemes

4.38 Similarly, in addition to their own internal costs, bidders must typically meet the costs of technical, financial, design and legal advisors. These costs do not necessarily fall in proportion to the size of the project, and so drive up the relative cost of small PFI schemes. For example, one private sector contractor has suggested that their bid costs, as a proportion of a project's capital value, are 33 per cent lower for a £50 million project compared to a project costing £20 million.

Procurement costs and the PSC 4.39 Procurement costs for the public sector are not included in the Public Sector Comparator (PSC) under the current guidelines, and so the evaluative comparison made on small projects in the past would not have captured these external value for money factors. To address this issue, proposals for a reform of the PSC are outlined in Chapter 7, which will enable value for money appraisal to take into account both the procurement costs associated with a PFI project, and the strength of market interest it is likely to generate.

Policy Implications

4.40 The overall implication of this research into individually procured small PFI projects is that, although PFI continues to perform well in these small schemes, its transaction and development costs and procurement times are disproportionately large. These factors make it difficult for small PFI schemes to consistently obtain value for money unless projects can be bundled together, a process outlined in paragraphs 8.26 to 8.40. Chapter 7 outlines policy measures designed to take account of this.

PERFORMANCE OF PFI IN IT

Overview 4.41 The Government is committed to improving the delivery of IT projects it procures to implement public services. The use of PFI in IT has been one method employed to achieve this. In particular, one objective was to introduce third-party finance into IT projects to effect risk transfer, impose further commercial discipline and ensure risk mitigation in the delivery of IT contracts.

4.42 HM Treasury along with Partnerships UK have recently reviewed the operation and performance of PFI in IT to determine how far PFI has been successful in achieving an appropriate sharing of risk in IT and so improved public service delivery. It also sought to investigate important differences between PFI in IT and PFI in other sectors. The evidence collected suggested that, in the majority of successful IT procurements, contracts were renegotiated to move away from the mainstream PFI model based around specified outputs, to adopt a different approach.

Principles of PFI and IT Procurement 4.43 Overall, this research indicated that because of the significant differences between IT PFI and PFI in other sectors, and the attendant difficulty of ensuring an appropriate sharing of risk through PFI, IT PFI may not be able to consistently offer value for money benefits. In particular many aspects central to IT procurement do not fit well with the central requirements of PFI, laid out in Chapter 3, particularly:

- the fast pace of change in the sector make it difficult for the public sector to effectively define the outputs it requires in a long-term contract;
- the high level of integration of IT infrastructure into the other business systems of the procurer makes it difficult to clearly delineate areas of responsibility to the client and the contractor, and so makes an appropriate sharing of risk more difficult to both discern and enforce;
- the lack of a market for third-party finance in IT PFI removes a powerful driver ensuring appropriate and effective risk allocation in a project. This detracts from PFI's ability to secure value for money for the public sector;
- the nature of the capital investment, with costs in IT dominated not by large up-front investment but by running costs; and

- the duration and phasing of investment, where IT projects have a short life, and include significant asset refresh, makes defining and enforcing long-term service needs more problematic.

These points are outlined in more detail below. The policy implications of these findings are detailed in Chapter 7.

Differences between IT PFI and PFI in other sectors

4.44 The successful implementation of IT procurement has always been difficult, for both the public and the private sector, no matter what method is used. The Standish Group's report[4] on IT projects from the United States suggested that only 16 per cent of software projects are completed on time and on budget throughout IT procurement. The report went further, stating that "even when these projects are completed, many are no more than a mere shadow of their original specification requirements. Projects completed by the largest American companies have only approximately 42 per cent of the originally proposed features and functions. Smaller companies do much better. A total of 78.4 per cent of their software projects will get deployed with at least 74.2 per cent of their original features and functions".

4.45 It was hoped that the use of PFI in IT, by achieving an appropriate sharing of risks between the procurer and the IT contractor, could drive improvement in sectoral performance. However, because of the particular characteristics of IT procurement, outlined below, achieving an appropriate level of risk transfer has been difficult.

Difficulty of specifying requirements

4.46 The close links between IT infrastructure and organisational operational needs, combined with the rapid pace of technological change, frequently make it difficult to codify long-term IT requirements into an effective contract, especially over the time periods that PFI agreements typically cover. Generally, the service requirement in an IT project is likely to change frequently during the course of a contract.

Difficulty of substituting suppliers

4.47 A consequence of the structure of IT PFI projects, the intricate nature of IT service provision, and the difficulty of integrating proprietary technologies is that it is very difficult and sometimes impossible to substitute in a timely manner a second IT service provider in the event of contractor failing to meet its obligations under the contract. This means that when an adequate service is not delivered, departments are often at a disadvantage in negotiating with their existing vendors. This problem has not occurred in the vast majority of the 440 other operational PFI projects.

Lack of third-party finance

4.48 IT PFI very rarely involves genuine third-party finance, whereas most non-IT PFI projects do. When PFI was introduced in the IT sector, it was hoped that a market for third-party finance of IT projects might emerge; however, for a variety of reasons including the general downturn in the IT sector, this has not occurred. As explained in Chapter 3 paragraphs 3.54 to 3.59, third-party finance provides a series of important benefits to PFI projects in other sectors

4.49 This lack of third-party finance in IT has had a number of consequences:

- it imposes constraints on the ability of the private sector to finance long up-front development costs, and often requires these costs to be met from corporate borrowing. This is especially significant in the context of large software development projects, in which IT service providers are often expected to finance months or years of development before receiving any revenues;

[4] The Chaos Report, The Standish Group, 1995.

- it removes a valuable source of due diligence, which has been shown to reduce optimism bias and tighten contract terms in non-IT PFI, as outlined in paragraph 3.54 to 3.59. This makes it more difficult to assure effective risk allocation in IT PFI; and
- it makes it difficult for small and medium-sized IT providers to bid for many projects, especially considering the large size of some projects and the requirement in many PFI contracts for the private sector to finance development costs up-front. This has weakened competition for projects.

Nature of capital investment

4.50 Although both IT PFI projects and other PFI projects involve the provision of capital assets (whether buildings or IT applications, systems or networks), the costs of delivering IT projects are dominated by the annual running costs associated with delivering the service requirement, rather than by the up-front costs of investment in the project assets. In a typical IT project, project assets often account for less than a third of the present value of projects; in a non-IT PFI project, this fraction is usually considerably higher.

Duration and phasing of investment

4.51 The life of IT PFI contracts is typically shorter than that of PFI projects in other sectors, with IT projects typically lasting ten years, and other PFI projects lasting 15 to 30 years. The expected life of an IT project's assets is typically even shorter than the contract duration, with the consequence that the contractor is expected to undertake significant asset refresh during the course of the project. For example, in a desktop outsourcing IT PFI project, the outsourcer will typically replace a procuring authority's PCs and servers more than once over a ten-year contract. In non-IT PFI projects, most assets typically will be useful for the whole life of the contract.

The Performance of PFI in IT

Overview of research findings

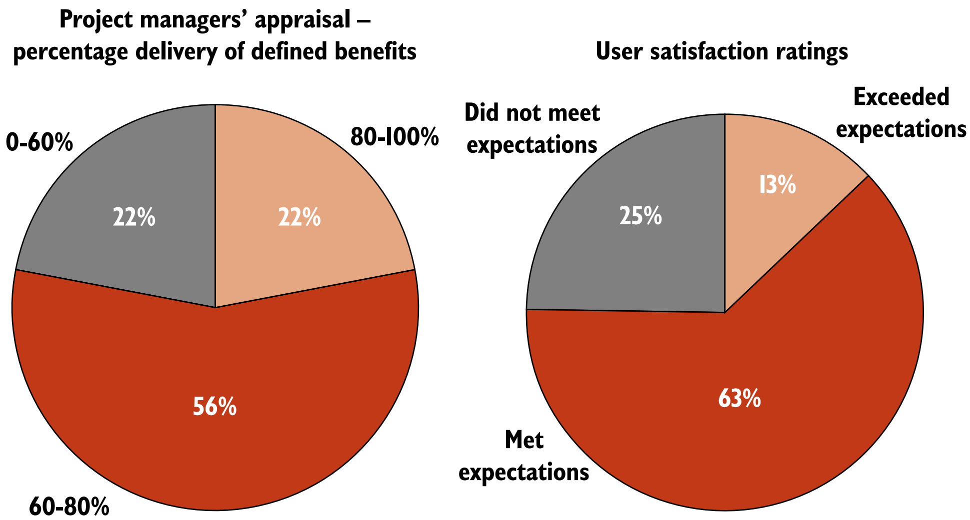
4.52 The track record of performance in IT has reflected these qualitative differences. Although performance has been good in comparison to the IT sector as a whole, the best performing projects were those that renegotiated their contracts after signature to obtain greater ongoing flexibility and looser output specifications, moving away from the PFI model. Although it is encouraging that user expectations were generally met or exceeded, the results suggest that there is still room for significant improvement in the procurement of IT, and that PFI has not delivered the step-change in performance that the Government originally intended, and still requires.

4.53 HM Treasury, with the assistance of Partnerships UK, sought views from managers and users of a sample of 16 operational public sector IT projects. This research was intended to be indicative, rather than comprehensive, and as such was more limited in scope than other surveys of PFI projects carried out by HM Treasury and reported in this document. The sample used was a representative one, including projects by a variety of departments and authorities and of a variety of size. 11 projects responded in full.

Project Performance

4.54 Most (75 per cent) of these projects were regarded as fulfilling or exceeding user expectations. However, only 22 per cent of projects were, according to managers, delivering 80 to 100 per cent of defined programme benefits (see Chart 4.8). This is in line with the result obtained in the Standish Group's survey of IT outsourcing.

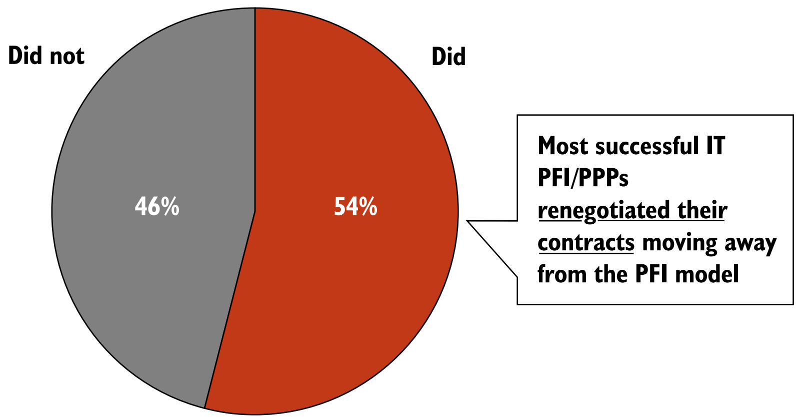
Chart 4.8: Client experience of IT PFI projects



Source: HM Treasury.

Details of research 4.55 However, the majority (54 per cent) of the more successful IT projects surveyed were those where the public sector had sought and obtained greater flexibility by renegotiating terms after the contract was signed – moving away from the PFI model.

Chart 4.9: Successful IT PFI/PPPs renegotiating contract after signing



Source: HM Treasury.

Policy Implications

4.56 The Government, like any customer, needs IT projects delivered to time, cost and full performance. The concern raised by this research is that expectations in the IT industry and among public sector procurers are set too low. But more importantly it demonstrates that the qualitative differences between PFI in IT and PFI in other sectors have a significant impact on the way that IT PFI has been delivering. The difficulties with achieving appropriate risk transfer in IT PFI, because of the need for significantly greater flexibility than in other sector, the high degree of integration into the other business operations of the procuring authority, and the lack of third party finance, mean that it may not be the appropriate value for money procurement route for IT. Policy measures to reflect this are laid out in Chapter 7.

5 IMPROVING THE PARTNERSHIP

It is a priority of the Government to ensure that it has the right skills and support mechanisms in place for the public sector to deliver on the reform and renewal of public services.

The Government recognises the need to improve procurement skills and ensure that procuring authorities have the capacity and support to pursue both conventional procurement and PFI effectively. By improving in its role as public sector client, the Government helps:

- **enable authorities to focus more effectively on securing overall value for money, taking in whole-of-life costs, allowing scope for innovative design and using discretion and good judgment in evaluating procurement options;**
- **increase the speed with which investment is delivered to the public by reducing time spent in procurement;**
- **reduce the cost to the public sector of procuring PFI projects, improving their value for money; and**
- **by being a better client, encourage the private sector to bid for PFI projects, strengthening competition and innovation in PFI.**

Future steps to improve the capacity of the public sector client in PFI will help address the remaining concerns of the private sector over the costs of bidding for PFI projects and the potential for delay in the PFI procurement process.

BACKGROUND

5.1 The Government places great importance in ensuring that the public sector develops strong delivery and procurement skills for both conventional procurement and, as particularly addressed in this chapter, for PFI. The Prime Minister's four principles of public sector reform, the Cabinet Office Civil Service reform programme and the OGC's programme of skills development in central civil government are all aimed at securing excellence across Government and in the delivery of vital public services.

5.2 Delivery skills in general, and procurement skills in particular, have historically been insufficiently valued and undersupplied in the public sector. Particular problems have been experienced with ensuring that these skills are consistently in place where they are needed:

- procurement has not been sufficiently valued in the public sector as a career choice, meaning that high calibre staff often pursued other options and did not develop these important skill sets;
- some procurement professionals were attracted away from the public sector; and
- procurement expertise, where it was built up, was often dissipated after a single procurement as project teams disbanded, rather than being applied to whole investment programmes.

5.3 In markets where the Government is a major procurer of goods and services, its own actions may impact upon competition and hence the long-term value for money it can secure. The Competition Commission last year made a number of recommendations to improve competition in procurement, following which the Government announced that the

Office for Government Commerce (OGC) would consider steps to increase competition and to encourage better long-term capacity planning in markets where the Government possesses significant purchasing power.

5.4 The Government recognises that procurement skills are at a particular premium in PFI procurement, because of its complexity, and the necessity therefore for high levels of expertise. Better procurement skills lead to lower transaction costs, better value for money in projects procured, and faster delivery of investment to public services. In PFI in particular, improved procurement skills:

- **enable the public sector to maximise the benefits available in the procurement process** by effectively conducting the long-term options appraisal necessary both to determine whether the PFI route is value for money, and to secure best value from PFI bidders;
- **improve value for money, by reducing delays and lowering procurement costs for the public sector** and actively managing the specialist advisers, such as technical, financial and legal advisers necessary for PFI;
- **secure value for money from contract negotiations** by achieving the Government's aims in risk-sharing, and ensuring a smooth and timely procurement process; and
- **create an environment that encourages the private sector** to bid for PFI projects, improving competition and delivering a stronger PFI market.

5.5 The Government has already taken significant steps to improve its ability to procure PFI projects, in the context of a wide-ranging programme to increase the public sector's delivery skills more generally. This chapter sets out these measures taken to increase Departments' and local authorities' ability to negotiate effective PFI projects quickly and with reduced cost to themselves and to the private sector.

PROGRESS TO DATE

5.6 The present Government took a number of immediate measures to improve the public sector's PFI procurement capabilities:

- it ended universal testing of all investment projects for the potential application of PFI in 1997, allowing departments to dedicate skilled resources to those areas most likely to give rise to effective PFI projects and to prioritise the most promising PFI opportunities;
- it instituted the Bates Review to suggest improvements to the delivery of PFI projects. The resulting report, published in 1997, led to a number of further measures, including the creation of the Treasury Taskforce on PFI and the establishment of standardised contract terms;
- in April 1999, Peter Gershon undertook a review of civil procurement in central government. One outcome of this review was establishment of the Office of Government Commerce, incorporating several existing government agencies. The OGC vision is to work with central civil government as a catalsyt to achieve best value for money in commercial activities. Among other policy measures, the OGC initiated the creation of standardised PFI contracts (see paragraph 5.23 to 5.26); and
- since 1997, public sector bodies have also significantly increased their internal PFI expertise. The Department of Health, HM Prison Service, the Highways Agency and other bodies have developed specialised private finance units to provide advice on the most effective use of PFI to achieve departmental investment targets.

Treasury Taskforce

5.7 The Treasury Taskforce, formed in 1997, provided departments with highly skilled procurement and project management advice, reducing procurement delays and helping to design robust projects. Following the advice of the second Bates Review in 1999 the Government re-established the Treasury Taskforce as Partnerships UK, a public private partnership with a public interest mission to make the public sector a more effective client in public private partnership and PFI transactions.

Gateway reviews

5.8 In 2001, OGC introduced the Gateway process, a performance management tool to allow the public sector to track and assess the effectiveness of projects, including PFI schemes, throughout their procurement process. Gateways are designed to ensure that any potential problems are addressed early on in any tender process. The process for each stage is outlined in Box 5.1 below.

5.9 All new central civil government procurement and NHS projects must undergo Gateway reviews, which are conducted on a confidential basis for the benefit of the senior official and ownership of the report rests with them. The senior official is then accountable for implementation of recommendations. Typically, the review team agrees an overall project assessment of red, amber or green for the inclusion in the Gateway report.

5.10 From April 2003, the Gateway process is being piloted in local government sector PFI projects by the Public Private Partnerships Programme (4Ps) (see paragraph 5.14), as recommended by the Byatt review.

Box 5.1: The Gateway process

Gate 0 Strategic Assessment: The evaluation is applied at the start of a project or programme and is designed to consider the strategic assessment of the business need.

Gate 1 Business Justification: This evaluation occurs once there is an outline business case in place. Its aim is to confirm that the business case is robust and make recommendations for improvements where necessary.

Gate 2 Procurement Strategy: Prior to the invitation for tender, this gate considers the project's potential for success and its ability to proceed.

Gate 3 Investment Decision: This gate is intended to establish whether the recommended investment decision is appropriate prior to the contract being awarded. It also examines the processes in place to select the supplier.

Gate 4 Readiness for Service: the purpose of this gate is to examine how the organisation will implement business change associated with delivery and how robust the solution is. It should also assess whether there is a basis for evaluating the projects ongoing performance.

Gate 5 Benefits Evaluation: The focus here is ensuring the delivery of benefits and value for money as set out in the initial business case.

The CABE Report

5.11 The Commission for Architecture and the Built Environment (CABE) was established to promote high standards in the design of public buildings. It aims to help public bodies towards improved performance as a client, so that public buildings are known for their design quality. Creative design is an essential ingredient in delivering value for money; and through the working life of a building, design excellence can make service delivery more efficient, and enhance the working environment for all those that use public buildings.

5.12 To ensure the public sector receives a high quality of design from public procurement in PFI projects, OGC published 'Improving the Standards of Design in the Procurement of Public Buildings' in conjunction with CABE in October 2002. The report highlighted the importance of ensuring the public procurement process produced buildings that facilitated the delivery of high quality services and which provided optimal value to the taxpayer. The report set out 11 recommendations to ensure the implementation of good design. An example of how some of the CABE recommendations are being applied in practice is the DfES plans for exemplar school design, described in further detail in Box 8.1.

PFI and Local Authorities

5.13 It is important that sufficient support is available at the local authority level to enable local authorities to procure PFI projects effectively, particularly where authorities are engaging in "one-off" procurements. The Government has taken a number of specific measures to support local authorities engaging in PFI.

4Ps

5.14 The Public Private Partnership Programme (4Ps) has been created to provide a supporting role to local authorities involved in PFI procurement and plays a significant role on the Project Review Group, which reviews the quality and value for money of local authority PFI. 4Ps has also created procurement packs providing information on street-lighting and leisure PFI schemes, as well as case studies and guidance notes on PFI projects, and is working with the Government to increase standardisation of local government PFI contracts.

The role of the Project Review Group

5.15 The Government established the Project Review Group (PRG) as an interdepartmental body to test the quality of local authority PFI projects prior to entering their procurement stage, acting as final gatekeeper for the delivery of PFI credit funding to local authorities. No PFI project can be submitted to the PRG before the relevant government department has agreed that it meets policy objectives, is likely to provide value for money and is suitable for a PFI approach.

5.16 Once departments have accepted that a scheme should be prioritised for development, the PRG then reviews the business case to assess the extent to which the project matches the 12 key criteria (shown in Box 5.2).

Box 5.2: Checking project deliverability – the role of the Project Review Group

Key criteria for the PRG in assessing the viability of projects are:

- affordability;
- output specification;
- design quality;
- risk allocation;
- key terms and conditions;
- bankability;
- use of appropriate comparators;
- indicative timetable;
- project team;
- suitability of advisors;
- commitment of sponsors/users; and
- statutory process.

5.17 By evaluating proposed local authority PFI schemes, the PRG provides:

- a review of the commercial deliverability of schemes before they go into procurement, and therefore provide reassurance to local authorities that PFI is the right value for money approach, or indicate whether alternative options should be pursued; and
- a procedure to review the progress of local authority projects so that a pipeline of deliverable deals is established and maintained, and so that lessons learnt from preceding projects are used to inform the development of new projects.

The Role of Partnerships UK

5.18 Partnerships UK was established in June 2000 as a public private partnership, incorporated as a private sector company, with 51 per cent of its shares owned by private sector institutions with the remaining 49 per cent held by HM Treasury and Scottish Ministers. It was created out of the Treasury Taskforce to ensure continued access to procurement expertise for the public sector. Partnerships UK's Board consists of three Executive Directors and six Non-Executive Directors, two of which are Treasury nominees. Partnerships UK is limited to working for the public sector in the UK and overseas. To preserve and assist in this mission of supporting the public sector, an Advisory Council consisting of twenty members and chaired by Sir Andrew Turnbull, the Cabinet Secretary, meets twice a year to review Partnerships UK's activities.

Partnerships UK's objectives

5.19 Partnerships UK's primary objective is to be available to support all parts of the public sector, including local authorities and devolved administrations in implementing their PFI and PPP programmes and projects. By creating Partnerships UK, the Government has put in place a central resource of professionals, drawn from both private and public sector, with procurement expertise relevant to PFI and other PPPs. Partnerships UK's primary aim, therefore, is to provide the public sector with an improved client capability. An example of this working in practice is set out in Box 5.3.

Box 5.3: Aquatrine

Partnerships UK entered a Development Partnership Agreement with MOD Defence Estates, in 2001, for the procurement of the Aquatrine project – a major PFI for the water and waste water treatment facilities of MOD sites across Great Britain.

As co-sponsor of this procurement, Partnerships UK joined the project board and has played a full and active role in assisting Defence Estates achieve not only improved value for money from the PFI but also increased efficiency and reduced timescales for the procurement process itself.

Since joining the procurement, Partnerships UK has played a leading role in achieving:

- **a reduction of 15 months in procurement timescale; and**
- **a corresponding £6 million reduction in the cost of delivering the project.**

The project is divided into three packages, the first of which – for sites in Wales and South West England – was awarded to the Brey consortium in April 2003. The remaining packages are due to be awarded in March 2004.

Partnerships UK provides PFI procurement expertise to the public sector

5.20 In understanding Partnerships UK's role, it is important to emphasise that it does not replace the need for the appointment of financial or legal advisers to assist the public sector, nor act in some way as the Government's "investment bank". Most of its staff are procurement specialists, not City professionals. Also, as a private sector company, it does not determine nor can it enforce PFI or PPP policy, which remains a matter for the Government. The responsibility for the implementation of individual PFI projects rests with procuring authorities and for overall PFI policy with HM Treasury. Instead, Partnerships UK acts in partnership with the public sector by providing an effective bridge between public and private sectors, and provides access to expertise for the public sector .

5.21 Partnerships UK achieves its objectives in a number of different ways:

- advising public sector clients;
- creating procurement joint ventures with the public sector for specific programmes, such as LIFT and Partnerships for Schools (see Chapter 8); and
- entering into development agreements with the public sector to jointly procure PFI projects.

Partnerships UK's role as a bridge

5.22 Because of Partnerships UK's active presence across the public sector in implementing projects, it can often act as a "bridge" between public and private sectors. It is called upon by procuring authorities to identify and seek to remove roadblocks to the successful and timely implementation of particular projects, whether they arise from the public or private sectors. Partnerships UK is also an important source of market intelligence in formulating PFI policy. For this reason, it can be tasked to more formally act as such a "bridge" between public and private sectors, as it was recently in implementing revisions to standardised contracts on behalf of the Government. The Government believes that it is important for Partnerships UK to retain and develop this role of a "bridge" between public and private sectors.

Standard Contracts

5.23 One of the key tools in the Government's approach to procurement of PFI projects has been the development of standardised commercial contracts. In July 1999 the first edition of Standardisation of PFI Contracts was published. In July 2002, the Government launched a revised version of the standardised contracts. This revised guidance built on the experience and best practice gained in the application of the earlier PFI standardised contracts across a wide range of projects and reflected the results of a widespread consultation with both the public and private sectors.

5.24 The three main objectives of the Government's guidance on standardised contracts are:

- to reduce the period and costs of negotiation;
- to promote a common understanding of the main risks encountered in a standard PFI project; and
- to allow a consistency of approach and pricing across a range of similar projects without detracting from their ability to cater for specific needs.

5.25 This generic guidance has then been used as the basis for sector specific guidance in health, education, and defence.

5.26 The revised standardised contract is now being used widely across PFI projects. It has already helped to reduce the scope and time of negotiations. Partnerships UK operate a help desk for the Government, which provides support to both the public and private sectors on the implementation of standardised contracts.

PFI and the Private Sector

5.27 The successful delivery of the Government's PFI investment programme requires an effective partnership between the public and private sectors. It is central to this partnership to ensure that the PFI procurement process runs smoothly, that there is sufficient capacity in the public sector to act as an effective client and a matching capacity in the private sector to deliver what is required of it and confidence on both sides that the partnership rests on a sustainable base.

5.28 For the private sector, the drive to improve capacity in the public sector means:

- a more certain market in PFI, which runs without delay;
- smoother deal flow, and so the confidence that the market is sustainable; and
- reduced transaction costs on PFI, improving their ability to bid for projects, and so improving competition and value for money for the public sector as well.

Private sector concerns

5.29 Private sector experience and views of the PFI process and the strength of the market remain of importance to the Government. HM Treasury conducted research into private sector participants' experience of PFI over 2002 in order to assess areas where private sector concerns might be impacting on the effectiveness of the PFI programme. Opinion was positive about PFI. In particular:

- all firms involved expressed pride and satisfaction in the facilities they have provided to the public sector through PFI. All believed they had contributed to an outcome which would not have been possible under conventional procurement and that this represented good value for money for the public sector;
- most were content that the risk sharing approach of Government set out in standardised contracts was a reasonable allocation of risks. Most also provided examples of where risks had materialised in practice, reducing their returns due to increasing costs which they had borne, and demonstrating that risk transfer has been effective; and
- most were content that the future flow of PFI projects was sustainable. All contractors sampled were happy there was sufficient funding liquidity available for projects, as were the funding sources surveyed.

5.30 Where the private sector raised concerns, these centred on:

- high bid costs, particularly after recent changes introduced by the Accounting Standards Board in the accounting treatment of such costs and for some, the length of time taken by some departments and authorities in procuring PFI projects; and

- some were concerned that the Government may pursue an approach to risk transfer that was unsustainable, seeking to transfer too much risk to the private sector. As outlined in Chapter 3, the Government's approach to risk sharing in PFI is to seek to transfer only those risks that the private sector can more effectively manage. It does not seek to maximise risk transfer, as this would offer poor value for money.

Bid costs and procurement timescales

5.31 Undoubtedly, high bid costs and long procurement times can represent a concern for both the public and private sector, can impair delivery and value for money for the public sector and limit companies' capacity to bid for projects. Several companies have found that new technical guidance published by the Accounting Standards Board on how to account for pre-contract costs increased the impact of up-front costs. The guidance required some bidders to recognise as costs in the year incurred the expense associated with PFI bids, which previously they had been able to capitalise, and has increased the sensitivity of some companies to bid costs.

5.32 The Government recognises that bid costs and procurement timescales for PFI transactions will always be somewhat longer than for conventional procurement. Unlike other forms of procurement, PFI projects benefit from whole-life costing over 30 years, involving both construction and service delivery, and a full competition for design with extensive involvement of users in deciding upon the preferred solution. Bidders must invest time and money in planning bids in some detail and persuading others to fund their proposed scheme. The Government believes this process leads to a greater degree of up-front due diligence by both public and private sectors and detailed analysis and negotiation of the risk aspects of a project. The evidence in Chapter 4 suggests this greater effort at an early stage of a project's development has significantly improved project outturns to the benefit of the public sector.

5.33 The cost of bidding for PFI projects will always place some constraints on the private sector in its ability to bid for large number of PFI projects. HM Treasury's research into PFI companies suggests that the cost of bidding for PFI projects can be a consideration as important as the funding of an investor's equity and subordinated debt investments. In funding such costs, a key consideration for the private sector is its success rate in winning bids. Irrespective of success, however, the aggregate level of bid costs expensed in a year does limit the number of bids a company can undertake in that year, usually determined by the overall financial capability of the contractor.

5.34 The Government does reimburse bid costs in certain very limited circumstances, where it is deemed that the increased competitive tension created by assuring bidders that costs will be covered provides value for money in the procurement, but the Government does not believe that this is a potential general solution, for the following reasons:

- to the extent that high bid costs represent wasted or duplicated work, the Government's aim should be to reduce these costs, rather than allow them to persist by funding them;
- to reimburse the bid costs of losing bidders will in effect subsidise less successful PFI companies or artificially discourage them from redeploying resources to other PFI opportunities where this could be more successful; and
- it will reduce the competitiveness of bids by limiting the downside faced by losing bidders. The Government wishes to maintain competitive tension throughout a procurement.

5.35 The Government's drive to improve public sector capacity is the best, most sustainable solution to problems associated with bid costs and delays in procurement. To this end, the Government's approach which is set out in more detail in Chapter 8 will be to:

- improve the enforcement of standardisation;
- develop new procurement models and reinforce procurement expertise to the public sector, to ensure all departments operate as best practice clients;
- improve the transparency of the future PFI programme to encourage private sector investment; and
- continue to encourage new entrants into the PFI market, including firms currently active outside the UK.

6 EMPLOYEE PROTECTION

PFI has the potential to bring improved value for money in public services with greater quality and innovation, but the Government has always made clear that this should not be achieved at the expense of staff terms and conditions. Throughout the 1980s and early 1990s, workers transferred from public to private sectors were extended only the limited protection offered by the 1981 TUPE regulations. Over the past six years, the Government has pursued a strategy for enhancing worker protections and ensuring their fair and reasonable treatment in PFI projects, based on the following principles:

- **being open with staff by providing greater transparency about workers' rights and through involving staff and their representatives in the contracting out process and its outcome through mechanisms such as the Statement of Practice on Staff Transfers in the Public Sector;**
- **protecting terms and conditions for both transferees and new joiners to PFI workforces through the Retention of Employment model and soft services testing in the NHS and the Best Value Code of Practice on workforce issues, which applies to staff in Best Value local authority PFI projects;**
- **protecting staff pensions through the Fair Deal for Staff Pensions which addressed one of the principal gaps in TUPE regulations covering public and private transfers; and**
- **retaining flexibility in public service delivery, including through PFI, to ensure efficient workforce management and encourage innovation in service delivery. The first stage of the Review of Efficiency in Public Services will be completed later this month. It has examined new ways of providing Departments, their agencies and other parts of the public sector with incentives to exploit efficiency savings, and so release more resources for front line delivery. The Review will lay the basis for a continuing programme of work to improve efficiency, as part of the Government's ongoing commitment to improve the value for money and quality of public services without a reduction in the level of terms and conditions for the workforce.**

COMMITMENT TO WORKFORCE PROTECTION

6.1 PFI has allowed for considerable innovation in workforce practices, but the value for money that PFI can deliver should not be achieved at the expense of staff terms and conditions. The Government has taken a range of steps to strengthen worker protection and ensure the fair and reasonable treatment of those working under PFI contracts.

6.2 Prior to 1997, there were limited safeguards in place to protect the terms and conditions of public sector workers transferred to the private sector as a result of PFI contracts. Each project was treated independently and the attitude of private sector employers bidding for contracts was a major input into the standard of staff treatment, which resulted in practices varying widely from project to project and contract to contract with no clear pattern across Departments or over time.

6.3 The main form of protection then available for transferees was the Transfer of Undertakings (Protection of Employment) Regulations 1981 (TUPE). In broad terms, TUPE protects employees' terms and conditions of employment when the business in which they work is transferred from one employer to another. The TUPE Regulations were designed to safeguard employees' rights when compulsorily transferred between firms. TUPE:

- guarantees transferees "no less favourable" terms and conditions at the time they transfer from one employer to another.
- applies to second-, third- and fourth-generation transfers as well as to the initial shift from the public to private sectors.
- is augmented by a Cabinet Office Statement Of Practice, see Box 6.1, which requires that transferees from the public to the private sector be given "broadly comparable" occupational pension rights as well.

6.4 Public sector employers were guided by advice that there was some risk of legal challenge if transferred staff suffered a material detriment to general terms and conditions as a result of the transfer. This resulted in court cases to establish that TUPE applied, not only to transfers within the public sector, but also to transfers from the public to the private sector. It is therefore accepted today that the measure applies to the public sector workers compulsorily transferred under PFI contracts.

6.5 However, contract terms relating to membership of occupational pension schemes were not required to be novated when staff transferred. Frequently, staff were denied any option to transfer their accrued service, and in some cases the pension scheme made available by the new employer was materially inferior to the scheme from which the staff were transferring. The treatment of pensions showed little consistency. In a few projects primary legislation was used to give special protection to pension scheme membership for the transferred workforce, far in excess of any protection enjoyed by other workforces in the private sector, or any workforce remaining in the public sector. At the other extreme, sometimes staff who had transferred from the public sector where they were members of a good quality defined benefit pension scheme were given no pension plan at all by their new employer.

Principles for extending workforce protection

6.6 Since 1997 the Government has been, and continues to be, determined to extend the protection of the terms and conditions for staff transferring to the private sector, to address uncertainty and anxiety caused to public sector staff in relation to a PFI, as well as the potential disparity between the terms and conditions of new joiners and transferred staff.

6.7 Over the past six years, the Government has pursued a strategy based on the following principles:

- being open with staff;
- protecting terms and conditions for both transferees and new joiners;
- extending protection to staff pensions; and
- retaining flexibility in the delivery of public services.

6.8 In 1997, the Government made it a priority to review their position and set out a common standard for treatment of workforces to which public sector employers would be pledged, which would create a partnership between employers and trade unions. This was intended to reassure public sector staff that, if transferred to the private sector, not only would their legal rights be respected in all cases, but beyond that, they would be reassured that they would always be treated according to a published standard of good employment practice with a right of appeal before any transfer if they felt that this standard was not being met.

6.9 In 1998 the Cabinet Office published guidance on "Better Quality Services" which reinforced the requirement for fair and reasonable treatment of staff, drew particular attention to the importance of ensuring that the new employer provided access to a good quality pension scheme, and which suggested that the availability of an agreement for staff to transfer past service into the new scheme should be a factor in evaluating bids. It was recognised that this left uncertainty in a number of areas about how staff would actually be treated in practice.

Treasury Taskforce guidance

6.10 To improve transparency and encourage greater consultation with staff during transfer, the Government published in 1998 Treasury Taskforce statement 4, which requires full and continuous communication where there are staff transfers, to ensure unions and staff are fully engaged throughout the process. This document was welcomed by both the TUC and the CBI.

Increased protection for staff pensions

The Fair Deal

6.11 To further enhance the protection of transferees' pension rights in PFI, the Government announced the Fair Deal for Staff Pensions in June 1999. The Fair Deal applied to all projects directly controlled by Ministers – central Government departments and their agencies – and it was set forward as good practice, which the Government expected other public sector employers to follow. It covers all transferees from central Government departments and agencies, including those transferred as part of PFI projects, and is recommended for use by other parts of the public sector. In addition the Fair Deal applies to all subsequent transfers. It states that:

- staff who transfer from the public sector should continue to have access to a good quality occupational pension scheme, under which they can continue to earn pension benefits for future service; and
- staff should be given options for the handling of the accrued benefits that they have already earned.

6.12 A good quality occupational pension scheme is defined as one that is broadly comparable to the public sector pension scheme. The new pension scheme does not have to be identical to the scheme available before transfer, but must overall be materially at least as good as it. The Fair Deal also requires, going forward, that all PFI bids include a bulk transfer agreement, which details how the full value of transferees' past service pension rights will be credited.

6.13 For the first time the definition of "broad comparability" was published which actuaries would be expected to apply, ensuring complete transparency to staff and unions. The Fair Deal also:

- required there to be a nominated minister for each project involving a compulsory transfer of staff to the private sector;

- pledged that in each case staff and trades unions would have the details of how the pensions protection was to be delivered, explained openly well in advance of the transfer; and

- required that no transfer would be conducted until there had been a reasonable time for the details to be studied and for questions to be asked and answered.

6.14 The Fair Deal sought to improve the transparency of the contracting-out process by setting out the principles that the Government will apply in its role as a contracting authority. These principles are:

- to treat staff fairly;

- to do so openly and transparently;

- to involve staff and their representatives fully in consultation about the process and its results; and

- to have clear accountability within the Government for the results.

6.15 In its 2000 document "Public Private Partnerships – The Government's Approach", the Government recognised the importance of protecting and valuing staff, setting out the importance of transparency and consultation, and required:

- "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"; and

- "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."

Cabinet Office Statement of Practice 2001

6.16 Building on this the Government issued a Statement of Practice on Staff Transfers in the Public Sector as a guarantee of staff terms and conditions in January 2001 (see Box 6.1). This applies directly to PFI and PPPs in central government, as well as to other situations involving staff transfers, such as outsourcing. It is also intended to apply to the rest of the public sector, including local government. The Statement of Practice requires that the public sector should follow TUPE regulations, and that if, as a matter of law, TUPE does not apply, steps should be taken to ensure equivalent protection for workers' terms and conditions.

6.17 These measures mean in practice that workers transferring from the public to the private sector as a result of PFI will receive the same terms and conditions that they did before their transfer, along with a comparable pension – extending Fair Deal beyond central government.

New entrants

6.18 The Fair Deal and the extension of TUPE provided enhanced protection to the pensions, pay and conditions of transferees, but it is important that PFI does not begin to result in a diminution in the terms and conditions of new entrants and the creation of a two-tier workforce in PFI projects, in which new joiners to PFI workforces receive worse terms and conditions than do transferred staff. At the same time, the Government believes that workforces in PFI projects must be allowed the flexibility necessary to deliver innovative and high quality public services.

Box 6.1: Cabinet Office Statement of Practice

The 2001 Cabinet Office Statement of Practice extended the themes of the Fair Deal across the public sector. It sets out that:

- **contracting-out exercises with the private sector and voluntary organisations and transfers between different parts of the public sector 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 and where a function is brought back into a public sector organisation where, in both cases, when the contract was first awarded staff transferred from the public sector;**
- **in circumstances where TUPE does not apply in strict legal terms to certain types of transfer between different parts of the public sector, the principles of TUPE should be followed (where possible using legislation to effect the transfer) and the staff involved should be treated no less favourably than had the Regulations applied; and**
- **there should be appropriate arrangements to protect occupational pensions, redundancy and severance terms of staff in all these types of transfer.**

The Statement of Practice covers the following types of situation that may involve transfers of staff:

- **Public Private Partnerships (e.g. following Better Quality Service reviews). This includes contracting-out; market testing; PFI; privatisation and other outsourcing and contracting exercises;**
- **second and subsequent generation contracting where, when the contract was first awarded, staff transferred from the public sector;**
- **reorganisations and transfers from one part of the public sector to another; and**
- **reorganisations and transfers within the civil service (where TUPE cannot apply because there is no change in employer but TUPE principles should be followed).**

NHS

6.19 The Government recognises that protection for new entrants to the workforce is also important. In the NHS two measures were introduced to address this with the specific workforce needs of the NHS in mind. These were the Retention of Employment model, and value for money testing for soft services. They recognise that the NHS workforce constitutes a distinctive "family", and that allowing employees in PFI hospitals to maintain a link to this family will help these projects operate successfully.

6.20 When a PFI hospital is planned, the department has the option to retain in-house soft services should their transfer prove not to be essential to service delivery, and does not enhance the value for money of the project. This reinforces the Government's commitment to deliver quality public services, but not at the expense of the workforce.

Retention of Employment

6.21 Retention of Employment applies to support staff in five areas: catering, portering, security, domestics and laundry. The model will be used in all major hospital PFIs in the advanced stages of procurement. Three pilots of Retention of Employment have been initiated, at Stoke Mandeville, Havering and Roehampton hospitals. The contract for the Walsgrave hospital PFI, which includes Retention of Employment, has now been signed.

6.22 Staff covered by Retention of Employment remain employed by the NHS, and benefit from NHS terms and conditions and pension entitlements. Under the scope of the contract, they are then seconded to the private sector joint venture. New joiners also become NHS employees, seconded to the joint venture. Typically, this means that around 80 per cent of a PFI hospital's staff will remain NHS employees. In order to ensure the effective management of PFI hospitals, risk-bearing supervisory staff are not covered by Retention of Employment, and are employed by the private sector.

Best Value Code of Practice

6.23 The Government's Best Value review in 2002 has led to the publication of the Best Value Code of Practice, which came into practice in March this year, and is currently being rolled out across England for all new contracts. The Best Value Code of Practice applies to new joiners to workforces employed by contractors in areas covered by Best Value. These include local authority projects in a wide variety of areas, such as transport, education, police and fire services, waste management, and housing.

6.24 The Code of Practice protects both term and conditions of employment and pensions. It requires that new joiners be offered terms and conditions that are "fair and reasonable" and "overall, no less favourable" than those available to transferees. The deal is designed to protect workers while maintaining the flexibility for employers to deliver quality public services. It does not prevent firms in tight labour markets from offering packages superior to those afforded by the public sector.

6.25 The terms and conditions should "offer reasonable pension arrangements", defined as either:

- membership of the local government scheme;
- membership of a "good-quality" employer pension scheme (if it is defined-contribution, the employer must match employee contributions up to six per cent); or
- a stakeholder pension (with the same matching requirement).

The government has since announced that this standard should also be written into new TUPE regulations to apply to all compulsory transfers of staff in the economy. It will remain open to any employer to set out a standard for protection of transferees which exceeds this minimum standard: and the government remains committed to maintaining its own standard of pension protection where TUPE applies.

6.26 The Government is monitoring the performance of these new measures to assess their effectiveness in preventing the emergence of the two-tier issue, whilst maintaining flexibility to support the delivery of high quality public services. Going forward, the Office of the Deputy Prime Minister have recently welcomed a proposal from the LGA, the Employers' Organisation for Local Government, the TUC and the CBI on an alternative dispute resolution procedure as part of the Code of Practice, although the detail is yet to be finalised.

Next steps

6.27 The Government will continue to monitor the performance of the measures now in place, to ensure that:

- PFI workforces are adequately protected;
- the measures are being effectively implemented in PFI projects;
- the measures do not undermine the flexibility or quality of delivery of public services; and
- any disputes that may arise are quickly and equitably resolved.

6.28 To ensure that the value of money delivered by PFI does not come at the expense of employees' terms and conditions, Departments have the option of not transferring soft services staff in a PFI project, where they believe their transfer is not essential for achieving the overall benefits of improved standards of service delivery specified by the procurer, and where not transferring staff is consistent with delivering the Prime Minister's commitment to flexibility in public service provision.

7 ASSESSING VALUE FOR MONEY

The Government's commitment to the PFI option rests on its ability to deliver value for money in public investment that is not at the cost of the terms and conditions of employees. The Government believes that procurement decisions must first be based on its approach to where different procurement methods can be appropriate. This approach, set out in Chapter 3, depends on the evidence about the characteristics of PFI projects which have delivered good value for money. Secondly, decisions must be based on a rigorous assessment of which of the available options represents the best value for money. The process must be one such that there is no inherent bias in favour of one option over another.

Appraising value for money is therefore a central process in procurement. The Government will:

- **institute a new assessment of the potential value for money of procurement options when overall investment decisions are made**, to ensure that PFI is used in those sectors where it is appropriate in accordance with the Government's approach and understanding of the evidence;
- **reform the Public Sector Comparator (PSC)** to ensure an economically rigorous appraisal of a project's outline business case prior to its procurement, to allow an alternative route to be chosen at this stage if it offers better value for money; and
- **set up a final assessment of competitive interest in a project**, and the market's capacity to deliver, at the procurement stage.

The Government will be consulting procurement practitioners, contractors and other stakeholders on the detailed issues to be considered under each of these three consecutive steps. These reforms will have no effect on projects already in procurement, and **the Government will continue to use PFI to invest in areas where the evidence shows value for money has been strongest: a further £8.9 billion in schools, hospitals, housing and defence projects by 2005 alone**. Among other facilities, this is expected to build 53 new hospitals and healthcare facilities and 323 new and refurbished schools.

To ensure that the value for money delivered by PFI does not come at the expense of employees' terms and conditions, **Departments have the option of not transferring soft services staff in a PFI project**, where they believe that their transfer is not essential for achieving the overall benefits of improved standards of service delivery specified by the procurer, and where not transferring staff is consistent with the Prime Minister's commitment to flexibility in public service provision.

The evidence of PFI value for money delivery discussed in Chapter 4 suggests a need to **reassess the role of PFI in projects with small capital values and in the IT sector**. The Government will therefore:

- consult on an appropriate minimum level of capital expenditure below which alternative means of procurement will be pursued; and
- replace PFI in IT with a range of procurement models which are better able to deliver, on which it will consult.

Equally, **the Government will investigate potential new areas where PFI investment could offer value for money**. Areas under consideration include the management of the existing prisons estate, urban regeneration, waste management and new applications in social housing. Initial indications on the basis of evidence from previous similar sorts of projects would be followed with a pilot stage to provide more solid evidence to judge performance in practice.

OVERVIEW

7.1 The Government's approach to the choice of procurement option is determined by a comprehensive testing of both the potential benefits of their application, their likely value for money in particular projects, and the evidence of previous procurements. Chapter 3 explained this approach in more detail, and Chapter 4 described the evidence which backs it up. This chapter:

- explains the emphasis the Government is putting on the rigour of an unbiased value for money test, and the reforms to it proposed;
- confirms that the appraisal approach proposed taken together with the evidence collected means that PFI is expected to continue to be an important tool in key areas of the Government's investment programme;
- draws the policy conclusions from the evidence presented in Chapter 4 about the need to reassess the role of PFI in individually procured small deals and information technology (IT) projects; and
- explores the possibility that the approach laid out and the evidence about the characteristics of successful areas for PFI could lead to pilots of new applications in some limited areas.

PROCUREMENT APPRAISAL BASED ON VALUE FOR MONEY

7.2 The Government's aim in procurement decision-making is to secure the maximum improvement in public services from investment through maintaining an unbiased stance on which procurement route will offer value for money in each case. The value for money appraisal process is therefore key to decision-making. The research set out in Chapter 4 showed that PFI works well for certain types of investment, but that conventional procurement may be better value for money for others, and therefore that evidence of delivery of value for money in practice for each sort of investment should be factored into initial decisions. Box 7.1 below suggests the characteristics of successful PFI that would shape this assessment. A robust appraisal of all the costs and benefits, including transaction costs, involved in pursuing a procurement route is needed, and paragraphs 7.8 to 7.12 describe the present PSC, and propose some reforms to it. Procurement authorities also need to have built in budgetary and procedural flexibilities to ensure that the best value for money option can be selected.

Box 7.1: Characteristics of successful PFI

The benefits which PFI can offer, outlined in Chapter 3, and backed by the evidence of its performance in practice presented in Chapter 4, indicate that there is a case for considering PFI where:

- **there is major capital investment programme, requiring effective management of risks associated with construction and delivery;**
- **the private sector has the expertise to deliver and there is good reason to think it will offer value for money;**
- **the structure of the service is appropriate, allowing the public sector to define its needs as service outputs that can be adequately contracted for in a way that ensures effective, equitable and accountable delivery of public services into the long term, and where risk allocation between public and private sectors can be clearly made and enforced;**
- **the nature of the assets and services identified as part of the PFI scheme are capable of being costed on a whole-of-life, long-term basis;**
- **the value of the project is sufficiently large to ensure that procurement costs are not disproportionate;**
- **the technology and other aspects of the sector are stable, and not susceptible to fast-paced change; and**
- **planning horizons are long-term, with assets intended to be used over long periods into the future.**

7.3 To date, PFI investment projects have been assessed for value for money at the project level, using the methodology set out in the Green Book and drawing on the guidance on constructing a PSC to compare the costs of a PFI procurement with a public sector option.

7.4 Taking the above analysis into account, the Government proposes to move to a three stage procedure:

- instituting a new assessment of the potential value for money of procurement options when overall investment decisions are being made in the context of the Spending Review, to ensure PFI is only used when it is the best option and has a good prospect of offering value for money;
- reforming the Public Sector Comparator (PSC) into an early, rigorous economic appraisal of an individual project at the outline business case stage prior to involving the private sector, to allow projects to proceed down alternative procurement routes where they offer value for money; and
- setting up a final assessment of competitive interest in a project, and the market's capacity to deliver, at the procurement stage.

7.5 Given that the proposals set out in this chapter are a broad framework, the Government will be consulting on the details of how these stages will be implemented, and in particular on the reformed PSC (see paragraphs 7.8 to 7.12 below). They will not affect or hold up projects already in procurement.

The Investment Programme Assessment

7.6 The Government proposes, in reforming the value for money appraisal process, to establish an investment programme assessment of the appropriate procurement option for those areas where PFI may offer best value for money. In this first stage, Departments will make both an assessment of the best choice of procurement route, and the appropriateness of PFI for these particular sectors. Departments will have to justify their assessment of the appropriate procurement route in the Spending Review context, demonstrating how the benefits of PFI outweigh the known costs, on the basis of:

- the Government's approach to where PFI investment can be appropriately used as laid out in Chapter 3, taking into account equity, efficiency and accountability;
- the general characteristics apparent from the evidence so far which seem necessary for PFI to be successfully applied as summarised in Box 7.1, including the ability to specify requirements in the long term, and effectively allocate risks; and
- the available evidence on where PFI and conventional procurement have proven successful at providing overall value for money in the past in similar investment projects. This evidence will be made available in new guidance, laying out what the objective benefits and costs of each procurement option are, benchmarked against the relative success of other PFI and conventional procurement programmes.

7.7 By making a value for money assessment of all procurement options at an early stage, as investment programmes are being considered, this new initial stage will allow maximum flexibility in the choice of procurement options in these areas. This early value for money assessment will be used, for example, to evaluate some potential new areas where PFI may be applicable, outlined below.

The Public Sector Comparator

7.8 The PSC is seen as a key tool for evaluating the value for money of PFI projects. The PSC provides a quantitative analysis to support a qualitative judgement of the best procurement option, taking into account the risks of each procurement approach as a means of informing a wider value for money assessment. However, the PSC at present is focused only on the narrower benefits and disbenefits of the future project options and is often done at a stage where it is not possible to take sufficient account of the wider factors around pursuing a PFI procurement programme, such as pre-contract costs.

7.9 Recent NAO reports[1] have highlighted a number of issues relating to the use of the PSC as an effective appraisal tool, specifically noting that in some instances procuring authorities had treated the PSC as a single pass/fail test to justify the choice of a PFI procurement route, and potentially striven for spurious accuracy. The NAO has put considerable emphasis on the fact that financial appraisal is just one part of an overall assessment of a project's value for money, suggesting that public sector managers should in future ensure that value for money decisions are not based on one-dimensional comparisons of single figures.

7.10 The Government believes that a rigorous economic assessment is important to ensure that the right procurement option is chosen on the basis of value for money. The Government agrees with the NAO, however, about the dangers of putting disproportionate emphasis on a single figure comparison. It therefore believes that the PSC continues to have an important role but as the second stage in a three stage process, and needs some reform in itself.

The Green Book **7.11** The first step in reforming investment appraisal has already been taken, with the publication of the revised Green Book in January 2003. This set out a rigorous approach to project appraisal for all investment undertaken by the public sector, whether procured conventionally or through PFI. The approach was designed to encourage a more thorough,

[1] For example, 'Ministry of Defence Redevelopment of MOD Main Building' April 2002.

long-term and analytically robust approach to appraisal and investment evaluation. Measures of particular relevance to PFI are:

- a new discount rate of 3.5 per cent, based solely on social time preference, should be used to assess the present value of any investment proposal;
- separate adjustments should now be applied to appraisal calculations for optimism bias and tax;
- the recommendation that appraisals should be conducted with the rigour appropriate to the scale of the expenditure involved, and the decision-making stage that has been reached;
- that more weight should be placed on valuing the benefits of proposals, and that more steps should be taken to ensure that benefits are realised as projects unfold;
- that greater consideration should be given to the wider impact of proposals across society.

The reformed PSC

7.12 The existing PSC will be reformed into a comprehensive project appraisal carried out at the outline business case stage, i.e. prior to procurement and the role of the private sector with the quantitative aspect remaining part of a broader qualitative approach to the assessment. At this stage the procurement team should be in a position to look in greater detail at the specific characteristics of the project. It should be able to make an informed judgment as to whether the original choice of PFI or conventional procurement, made on the basis of the investment programme assessment, is confirmed. Should the specific characteristics of the project suggest that value for money would best be achieved through alternative procurement options, there should be sufficient flexibility within internal budgets for investment to ensure that the best value for money options are taken forward. At this point appraisers should also be preparing for the third stage, considering the project in the light of the potential strength of market interest. Annex A describes the proposed criteria to be used in the reformed PSC in more detail.

The Final Procurement Assessment

7.13 The final stage focuses, prior to going out to tender, on the potential market capacity to deliver the project, and then on the quality of the competitive interest in it. This stage should inform the way the project is taken to market, and the timing of that competition. In the very few cases where it is not possible to achieve suitable competitive tension for a project, prudent investment planning by Departments should ensure that it will still be possible to procure the project conventionally. Given the previous assessments, the probability of changing procurement routes at this stage should be very small.

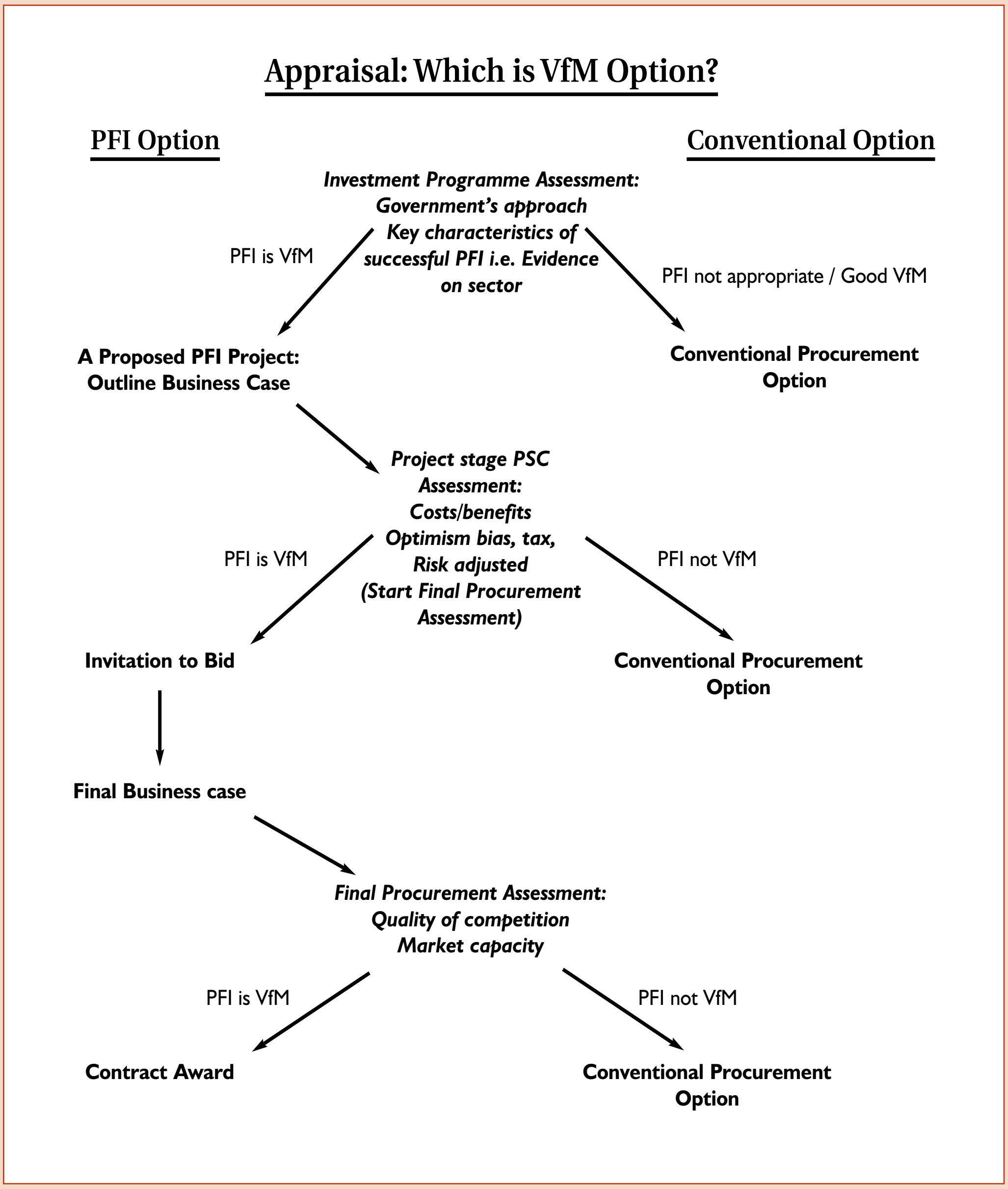
Competition

7.14 Market feedback and quality of competition are both key factors in delivering the expected benefits of PFI, and the final procurement test is designed to take them into account. The Government also considers that incorporating assessment of the market and competition in the appraisal of value for money will continue to encourage procuring authorities to adopt a forward looking approach to maximise competitive pressure during the tendering process. In extreme cases of market failure where the competitive process fails it is also important for public sector managers to have available alternatives.

Next Steps in Implementing the New Appraisal Process

7.15 An early and comprehensive appraisal of both the financial and non-financial factors of each procurement option should lead to a low probability of projects not proceeding as expected by procuring authorities close to contract close. But investment programmes will need to be actively managed to ensure sufficient budgetary flexibility to alter the procurement route in the event that this proves necessary so that the best value for money procurement option can always be pursued. The process is shown schematically in Box 7.2.

Box 7.2: Three stages in VfM appraisal



By applying this appraisal process throughout the competitive process, public sector clients will safeguard value for money by:

- ensuring there is no inherent preference for a particular procurement option;
- making the quality of the competition an explicit part of evaluation;
- encouraging intelligent management of market capacity as part of procurement and pre-tender dialogue;
- feeding information back into projects and programmes in earlier stages of procurement. This will be supported going forward by the improved signed deals list and the adviser database; and
- providing an early warning of when competitive tension may be reducing, and how this can be remedied.

PFI procurement will only be pursued if these assessments show that it will deliver value for money.

7.16 HM Treasury will consult on the guidance for the new value for money appraisal framework with Departments, particularly in terms of the timing and application of the tests to ensure that they represent best practice and fit in with existing processes for allocating and managing investment (including the next Spending Review). The development and implementation of the new framework will not be allowed to disrupt programmes or individual projects which are already underway. More detail on the scope and application of the new value for money appraisal framework can be found in Annex A. The Annex covers in more detail:

- the factors to be considered at each of the three stages of assessment: investment test, project test and final procurement test; and
- the elements included in the economic analysis undertaken at each stage.

Value for Money in Soft Services

7.17 The Government's commitment to PFI is based on its ability to deliver value for money in public investment, while protecting the terms and conditions of employees. Therefore – as the Government has always made clear – value for money should not be achieved at the expense of staff terms and conditions.

7.18 The Government believes that PFI procurement does not involve maximising the transfer of employees to the private sector and that the value for money benefits it can offer, outlined in Chapters 3 and 4, are not obtained at the expense of workers' terms and conditions.

7.19 To ensure that the value of money delivered by PFI does not come at the expense of employees' terms and conditions, Departments have the option of not transferring soft services staff in a PFI project, where they believe their transfer is not essential for achieving the overall benefits of improved standard of service delivery specified by the procurer, and where not transferring staff is consistent with delivery the Prime Minister's commitment to flexibility in public service provision.

7.20 Where staff transfers do occur, the Government will continue to protect the terms and conditions of transferred staff.

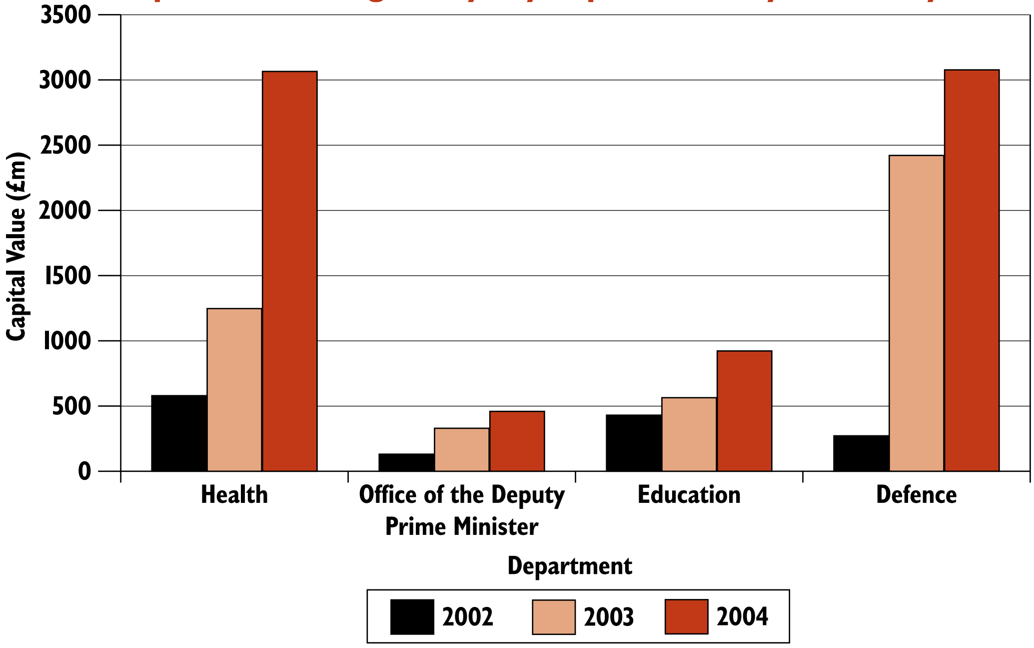
FUTURE OF EXISTING PFI

Overview

7.21 Where PFI has demonstrated that it can deliver value for money based on a rigorous and even-handed appraisal process, it should be used as one important tool to deliver the Government's significant increases in public investment. The Government's analysis suggests that PFI has been successful in delivering high quality facilities for public services, with the benefit of on time and on budget delivery in certain key sectors of public investment. These sectors – particularly health and education, but also defence and transport – display certain common factors which mean that the continued use of PFI has a sound value for money basis. Consequently, the Government plans to continue to use PFI to deliver part of its plans for rapidly increasing investment in these sectors.

7.22 Consequently, the Government expects a significant number of major new capital investment projects to continue to be procured using PFI in 2003 and 2004, as in Chart 7.1 below. Chart 7.1 shows the projected capital value of PFI projects by key Departments that are currently in the procurement process and expected to reach financial close by 2004, alongside the expected total capital value of signed and unsigned projects expected to close in 2003, and the actual capital value of deals signed in 2002. Even with these increases, the speed of conventional capital spending growth is projected to be such that PFI will remain broadly at the same small but important proportion of total investment as it is today.

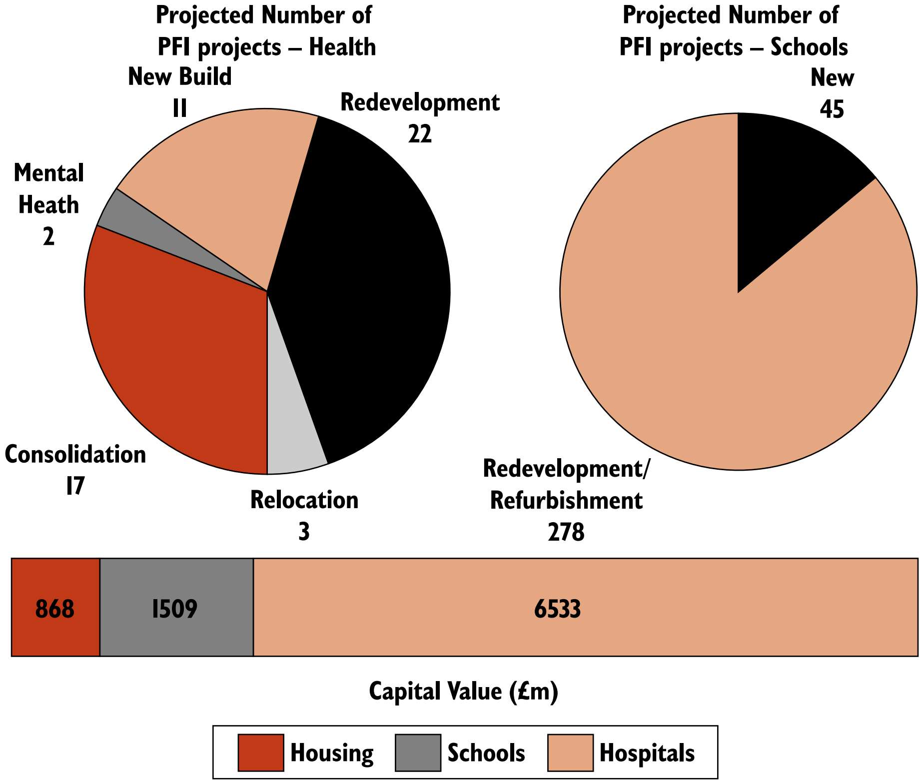
Chart 7.1: Future projected capital value of projects signed or expected to be signed by key departments by calendar year



Source: HM Treasury.

7.23 The Department of Health are expecting to see both the number and capital value of deals signed rise significantly over the next two to three years. The projected number of deals for health is 55, amounting to a total capital value of £6.5 billion by the end of the 2005 calendar year. The projected capital value for Ministry of Defence PFI projects is also expected to rise with an estimated 14 deals totalling £5.7 billion over the same period.

Chart 7.2: Public assets to be procured through future PFI projects, 2003–05



Source: HM Treasury.

7.24 This investment is expected to deliver significant new public infrastructure over the next few years. As shown in Chart 7.2 above, the PFI investment programme in health projects is expected to deliver 11 new hospitals or other health facilities, and redevelop or consolidate to a central site 44 more. In education, £1.5 billion in planned investment will redevelop or refurbish 278 schools and deliver 45 new schools. In housing, 28 PFI projects will deliver capital investment estimated at over £800 million, even without the potential new applications of PFI in social housing discussed at paragraph 7.53 below.

7.25 Furthermore, in secondary schools, the Building Schools for the Future initiative has recently outlined an extensive investment programme that will involve the use of PFI and conventional procurement. It is expected that the initiative will lead to sustained investment in secondary schools worth £2.2 billion in 2005–06.

Investment through new methods

7.26 In some sectors, like schools and primary care trust facilities, although the capital value of individual projects is small, meaning that transaction costs for PFI would be disproportionately high, the Government is using new procurement methods to deliver investment more effectively. These procurement vehicles (outlined in more detail in paragraphs 8.26 to 8.40) will improve the speed and reduce the cost of PFI procurement, improving value for money, and allow PFI to be used to provide:

- up to £1 billion of investment through the Local Improvement Finance Trust (LIFT) initiative in new areas of health where it had previously been impractial, such as primary care facilities; and
- over £1.5 billion worth of investment in schools over the next ten years, to schools like those in the Church of England Schools estate (through the Partnerships for Church of England Schools programme).

INDIVIDUALLY PROCURED LOW CAPITAL VALUE PROJECTS

Overview

7.27 Because the Government's commitment to the use of PFI rests only on its analysis of where it may be applicable and the evidence of its delivery of value for money in practice, it is necessary to examine continually particular aspects of the programme to determine whether PFI is the appropriate procurement route. Where PFI procurement does not represent the best value for money option, the Government is committed to pursuing alternative options that offer better value overall. One area where the Government's analysis of PFI suggests that a reassessment of the overall value for money of PFI is necessary is in individually procured low capital value projects, due to disproportionately significant procurement costs and times.

Analysis

7.28 The research set out in Chapter 4 demonstrated that PFI had performed well in some important respects in projects with small capital values, achieving levels of on-time and on-budget delivery and performance satisfaction in line with the results of PFI in major capital projects and delivering the kinds of benefits that drive PFI's value for money in large projects.

7.29 However, delivering these advantages involves considerable time and resources invested by both public sector clients and private sector bidders alike. The evidence presented in paragraphs 4.34 to 4.38 demonstrated that procurement costs and times in small projects did not decrease in proportion to their size, but remained at roughly the same level as for much larger projects. It outlined that:

- small projects face the same costs of using third-party finance, employing legal and technical advisors, and conducting due diligence financial modelling in the same as for much larger schemes. As a result, these costs are relatively higher for small projects individually procured;

- similarly, bidders in small PFI schemes must typically meet the costs of technical, financial, design and legal advisors. These bidders' costs also do not necessarily fall in proportion to the size of the project, and so the disproportionate costs reduce interest and competitive tension in small PFI schemes; and

- public sector clients tend to develop their own specialised PFI procurement skills far more when they are engaged in a range of projects on a sufficiently large scale. Small, one-off PFI projects raise questions about whether the public sector has the capacity and expertise to secure the best deal.

7.30 The threat that these potentially disproportionate transaction costs pose to a project's value for money was not adequately reflected in the original PSC, which failed to capture consistently the costs, and did not take into account the disbenefits associated with delayed delivery of investment to the public services. There was therefore the potential that some small projects would pursue PFI on the basis of a value for money assessment which did not take into account the wider disbenefits in terms of transaction costs and extended procurement times.

Measures **7.31** In recognition of these disproportionate costs at the lower end of the scale, the average capital value of PFI schemes has risen in recent years, partly thanks to a trend towards bundling small projects together (new initiatives in this area are discussed in Chapter 8). For example, the average capital value of PFI schemes sponsored by Local Authorities has risen steadily in recent years and stood at £37 million in 2002. Further action to improve general procurement skills and drive through standardised contracts across the public sector, detailed in Chapter 8 can also improve the value for money achieved in PFI. However, there are strong grounds for a new approach which builds on the trend toward larger capital value projects and helps ensure decisions between procurement options are always made on a value for money basis by:

- reforming the process of PFI procurement to include consideration of the transaction costs associated with PFI at an early stage in the process, and identifying alternative procurement options where those costs mean a project does not offer overall value for money, as outlined above; and

- making a general presumption against PFI being used for small schemes, below a level on which the Government will consult (see paragraph 7.34 below).

Process **7.32** These reforms will be introduced in a way that maximises flexibility for the public sector to manage the transition, ensuring that both allocations of PFI credits to Departments and investment plans by Local Authorities are not disrupted, and that current projects can continue to be delivered according to plan. Both reform of the PSC process and of the minimum value for PFI projects in each sector will take place in the context of the Spending Review. Specifically:

- HM Treasury will begin consultation with Departments and other stakeholders on where robust, minimum values should be set in each case to promote those projects where the public benefit is greatest; and

- on the basis of these discussions, new minimum values for PFI projects that receive Government funding will be rolled-out in the context of the next Spending Review.

7.33 At present, the great majority of small PFI schemes are sponsored by local authorities and funded through PFI credits allocated to central government Departments to pass on to local authorities as part of the Spending Review process. Any change in minimum values must respect the credit allocations to Departments made in the 2002 Spending Review and avoid any disruption to both current public investment plans and projects which are already in development.

7.34 While the appropriate minimum value of projects will vary from sector to sector, experience to date suggests that these values are likely to be above £20 million. For schemes below this level which do not benefit from initiatives which increase value for money by aggregating projects and streamline the procurement process (such as NHS LIFT), a range of other procurement routes are likely to be more appropriate.

7.35 The Government's policy is to use PFI only where it represents the best procurement option and as shown above, this is unlikely to be the case for projects with a small capital value. It is important then that local authorities have the flexibility to develop such projects through a wide range of procurement routes, choosing the most appropriate option that delivers the best value for the project. This flexibility is part of a wider commitment to devolve responsibility to local councils to meet local priorities, increase local choice and improve performance by removing unnecessary controls that stifle local innovation.

7.36 The Government is currently reviewing how it allocates support for capital expenditure to local authorities. A consultation document outlining the options for future capital support to Local Authorities will be issued shortly. This will focus on support for traditional (non-PFI) capital expenditure. Give the desire to improve efficiency and flexibility and recent developments in the PFI market, this review will provide the context for the Government to consider the PFI credit regime and how best to support the principle that there should be no bias in favour of particular procurement options and a genuine range of procurement choices available to Local Authorities.

IT PROJECTS – IMPROVING PROCUREMENT

Overview 7.37 The Government's analysis of the characteristics of successful PFI projects, and the evidence collected to examine how these characteristics related to the performance of PFI in practice, suggested IT was also an area where an approach that took into account all the potential benefits and disbenefits of PFI would mean a strong presumption against PFI.

Analysis 7.38 The review of PFI IT procurement in Chapter 4 suggested that, even though the majority of projects had been delivered to the satisfaction of public sector users, there was still room for significant improvement. There are significant differences between the IT sector and other sectors whose characteristics are more aligned with those outlined above, in Box 7.1 and so fit better with PFI. In particular:

- the fast pace of change in the sector makes it difficult for the public sector to effectively define the outputs it requires in a long-term contract;
- the high level of integration of IT infrastructure into the other business systems of the client makes it difficult to delineate clearly areas of responsibility to the client and the contractor, and so make effective risk transfer considerably more difficult; and
- the lack of a market for third party finance in IT PFI removes a powerful driver ensuring appropriate and effective risk allocation in a project. This detracts from PFI's ability to secure value for money for the public sector.

7.39 The findings of the research suggest that better performance can be achieved in the procurement of IT if the public sector uses procurement models that better reflect the unique needs of IT projects. The research showed that in those IT PFI projects going particularly well, contracts had in fact been renegotiated to accommodate improved structures and better, more flexible outputs – suggesting that in practice a move away from a PFI model brought operational benefits by allowing for better risk allocation, better response to changing business requirements, and more effective incentive structures.

Measures **7.40** This experience and the underlying differences between IT projects and other infrastructure procurement suggest that it is appropriate to look again at the methods used to procure IT. This will involve ensuring that the forms of contract and financing used contribute to overall delivery success. As a result, the Government will now adopt a presumption against the use of PFI in future IT projects.

7.41 PFI in the IT sector will be replaced by a set of procurement options appropriate for different types of IT project. Over the course of summer 2003, OGC and HM Treasury will lead a project to draw up guidance on a range of models for government IT partnering projects, which will allow for joint consideration by customer and supplier of objectives plans, risk and problem resolution. This guidance will replace existing IT PFI guidance but will draw extensively on the innovations and improvements obtained as existing IT PFI contracts have been renegotiated.

Process **7.42** The non-PFI procurement options to be set out in the guidance will:

- offer a level of flexibility appropriate to the specific type of IT project being procured;
- ensure an optimal level of risk transfer to achieve value for money for the public sector given the lack of available third-party finance;
- tackle specifically the handling of IT integration risk;
- address the questions of when it is appropriate for the public sector to own IT assets and what appropriate levels of contract termination costs; and
- take into account the capital and operational constraints of the private sector.

7.43 This reform should ensure that more IT suppliers are encouraged to bid for Government business. By encouraging greater market access, the Government aims to create the conditions for more competitive choice, thereby delivering good value for money in procurement.

7.44 The consequence of these proposed changes will be to provide forms of contracting and financing that can be used as part of the Government's overall agenda for tackling the weaknesses in IT-embedded programmes and projects, and ensuring successful delivery through the use of Best Practice.

7.45 The process of drawing up the new guidance will involve consultation with both the public and private sectors to ensure the new models are robust and satisfactory. Once the guidance is issued, it will be applied by OGC as part of its wider remit for improving the effectiveness of government IT. HM Treasury will remain responsible for advising Departments on any financial dimensions of IT projects.

Improving IT procurement ability **7.46** The Government is aware that, as part of this reform of IT procurement to improve outcomes and the deliver of value for money, it is vital to improve the public sector's ability to procure and manage complex IT projects. The OGC is currently working to address

Departments' IT delivery capabilities, for example through the creation of Centres of Excellence in Programme and Project Management.

7.47 Action is in hand by OGC on a range of improvements. First, OGC is developing the Programme and Project Management specialism to help Departments define and acquire the skills they need for all projects, including IT. This will involve professional development of existing staff and a recruitment drive to bring in additional talent. Secondly, Centres of Excellence in Programme and Project Management have been set up in all Government Departments with the aim of overseeing their project portfolios and ensuring that appropriate approaches are being adopted. Senior Responsible Owners have been appointed for all major projects and robust Business Cases are now required. Departments should not adopt a big-bang approach to IT, but must seek a modular or incremental approach. The Gateway process ensures that projects not adopting an appropriate approach in all these areas are identified at an early stage.

7.48 OGC have issued revised guidance on evaluating suppliers' proposals on the basis of true life-cycle value for money, giving due weight to the deliverability and quality of proposals as well as the price tendered. Guidance has been provided to Departments on how to prioritise their projects to help ensure that they operate within their delivery capabilities. And OGC has put in place arrangements to ensure that appropriate training in delivery skills is available to all those involved in the process. All OGC guidance is now available through one Successful Delivery Toolkit at its website www.ogc.gov.uk.

CONSIDERING NEW APPLICATIONS FOR PFI – ANALYSIS AND PILOTS

Overview **7.49** The Government is committed to securing value for money for all of its investment programmes. The appraisal and decision-making process outlined in this chapter supports that commitment by putting in place an assessment process focused on the real merits of different procurement options, building in the ability to select alternative routes at each stage. As part of this process, the Government intends to consider potential new areas for piloting PFI investment whose characteristics suggest that they could benefit in value for money terms, and so allow that investment to go further toward improving public services.

7.50 This section examines the characteristics of sectors which could benefit from PFI investment, and outlines the process of investigation and consultation, value for money testing and piloting the Government will pursue in these areas as part of the process of continual assessment of the scope of the PFI programme laid out above, specifically providing a basis for assessing an investment programme test in these areas in the context of the next Spending Review.

Regeneration **7.51** The Deputy Prime Minister's Sustainable Communities Plan, published in February 2003, sets out an action programme for building successful, thriving and inclusive communities, including through substantial development in four growth areas in the South-East and East, and renewal of areas of housing market weakness in the Midlands and North. There is a case for looking at the scope for PFI, and other public-private partnership approaches to contribute to this programme. PFI could have a part to play, for example:

- in the procurement of major capital assets, where the risks attached to conventional procurement, and hence the potential benefits of PFI, are great; and
- particularly where the nature of this investment makes it possible to draw clear lines in the allocation of risk, giving a potential private sector contractor responsibility for the design, construction and maintenance of the assets.

Waste **7.52** Waste and recycling are areas of high priority for Government investment whose characteristics mean that PFI investment could offer significant value for money gains. Specifically:

- waste reduction is a strongly outcome-orientated policy initiative, with scope for innovation as to how those goals will be achieved. For example, there is a statutory requirement to achieve a 33 per cent recycling target by 2015, driven by the landfill tax – set to more than double to £35 per tonne in the same period. This means that the public sector can clearly define outputs, and make use of private sector innovation and expertise to deliver them;

- this is a high turnover, low margin sector with the potential to harness large economies of scale. The waste sector therefore involves the procurement of very significant capital assets, potentially increasing the benefits of PFI and the risks of conventional procurement. Private sector estimates of the investment required to deliver on policy goals run to £8 billion by 2008-10.

Social housing **7.53** Delivery of the Government's objectives for housing are dependent on significant programmes of capital investment. The Government is turning round a £19 billion backlog in repairs and maintenance in the social housing sector and has set a target to make all this housing decent by 2010. PFI is already contributing to delivery of that objective, but its role could also be expanded to assist with the major programme of affordable house building for social housing tenants and keyworkers, as one possible element in a range of public-private partnership approaches to the procurement and ongoing management of different kinds of affordable housing stock. Affordable housing provision could benefit from PFI investment because:

- it involves the provision of capital assets where effective project management incentivised by appropriate risk-sharing would bring significant benefits; and

- because of their long life, these assets could benefit from design, construction and costing made on a whole of life basis by private sector parties incentivised to ensure best value.

Prisons **7.54** The prisons estate could potentially benefit from further PFI involvement in its refurbishment, management and maintenance. New investment in the prisons sector already involves an extensive and successful programme of new-built PFI prisons, and this suggests that the management of the existing prisons estate could benefit from investment through PFI. Involving PFI in the prisons estate could bring benefits because:

- the prisons estate sector is characterised by large, depreciating assets, with the expectation of an extensive life into the future. Consequently, it could benefit from PFI's potential to assess and make repairs with the long-term life of the asset in mind because of a long-term contract structure; and

- the structure of services to the prisons estate is suitable for PFI, allowing the public sector to specify quality standards for the facilities it needs, and effectively enforce performance against those standards.

Process of Assessment

7.55 Before any major use of PFI in new areas like those outlined above, the Government is committed to ensuring:

- that the involvement of PFI in delivering investment is appropriate on the basis of the Government's principles of efficiency, equity and accountability;

- a rigorous assessment of the applicability and value for money offered by PFI in the sector, including an assessment of its impact on employees, in accordance with the reformed decision-making process outlined in paragraphs [7.x to 7.y] above; and

- a pilot stage, which could present demonstrable evidence that PFI in this area is potentially capable of delivering its benefits in practice.

7.56 In preparation for the Spending Review, HM Treasury in consultation with Departments will be collecting evidence of PFI's applicability in the sectors outlined above, and considering next steps as part of the Spending Review process. This preliminary assessment will involve:

- consultation with frontline public servants on what benefits and difficulties could be involved with the use of PFI to procure new investment in a sector;
- examining NAO, Audit Commission and other bodies' evidence on procurement in these sectors; and
- conducting research along with and through Partnerships UK on both the appropriateness of the sector and, in areas where it is likely they will add value, the potential to put in place procurement vehicles to deliver investment.

7.57 If this preliminary value for money assessment suggests that PFI indeed offers significant benefits as a procurement route for capital investment in these sectors, then a pilot programme will be put in place to collect and assess the delivery of that potential in practice.

FUTURE AGENDA

7.58 A crucial part of this process of value for money assessment, separate from but feeding into the reformed process for determining where PFI can and should be used, is an open and continuing evaluation of PFI. This process will involve further research into aspects of PFI which cut across individual areas of the public sector, building on the research reported in Chapter 4, and a commitment to transparency in that evaluation and in the progress of the PFI programme.

Ongoing monitoring of PFI

7.59 The research reported in this document into horizontal aspects of PFI has been a key input into the refinement of the PFI programme outlined in this and succeeding chapters. The Government intends to continue with this process.

7.60 In particular, the future agenda of research in this area is intended to focus on the operational performance of PFI projects. Chapter 4 included limited data on this operational performance. The Government intends that the preliminary opinion data produced by this research to be the starting point for a thorough, objective data set on the operational performance of PFI projects. Future research into this project sample and others will focus, among other factors, on:

- the impact of performance regimes and payments deductions on private sector responses;
- the ability of the public sector to manage the flexibility of PFI contracts (see paragraphs 8.45 and 8.47);

- the impact of private sector asset management on the workload of frontline public sector staff like teachers; and
- the assessment of factors leading to the small number of reports of unsatisfactory performance in PFI projects.

Transparency **7.61** At the same time as conducting this further research on cross-cutting aspects of PFI, the Government seeks, where possible, to increase the availability of information concerning PFI and the PFI process. Since 1997, it has increased the information disclosed in the Financial Statement and Budget Report to include:

- a record of future payments contracted for by each PFI scheme; and
- the capital value of contracts signed to date and in procurement.

7.62 The Government believes it is important to increase the data available concerning the PFI process. With the increasing number of projects being completed and becoming operational, it is now possible to contemplate seeking to publish further information on their performance on a regular basis. This will not only lead to better management of programmes and projects in the future, but also increases the accountability and openness of the programme.

7.63 The Government also recognises that to help the private sector to plan its investments in PFI it would be useful to publish, on a more comprehensive basis, what the short and medium term plans are for future projects to be delivered under the PFI process.

7.64 Consequently, the Government plans to publish on an annual basis a comprehensive statement concerning the progress of the PFI programme to include:

- a record of transactions committed to in the previous year;
- a statement of future transactions, indicating the different stage of development;
- a record of projects that have been completed in the year in question and their performance against expectations; and
- a statement as to progress made on standardisation of contracts.

7.65 HM Treasury will consult over the next six months with private and public sectors as to what further information it would be possible to collate and publish on the following subjects:

- the operational performance of PFI projects;
- developments in the cost of financing PFI projects; and
- returns on equity actually achieved by the private sector.

7.66 The more detailed research behind the conclusions set out in Chapter 4 will also be published via the internet shortly.

8 Improving Delivery

Determining and applying where PFI offers value for money is only part of the process in the delivery of quality public services. It is important that the procurement process is managed efficiently, intelligently and in a timely manner in order to maximise the benefits of PFI, and to secure value for money from other forms of procurement too.

The evidence shows there is still room to improve delivery of investment in public services through PFI, as well as through conventional procurement, by reducing the timescales over which investment is delivered and looking at ways of further reducing procurement costs, so that value for money is not compromised. The Government will be taking action in both areas.

Introducing measures that help the public sector become a better client, the Government will:

- **continue to prioritise improving the general skills of the public sector** to deliver value for money in Government investment;
- **rigorously enforce contract standardisation across the public sector** to reduce bid costs and ensure a consistent approach to risk sharing is maintained throughout the public sector;
- **enhance the role of the Project Review Group in monitoring PFI procurement by local authorities;** and
- **increase the level of support provided through Partnerships UK,** in developing and supporting standardisation and enhancing procurement skills.

Ensuring the benefits achieved by co-ordinating activity as a client, the Government will:

- set up a system for the **accreditation of public sector advisers and introduce an information resource accessible to all public authorities** to make sure that external advisers appointed by the public sector are of the highest quality, and provide services to Government in a manner which recognises its status as a single significant client;
- **create vehicles to coordinate procurement in particular areas and put in place procurement support** so that best practice is shared across the public sector, the public sector can control the flow of projects to market to maximise competition, and procurement expertise is injected into PFI investment projects undertaken at all levels; and
- **promote the sharing of best practice and better harnessing of institutional memory** across the public sector.

As part of the ongoing agenda of improving delivery the Government will also be evaluating public sector skills in bid evaluation and flexibility, to ascertain whether, where and how further support can be provided.

OVERVIEW

8.1 Having assessed what procurement option offers the best value for money for the public sector in a particular case, and put in place a programme of PFI or conventional investment, the Government must ensure that the benefits of that investment are delivered as quickly and efficiently as possible without compromising the achievement of value for money gains.

8.2 The Government believes, and the analysis of PFI procurement reported in Chapter 4 demonstrates, that while investment is delivering significant benefits in practice, there is still a need to concentrate efforts in certain areas to secure maximum value for money for all types of procurement. In particular, the analysis suggests that there are two areas where further measures could increase overall value for money:

- **procurement timescales.** Putting in place the skills and processes necessary to reduce them will improve the swift delivery of the benefits of investment to public service users and reduce the costs of delay and long lead times; and
- **procurement costs.** The Government is committed to improving the value for money of all types of procurement by reducing transaction costs.

8.3 Following on from this analysis, there are a number of measures the Government can and has put in place to improve delivery and value for money in PFI particularly, such as the standardisation of contracts, making available procurement expertise through the Office of Goverment Commerce (OGC) and Partnerships UK and ensuring consistent project quality through the Project Review Group. Chapter 5 has already outlined the significant steps taken in this area, but the evidence and analysis suggests that more action can be taken on two fronts.

8.4 First, the Government needs to put in place policy initiatives and measures designed to make the public sector a better client in procurement across the board, and in PFI in particular. Measures outlined below are that the Government will:

- **continue to prioritise improving the general procurement skills of the public sector** to deliver value for money in investment;
- **rigorously enforce the standardisation of PFI contracts across the public sector** to reduce bid costs and ensure a consistent approach to risk sharing is maintained throughout the public sector;
- **enhance the role of the Project Review Group in monitoring PFI procurement by local authorities;** and
- **increase the level of support provided through Parternships UK,** in developing and supporting standardisation and enhancing procurement skills.

8.5 Second, there have been difficulties in the past in acting effectively as a client in a co-ordinated way, sharing experience and best practice and extracting the benefits that flow from acting as a single client to the private sector, while maintaining local autonomy and accountability. In this regard, the Government will:

- **put in place an information resource accessible to all public authorities providing accreditation of public sector advisers** to ensure the public sector appoints experienced and qualified advisers who have performed well on other procurements;

- **create vehicles to co-ordinate procurement and provide expert support** so that best practice is shared across the public sector, the public sector can control the flow of projects to market to maximise competition, the economies of scale and other benefits that can come from bundling projects and procurement expertise is injected into PFI investment projects undertaken at all levels; and

- **promote the sharing of best practice** and better harnessing of institutional memory across the public sector.

8.6 The improvement of delivery, procurement and other public sector skills is a continuing priority of the Government, and so this chapter outlines further areas of research on the Government's agenda to establish where improvements can be made in PFI. In particular, this future agenda will examine:

- how bid evaluation is carried out in practice in the public sector; and

- how the flexibility built into PFI contracts is delivering value for money in practice.

BACKGROUND

8.7 As set out in Chapter 5, the Government recognises that procurement skills are an important factor in securing value for money in public procurement. Better procurement skills lead to lower transaction costs, better value for money in projects procured, and faster delivery of investment to public services. In PFI in particular, improved procurement skills:

- **enable the public sector to maximise the benefits available in the procurement process** by effectively conducting the options appraisal necessary both to determine whether the PFI route is value for money, and to secure best value from PFI bidders taking into account the whole-of-life benefits and the quality of assets and services that different PFI bids may offer;

- **improve value for money, by reducing delays and lowering procurement costs for the public sector** and actively managing the specialist advisers, such as technical, financial and legal advisors necessary for PFI;

- **secure value for money from contract negotiations,** achieving the Government's aims in risk sharing, and ensuring a smooth and timely procurement process; and

- should **create an environment that encourages the private sector** to bid for PFI projects, improving competition and delivering a stronger PFI market.

8.8 In order to ensure that these benefits are secured, the Government believes it is important to address past difficulties in providing effective procurement expertise to all procurement projects. In particular the Government is determined to ensure:

- that procurement skills in the public sector are highly valued, and that where they have been built up they are maintained and utilised;

- that procurement expertise is delivered to the frontline to help procuring authorities secure the best deal for their money; and
- that where best practice in procurement is identified, it is effectively spread across the public sector, with the Government acting in a coordinated fashion securing the benefits that flow from that spread.

8.9 The remainder of this chapter details measures the Government will take in the future to address these issues. These measures will help spread the necessary expertise and provide expert support to make accurate value for money judgments and ensure a smoothly running PFI process. They will enable investment to remain locally controlled and locally accountable, while helping authorities improve the value for money they obtain in PFI projects.

NEXT STEPS IN IMPROVING THE PUBLIC SECTOR AS A CLIENT

Upgrading Procurement Skills

8.10 It remains an overall Government priority to improve general procurement skills across the public sector. A lasting step-change in the quality of public services in the UK can only be achieved if Government and the public sector have the skill sets necessary to ensure that public investment projects deliver value for money improvements in frontline public service facilities. Addressing this need to upgrade procurement skills is a part of the OGC's 'Successful Delivery Skills' programme, a framework of assessment against an agreed benchmark and training in public sector delivery skills.

8.11 The OGC's latest figures from its Gateway process across the public sector's procurement programme, up to April 2003, indicate a number of systemic weaknesses. These included a weakness in identifying the adequate skills and business resources for investment projects. The Successful Delivery Skills programme aims to address this by providing a benchmark level for each of the common programme and project management roles against which the potential project team members can be assessed before the start of the project. This drive to improve the procurement skills of the public sector can, in the context of PFI, ensure that the right value for money options are identified, and that the process is effectively managed to ensure smooth and cost-effective delivery investment in public services.

8.12 OGC has supported Centres of Excellence in departments that bring together the essential functions needed to support the successful delivery of programmes and projects, the aim of which is to ensure there is:

- coherent upward reporting to the management board on its key programmes and projects to support effective decision making;
- timely sharing of information and lessons learned through outward relationships with departments and beyond; and
- inward support to help delivery programmes and projects with the right expertise when they need it.

8.13 Further improvements in this area need to focus on both the quality of public sector procurement skills and on the way in which they are utilised. Public sector managers need to:

- be skilled enough to assess procurement options over the long term;
- effectively identify the value for money option, not simply opt for the least-cost option, including taking full account of the quality of design in bids;
- negotiate effectively with the private sector;
- apply skills with sufficient confidence to ensure that appraisal is a real test of procurement, and not an exercise in fulfilling set criteria without regard to a wider view of which option is in the public interest; and
- carry out the evaluation and management of investment delivery in a way that ensures that the public sector is accountable for both the public money which it spends and the public services which it provides.

A key challenge for managers is understanding the contribution high quality design can make to raising the standards of service in line with public expectations, and to greater cost effectiveness in service delivery and asset maintenance over time. Box 8.1 explains the Goverment's approach.

Box 8.1 Design and PFI – the CABE report

Good design in public buildings is a priority of the Government, and evaluation of bids in PFI should place the proper weight on the design quality of options presented. Procuring authorities need to extract the benefits in design and whole life costing which PFI potentially offers by making sure they select bids on an a comprehensive assessment of their quality, including the merits of their design.

The Commission for Architecture and the Built Environment 'CABE' was established to promote high standards in the design of public buildings. It aims to help public bodies towards improved performance as a client, so that public buildings are known for their design quality. Sound, creative design is an essential ingredient in delivering value for money; and through the working life of a building, design excellence can make service delivery more efficient, and enhance the working environment for all those that use public buildings.

To ensure the public sector receives a high quality of design from public procurement in PFI projects, the OGC published 'Improving the Standards of Design in the Procurement of Public Buildings' in conjunction with CABE in October 2002. The report highlighted the importance of ensuring the public procurement process produced buildings that facilitated the delivery of high quality services and which provided optimal value to the tax payer. The report set out 11 recommendations to ensure the implementation of good design in PFI. An example of how some of the CABE recommendations are being applied in practice is the DfES plans for exemplar school design, described in further detail in paragraph 8.40.

Recent evidence from the NAO indicates that the standard of design in PFI is highly rated. Its survey of departments and project managers reported three quarters of both Departments and projects teams rated the design quality of their PFI projects as good or very good, and none as less than adequate. To date, PFI buildings have been twice nominated for the Prime Minister's award: the Norfolk and Norwich University Hospital and the Cumberland Infirmary.

Standardisation of Contracts

8.14 As outlined in Chapter 5, the process of standardising PFI contracts helps spread best practice, improving PFI procurements across the public sector, and significantly reduces the length and cost of PFI procurement. These standard terms maintain the individual flexibility of a particular procurement to set its needs and requirements, but provide a standard form for those aspects of PFI common to all its procurements. Further action to drive through these advantages, and ensure they are enjoyed across the public sector, will improve the value for money of PFI projects being procured across the board.

8.15 The Government accepts that it is important, if all parties are to gain from the effective implementation of the guidance on the standardisation of PFI contracts, that there is not significant variability from transaction to transaction in the application of the standardised PFI contract. It is also important that a more regular assessment and consultation with private and public sectors as to how the application of the standardised PFI contract is undertaken. In future, therefore, the Government's approach to developing and implementing the standardised PFI contract will be as follows:

- there will be a regular dialogue with the private and public sectors over how successfully the standardised PFI contract is being applied;
- any future change to the standardised PFI contract will be incremental, rather than a wholesale review, and will be on the basis of specific issues raised by public or private sectors or resulting from new legislation being enacted which impinges on the standardised PFI contract; and
- the Government will act to ensure more rigorous enforcement of the standardised PFI contract across both public and private sectors with a more robust line to be taken by the Project Review Group, Gateways and by HM Treasury.

8.16 To help with this process, HM Treasury has agreed with Partnerships UK that it will increase the resources it will make available to both public and private sectors to support the adoption of the standardised PFI contract across the programme. In particular, Partnerships UK will:

- provide greater resources through its Help Desk to public and private sectors in implementing the standardised PFI contract; and
- engage with private sector and public sector authorities on a regular basis to assess progress in implementing the standardised PFI contract, reporting quarterly to HM Treasury.

8.17 HM Treasury will periodically review the application of the standardised PFI contract, taking account of Partnerships UK's recommendations and any other representations which the private and public sector may wish to make. These reviews will be focused primarily on the implementation of the standardised PFI contract across the public sector and address new issues and concerns which may arise which are not adequately addressed by the current standardised PFI contract. The Government will, however, seek to avoid any wholesale review of the standardised PFI contract or shift the current risk sharing balance of the standardised PFI contract, unless there are strong arguments for doing so in light of the findings of any review.

Enhancing the Project Review Group

8.18 As the gatekeeper to PFI credits, the PRG has an important role to play in identifying obstacles to successful delivery early on and taking action to ensure that only high-quality deals proceed to tender. The PRG is developing a number of innovations to deliver this role more effectively.

Enforcing standardised contracts

8.19 The PRG plays an important role in making sure that proper judgment and discretion are employed in the PFI procurement process, and that procuring local authorities have had access to and implemented all the necessary support. As part of this, ensuring compliance with the standardised PFI contract is crucial to avoid poor commercial deals and higher transaction costs for local authorities. For this reason the PRG already assesses compliance with the standardised PFI contract at an early stage and will take an increasingly robust line against non-compliant projects in the future, including the possibility of withholding credits.

8.20 Often, the PRG only has the opportunity to judge compliance with the standardised PFI contract if projects experience difficulties and revert to the committee for additional resources. In order to better promote compliance with standardised terms, the PRG is currently developing new mechanisms to apply a specialist evaluation of contract compliance:

- prior to, and as a condition of selection of preferred bidder, this would identify all derogations from the standardised PFI contract and any sector specific guidance, and ensure that adequate commitment letters have been obtained from bidders, subcontractors and lenders; and
- shortly before financial close, when a PFI project contract is signed, to identify and rectify late deviation from the standardised PFI contract.

Monitoring procurement

8.21 It is important that sponsoring departments are aware of procurement difficulties at an early stage, so that the proper support can be provided to local authorities to help them secure value for money. The PRG has conducted a review of how departments monitor the development of projects once they have been awarded PFI credits. Practice varies widely between departments and the PRG will be developing a clear framework to spread best practice across the public sector.

CO-ORDINATING THE PUBLIC SECTOR CLIENT

Accreditation of Public Sector Advisers

The role and quality of advice

8.22 As well as increasing procurement skills within the public sector, the Government believes that it is important that public sector managers are well advised, especially when undertaking complex procurement projects such as PFI. In the past, the difficulties which the public sector faces in acting like a single client, sharing experience and expertise and presenting a single face to the public sector, have hampered the public sector's ability to secure and make use of the best advice in a PFI project. Poor advice contributes to slowing the procurement process, can inflate procurement costs, and will impair the ability of the public sector to identify value for money in options appraisal and negotiation. In particular, there is a potential difficulty in a fragmented approach to securing advice because:

- the public sector cannot negotiate the best deal if it does not have the capacity to benchmark price and quality of advisors; and

- where the retention of advisers is undertaken in a fragmented 'one-off' fashion by the public sector, there is little potential to reward good advice with further work, and so ensure that advisors are incentivised to use their best people to provide support to a public authority.

8.23 It is also important that private sector advisers fully support the Government's approach to standardisation of contracts and appraisal including public sector comparators (see paragraphs) and that the appointment of such advisers takes full account of potential conflicts of interest.

A single information resource on accredited advisers

8.24 To assist in meeting these objectives, the Government will seek to put in place over the next 12 months a single information resource, covering accredited advisers who have demonstrated their expertise and performance in PFI projects in fields such as law, commercial structuring or finance. This resource will be developed over time, reflecting the experiences of departments and public sector managers. It will provide recognition for the contribution of high-quality advisers, and reduce uncertainty over quality on the part of the public sector. It is crucial to its successful implementation that this single point of information and experience in hiring and managing professional advisers reflect the qualitative judgment of public sector clients on the standard of the advice they have received, rather than representing simply a list of potential advisers in different areas of expertise. By implementing this single information resource and its use by procuring authorities, the Government is therefore able to:

- ensure that the public sector is able to act as the single, important client for advice service in PFI that it is;
- benchmark the price and quality of advisers, based on evidence of their past expertise and performance, to help authorities secure value for money from their advisers; and
- provide positive incentives for advisers to ensure that they give the best advice to Government, utilising their most skilled personnel and full resources, as the accreditation system will provide an effective means for the public sector to reward excellence.

8.25 The Government will also explore the greater use of framework agreements for advisers whereby they can be engaged over more than a single project to provider greater consistency across the public sector's procurement programme and possibly lower the costs of such services.

CO-ORDINATING AND SUPPORTING PROCUREMENT

Overview

8.26 To improve both the quality of the public sector client, and its co-ordination across a sector, the Government is introducing a range of new procurement models that can increase the involvement of PFI experts in some clearly defined areas of the public sector's procurement process, from the earliest stages through to the operational phase of projects, where there is benefit in bundling projects together and ensuring that the timing of projects maximises market interest. These models are designed to bring all the necessary expertise and experience to locally procured PFI projects, providing procuring authorities with the support they need to obtain value for money, while maintaining local control and local accountability in the delivery of public services and public service investment. They are therefore likely to be most applicable where small projects can be grouped together, and there is no obvious centralised procuring authority.

8.27 To obtain the full value for money benefits of PFI procurement, public services need to be able to call upon experience and expertise in managing the PFI process and making value for money appraisals. Making these specialist skills available to the local providers of public services, who are best placed to determine what investment is actually needed but not necessarily procurement specialists, is an ongoing priority which these new methods will help to deliver.

8.28 These new models of PFI delivery will help to provide that procurement expertise, supporting the local public sector in its own assessment and delivery of local public service investment needs. Responsibility for and control of the planning and delivery of local public services and local investment remains with the local manager, who will have improving access to the support and expertise needed to get the most out of that investment.

8.29 These models involve the establishment of public sector procurement bodies specialising in structuring and delivery of PFI projects, which will work with local public sector managers in certain suitable areas to procure such projects, to increase the quality of specifications and reduce delays in the process. These procurement vehicles can then support local procuring authorities in particular markets.

8.30 By increasing the public sector's ability to procure quickly robust and effective PFI projects, these supporting vehicles will also allow the introduction of PFI into new areas such as those proposed for further consideration in Chapter 7, as well as offer a way to increase the number of PFI projects in existing areas. It should also provide the private sector with the confidence to invest in the additional capacity necessary to facilitate the Government's plans to increase investment in new public sector infrastructure. Four different examples of how this approach will work in practice are set out below.

LIFTs – excellence in primary healthcare procurement

8.31 The NHS Local Improvement Finance Trust (LIFT) delivers investment in primary and community-based healthcare facilities to achieve more integrated local service provision. Individual primary care facilities are often relatively small – typically less than £5 million in capital value, and in many cases less than £1 million. The occupants and users of the facilities reflect the diverse mix of providers of primary health care – employees of Primary Care Trusts or local authorities, and self employed contractors or partnerships such as GPs, Pharmacists and Dentists. To meet the needs of these groups across a variety of small sites and retain private sector confidence in the programme requires a high level of procurement skills.

8.32 To meet this challenge, NHS Primary Care LIFT was created as a nationally managed procurement programme by Partnerships for Health (PfH), a company formed as a joint venture between the Department of Health and Partnerships UK. The key features of PfH's role are to:

- develop a standardised procurement approach, including the agreements to be entered into in relation to each scheme;
- create a team of experienced transactors who assist local teams to define their requirements effectively and to procure long term partners who can meet their objectives; and
- create a sustainable, predictable flow of transactions for the private sector to permit forward planning of future capacity to bid and implement such schemes.

Batched acute hospitals

8.33 The procurement of major hospital schemes in batches is a new approach developed by the DoH, with the support of HM Treasury and Partnerships UK. The invitation to bid for the first batched scheme was issues in May 2003. This approach has three objectives, to:

- reduce bid costs and procurement times for major acute hospitals. The PFI batch partners will incur only one set of bid costs before being given preferred bidder status for the three schemes, without losing the benefits of PFI;
- provide greater certainty over the future flow of investment which will enable the private sector to invest in new capacity to delivery such schemes; and
- increase opportunities for greater standardisation of design and service delivery, which will improve value for money.

8.34 Although this approach should reduce the costs of the PFI procurement process, it will not be at the expense of the desired risk-sharing arrangements for each hospital, which will enjoy a separate contract with the PFI batch partner based on the standardised PFI contract.

8.35 The Church of England (CofE) schools estate comprises around 2,000 schools, individually the responsibility of the school governors and trustees, with a major aggregate investment need of £1.5 billion over 10 years. As most of these schools are small primary schools with a new build capital cost of £2 million, their staff, governors and trustees do not have the procurement experience to access the flow of investment that has been delivered in schools more generally through PFI.

Partnerships for Church of England schools

8.36 To meet this challenge, a new vehicle has been established to manage a programme of centrally procured schemes, each covering a grouping of CofE schools. The scheme brings the potential benefits of PFI, in terms of on-time, on-budget delivery and whole-of-life design and costing, to a sector where without bundling it would not be economic to use PFI. Partnerships for Church of England Schools (PfCS) is a joint venture between DfES, Partnerships UK and the National Society (responsible for education within the CofE), that will scope, develop and procure private sector partners for geographically coherent groups of dioceses.

8.37 PfCS is expecting to take 13 schemes into procurement in three tranches in the next two years, each scheme covering between two and four dioceses, so that all 42 dioceses in England are covered, establishing in each case a local partnership under which the future investment requirements can be delivered efficiently. The first schemes are expected to go into procurement in the summer, with all 13 local partnerships expected to be in place in around three years. Each local partnership is expected to require an investment programme of at least £40 million over its first three years.

Building Schools for the Future

8.38 In 'Building Schools for the Future' the Government has committed to a programme of rebuilding and renewal to ensure that all secondary schools in England have facilities to 21st century standards. With over £5 billion a year available for capital investment in schools by 2005-06, over £2 billion of which is earmarked for strategic renewal of the secondary estate, the Government is committing the resources necessary to enable local education authorities (LEAs), schools, parents and governors to work together to achieve 21st century standards for every school in the country over the next 10-15 years.

8.39 DfES is currently working with Partnerships UK and 4Ps to develop a new national body to manage its programme of PFI and conventional investment in secondary schools, and to work with LEAs on solutions to meet their needs. This offers a way to increase procurement skills and reduce procurement costs and delays in the schools sector, and ensure that the expertise is in place to identify where PFI can offer value for money and where conventional procurement will provide the better option. This new national procurement body is planned to launch in the autumn, ready to take forward the first local strategic plans.

8.40 The DfES is in the process of developing exemplar designs that will set a new benchmark standard for school design, and which can be customised to meet local needs and circumstances. Much greater support to LEAs and schools in negotiating terms for large-scale investment will also be provided, reducing the procurement burden on local authorities, while helping them realise their local vision and strategies. The new body would be expected to:

- manage the delivery of the programme of strategic investment, supporting local procurements to reduce time, cost and complexity;
- use both PFI and conventional procurement, efficiently and as appropriate to local needs;
- work with LEAs and schools to develop the programme of strategic renewal;
- ensure supply chains are tested to achieve best value and gains are passed on to schools; and
- encourage and develop the market of private sector suppliers.

FUTURE AGENDA

8.41 The Government is committed to improving the effectiveness of the public sector in all kinds of procurement, and in PFI procurement in particular. HM Treasury intends to research in more detail the performance of the public sector in the two particular areas of PFI below, which are important in securing value for money from PFI procurement. Once HM Treasury have concluded a research and consultation process, the evidence will be published and an assessment made of any guidance or policy measures that might be required. HM Treasury expects the research and consultation process to be completed over the next year. The specific areas involved are:

- the public sector's evaluation of PFI bids; and
- the public sector's record in managing PFI projects to ensure: first, that they offer in practice the flexibility built into standardised PFI contracts; and second, that authorities are equipped to manage their contracts effectively, particularly when termination or the exercise of step-in rights is required.

Bid Evaluation

8.42 The proper evaluation of bids for PFI projects is essential in securing value for money. It is important for the public sector to evaluate bids for PFI projects from the perspective of overall best value in the long term. It can be a mistake for the public sector to confuse least cost with value for money (see paragraph 8.13 and Box 8.1).

8.43 Three additional factors of significance make sound bid evaluation even more important:

- the new Green Book's unbundling of the discount rate to make separate assessments of risk and uncertainty and optimism bias mean that the public sector's evaluation of bids presented must be more rigorous, with a particular need to assess the trade off between value for money and affordability of bids;
- because the PFI market is increasingly competitive, in bidding to the public sector and in the financing terms offered by funders (see Annex C for technical details) public sector bid evaluation has to be expert and comprehensive

enough to take into account the financial robustness of each bid, to ensure that bidders have not reduced safety margins in their financing arrangements to a level that endangers their own long-term financial stability. The public sector does not underwrite private sector partners, but it does need to ensure the long-term viability of its private sector contractors; and

- the public sector needs to consider and value the flexibility offered by different bids. Paragraphs 8.45–8.47 cover this in more detail.

8.44 To take account of these concerns, HM Treasury will be reviewing, in consultation with public and private sectors, the current effectiveness of the public sector's approach to bid evaluation. The research will look particularly at the expertise deployed by the public sector client to undertake bid evaluation and the grounds on which bids are evaluated.

Delivering Flexibility

8.45 It is important that the public sector client has the ability to ensure that the flexibility mechanisms built into standard PFI contracts, to accommodate changes in the public sector's requirements over the life of a PFI contract, are effective in practice. Chapter (3.38 – 3.44) outlined what those mechanisms are, the circumstances where they might be used, and compared them to the inflexibilities also inherent in conventionally procuring major capital assets.

8.46 In a PFI contract, the public sector needs to secure value for money in meeting its changed requirements through exercising its rights under PFI contracts. To exercise those rights effectively it must:

- ensure an effective co-operative relationship with the public sector client, which can facilitate changes swiftly, and secure a fair agreement with the PFI contractor on cost that represents value for money;
- negotiate effectively over changes with the PFI contractor, to ensure the best value for money;
- have in place the expertise and capability to run effective competitions for changes to PFI facilities where the public sector client deems it necessary to secure value for money; and
- maintain the ability, where necessary, to terminate PFI contracts without private sector default in the rare event of a radical change in public sector requirements. Paragraphs 9.24–9.29 examine this area in more detail, and outline measures to make it easier to safeguard the public sector's position where termination is necessary.

8.47 The Government is concerned to ensure that these capabilities are in place. To establish the extent to which the public sector is capable of ensuring the flexibility of PFI contracts it manages, HM Treasury will be conducting research and consultation on the public sector's record of securing flexibility in PFI contracts on value for money terms over the next year.

9 PRIVATE FINANCE

The involvement of third-party finance is an important factor in the success of PFI. Private finance offers value for money in PFI procurement in circumstances where the benefits it brings outweigh any cost involved.

The Government seeks to ensure that it receives the best value for money in securing the benefits of private finance for PFI projects. Consequently it is determined to:

- **maintain a variety of sources of funding for PFI projects** to ensure that competitive tension provides value for money, that the risks associated with a major investment programme are spread in a sustainable fashion, and that the Government's exposure to systemic market risks is minimised;
- **explore the provision of framework funding, particularly in bundled small PFI schemes** to provide a faster, cheaper funding solution for these kinds of schemes; and
- **explore through pilot projects and consultation the potential of a form of credit guarantee finance,** as one of the variety of sources of funding that could be available for PFI. This type of financing separates funding and risk taking by retaining the involvement of private financiers as risk takers in PFI, but funding projects through Government gilts; thus saving the cost of the private sector securing funds, which is separate from the cost of it taking risks.

Also, the Government wishes to ensure that the involvement of private finance does not lead to unnecessary inflexibility in privately financed projects because of excess termination costs. It will explore measures to assure this flexibility, including:

- consulting on **the role of the Spens clause** in the termination of PFI projects funded through bonds; and
- examining and consulting on the value for money of **requiring the private sector to hedge interest rate risk** on a project specific basis.

BACKGROUND

9.1 The Government's approach to PFI, laid out in Chapter 3, makes clear that the involvement of private finance in taking performance risk is crucial to the benefits offered by PFI, incentivising projects to complete on time and on budget, and to take into account the whole of life costs of an asset in design and construction. It is necessary for private sector capital to be at risk for it to take responsibility for the work it carries out. The involvement of third-party finance in PFI brings with it extensive due diligence work to identify, allocate and enforce risk sharing in a project that can significantly improve its value for money. The evidence presented in Chapter 4 demonstrated that these benefits of private finance are being realised.

9.2 Because of the benefits it brings, the involvement of private finance in PFI should represent good value for money, reducing the overall cost of delivering certain types of public investment. The Government recognises that to obtain the benefits of private finance there is an associated risk premium compared to the risk free rate of government gilts. This risk premium represents value for money in PFI, as it reflects the private sector taking on and managing the appropriate risks – risks which, although inherent in a project however procured, are not reflected in government borrowing. An explanatory comparison of the relative costs of public and private finance is laid out in paragraphs 3.60 onwards, which outlines how the cost of capital in a PFI project, which explicitly calculates the risks involved, cannot be compared with the cost of gilts, or government borrowing, as these rates are set 'risk-free' although there is an extra cost to funding PFI through private sector finance, associated with the higher cost of the private sector securing funding in the capital markets compared to the Government. Moreover, these costs of finance are:

- controlled by competitive pressure – not only do PFI contractors bid to win contracts, but they themselves typically put the financing arrangements out to bid;
- not the most important cost in evaluating PFI bids, as a bidder's proposals for construction and operation of the asset are likely to have a more significant effect on unitary charge; and
- a shared interest of both the public sector and the private sector PFI consortium, who both have an interest in securing value for money for the finance raised.

9.3 PricewaterhouseCoopers are publishing separately on their website a study commissioned by OGC into the rate of return bid by the private sector in PFI projects. The findings of the report are summarised in Annex C.

The role of Government in private finance

9.4 For most PFI contracts, the Government's direct role in raising the finance for a PFI project is limited although there can be exceptions in unusual or particularly complex schemes. It is the responsibility of the PFI contractor to put in place its own financing arrangements to fund the investment required by the PFI project. It is recognised that each PFI contractor has its own relationships with sources of private sector finance, which it may wish to use throughout its portfolio of projects. It is also important to ensure that the private sector funders do not infer from any Government involvement in this aspect of the PFI project that it is in any way underwriting the finance raised. The key role of the Government is to set the terms of the competition for the PFI project, which gives the private sector the right incentives to obtain the best value for money, including in terms of the finance secured in the PFI contract.

Financing PFI projects

9.5 The private sector has typically financed PFI projects with a combination of all or some of the following: bank finance; debt raised in the capital markets with a credit guarantee; debt raised in the capital markets without a credit guarantee but rated by one of the established rating agencies and finance provided by the European Investment Bank, which usually benefits for part of or all of the project's life from a bank guarantee. In addition, a limited number of projects have been financed by the private sector without the involvement of third party finance.

9.6 The Government wishes to ensure that all the traditional means of funding PFI will continue to be available to be used by the private sector, with the private sector left in charge of the process for selecting which financial counterparty to engage in support of its bid. The Government's overall aim is to maintain a 'mixed economy' in finance provision:

- that there is healthy competition between different sources of finance, ensuring value for money;
- that the risks associated with the major investment programmes undertaken through PFI are spread in a sustainable fashion across a number of sources of credit;
- that the Government is not overly exposed to systemic market risk on one particular source of finance; and
- that the terms of credit support for the private sector are part of the tender process.

IMPROVING VALUE FOR MONEY

9.7 The Government continues to be committed to working with the private sector and their funders to identify new approaches to financing PFI projects which may offer value for money benefits. In assessing any new financing schemes, the Government will seek to ensure:

- that it retains the benefits of risk sharing with the private sector, including with the funders of the PFI project (as set out in Chapter 3);
- that it avoids any Government guarantee of the funding raised; and
- that it does not interfere unduly with the ability of the private sector to raise funds for their project or add costly delays to the procurement process.

9.8 Within this framework, the Government will always be interested in proposals which reduce the costs associated with private finance, but which do not compromise its desire to ensure that the disciplines, value for money and risk sharing brought by private financiers to the PFI process are retained. At present, the Government wishes to pursue further two new financing schemes, set out below, which may achieve these objectives.

Framework Funding

9.9 The Government is looking at framework funding solutions, particularly for application in those schemes which bundle together smaller schemes, for example Partnerships for Church of England Schools (bundled schemes are explained further in Chapter 8). The aim will be to provide a faster, cheaper funding solution, which maintains the benefits of third party finance but reduces its inherent inefficiencies when applied to smaller schemes. The finance would continue to be provided by the private sector, with the same advantages for the PFI project this brings.

9.10 While such a framework funding solution would make access to third party finance easier and more cost-effective for smaller schemes, all control and accountability for those schemes would remain at the level of the procuring authority itself. Funding for locally-driven schemes would become cheaper to access, allowing authorities to get better value for the investment they control.

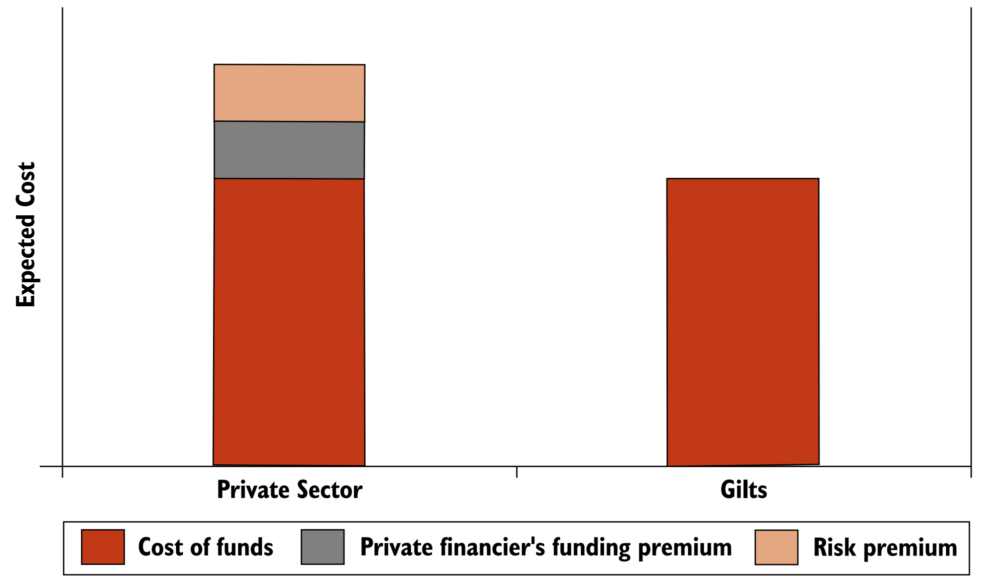
9.11 Work is underway to analyse the benefits of these framework funding conduits, and look at the degree of flexibility on drawdown that would be available within such a scheme. It is not envisaged that framework funding schemes would be applied more widely to stand alone schemes. The benefits are seen to occur predominantly in grouped small projects potentially using the procurement of the kind outlined in Chapter 8.

Credit Guarantee Finance

Overview **9.12** The Government will pursue a small number of pilot projects to test the practicality, attractiveness, and applicability of a different means of funding the senior debt raised to fund some PFI projects which has been called Credit Guarantee Finance. The aim of this scheme is to retain all the benefits to the public sector of banks and insurance companies' risk taking in PFI projects, described in paragraphs 3.54 to 3.59, but funding the PFI project's senior debt requirements with loan finance provided directly by the Government, fully guaranteed by these private risk takers, which it would fund by the issuing of gilts. This approach combines the lower cost of the Government borrowing funds with the benefits of paying a risk premium to private financiers to take, allocate and manage risk. By doing so, this approach offers the prospect of a cost saving in terms of the overall cost of finance for the PFI projects involved.

9.13 The cost of private sector debt finance for a PFI, as explained in paragraphs 3.62 to 3.63, contains a risk premium charged by the lenders for assuming, allocating and managing the risks inherent in the project. This risk premium, typically 0.3 to 1 per cent, represents good value for money for the public sector in a PFI project, because the lenders' involvement contributes significantly to on time and on budget delivery and whole-of-life costing in PFI investment. This risk premium is not paid in financing conventional procurement through gilts; but the risks in conventional procurement are instead paid for in full by the public sector if and when construction runs over budget or projects are delayed.

Chart 9.1: Cost of finance



9.14 Inherent in raising private finance is the cost of the private sector securing funds in the market due to the higher risk in funding private sector credit providers as opposed to Government (see Chart 9.1). Paying this funding premium has provided good value for money overall, and will still represent value for money in future PFI, because of the benefits flowing from the private sector assuming risks.

9.15 However, the Credit Guarantee Finance option explores a way (for some projects), of continuing to pay a risk premium to the private sector for some projects, but reducing this funding premium and hence improving further overall value for money offered. This option could lead to savings in some PFI projects which pursue it, but it would not be possible to use it for a large number of projects, because of the importance of maintaining a variety of funding sources and bearers of risk and for the reasons set out in paragraph 9.19 below.

How it works 9.16 If adopted, this approach could be implemented on an individual PFI project in the following manner.

9.17 As currently, the PFI contractor would be responsible for engaging its financial partners subject to a limited number of restrictions, related to the credit worthiness of the credit provider selected. The funders would provide guarantees to pay principal and interest as and when they fall due, rather than cash advances to commit to fund the project. At signature of the PFI contract, the Government would lend to the PFI project the sums needed to finance the senior debt portion of the overall financing package, provided the PFI contractor was able to offer credit guarantees for the full amount of these loans from credit providers of acceptable standing

9.18 With this arrangement in place, the Government would be lending funds to the PFI project with the benefit of a guarantee from the credit providers. If there was a default by the PFI contractor for any reason, these credit providers would fully repay the Government's loans in a timely manner. The Government's principal risk in lending would therefore be the credit worthiness of the credit provider, not the PFI project itself. In using this approach, the Government would not seek any significant additional rights, either in respect of drawdown limitations, covenants or in respect of events of default to those normally required by investors in similar transactions where they are currently guaranteed by specialised insurance companies.

Scope of use 9.19 If adopted, there will be natural limitations to the use of guarantee finance in PFI projects, being, among others:

- the Government will need to manage its overall exposure to each credit provider, whether it be a bank or an insurance company;
- the Government may also need to ensure that it will limit its exposure to certain types of credit provider, for example it will need to limit its exposure to insurance companies as a group;
- the Government will only wish to use this for PFI programmes that are well established, where the risk profile of the PFI project is well known; and
- it is unlikely to be attractive to use this for a large number of projects, as it is necessary to ensure the maintenance of a mixed economy in financing PFI, and the lower exposure to systemic market risk that comes with that.

9.20 If Credit Guarantee Finance is adopted for some projects, the Government will seek to use both banks and insurance companies to provide the credit guarantees, as a part of its interest in maintaining a variety of risk takers and sources of finance in PFI.

The Pilots 9.21 A small number of pilot projects will be chosen, one of these being a pilot of how Credit Guarantee Finance could be used with banks as the credit provider, a second with an insurance company as the credit provider, and the Government will also wish to test the scheme on two different types of PFI projects. In pursuing the pilots, the Government will be concerned to ensure that these will not delay the financial close of any PFI project and all relevant concerns which could arise for the public and private sectors as a result of Credit Guarantee Finance are addressed in consultation with all relevant parties.

9.22 Following a successful conclusion to these pilots and consultation with both private and public sectors on whether and how this approach could be implemented more widely, the Government will decide whether or not to proceed and will issue guidelines for its use. However, the Government envisages that it will not use Credit Guarantee Finance for more than a limited proportion of its PFI programme and is committed to maintaining a mixed economy in PFI financing.

9.23 As part of the consultation exercise, HM Treasury will be providing further detailed technical information concerning Credit Guarantee Finance on its website in the early Autumn.

FINANCE AND FLEXIBILITY

9.24 Flexibility is important in the delivery of public service investment in PFI, just as in conventional procurement, to take account of major changes in requirements or technology in the long term. Natural limits are placed on flexibility by the very nature of the capital assets being built, and they are present in both PFI and in conventional procurement. However, the means by which this flexibility is realised differ in the case of PFI, and Chapter 3 outlined the measures in place in standard PFI contracts to deploy that flexibility. In brief, these measures are:

- the public sector has a right to change any aspect of the building or service provision, subject to agreement with the PFI contractor on cost;
- to ensure agreement is reached quickly and that value for money is maintained, for changes over £100,000 in value, the public sector can require a competitive tender for any works, to be appropriately audited; and
- where there is a requirement to change service configuration, there is a similar right for the public sector to change any aspect of service provision, subject to agreement on costs, with the ability to require a competition for the services provided to ensure best value for money. This is in addition to their rights to re-tender service provision regularly throughout the contract's life.

9.25 In very rare circumstances, where there is an unanticipated wholesale change in the public sector's needs which makes public infrastructure redundant, or requires very radical change in its use, the public sector will need to be able to implement such change whatever the procurement route originally chosen.

9.26 In conventional public sector procurement there will be costs in implementing such change. As in PFI, the costs may relate to the financing arrangements, and may involve the termination of service provision contracts. When a public sector project is financed by the Government, it typically issues gilts to fund the project. Even if the building is now redundant the Government will still need to repay and meet the interest costs of the gilt issue over its remaining life. Likewise any service contracts terminated would also lead to compensation. This would typically be calculated as a payment of foregone profits for an agreed period.

9.27 If the Government voluntarily terminates a PFI contract in such circumstances (rather than where the private sector is in default) it will face similar costs. There are, however, areas where PFI contracts are more expensive to terminate. In a standard PFI contract, shareholders would receive compensation for their loss of profit from the PFI project. This would typically amount to a present value of the foregone profits. The level of this compensation is dependent upon the performance of the project as well as the proportion of equity in the deal. Generally the low level of equity in the financing of these projects reduces the significance of this element of compensation.

9.28 The other elements of compensation on a PFI contract in these circumstances relating to the private finance elements of the project can represent an unnecessary cost. In particular, the Spens formula which is normally applied to the termination of PFI-linked bond issues – a small proportion of PFI projects – can be an unnecessary cost in the voluntary termination of a project, as it compensates the bond holder for the risk margin on the debt for the remaining life of the bond. The hedging of interest rate risk in a PFI project can give rise to similar issues.

9.29 To examine these issues further, the Government will be consulting with the public and private sectors on the role of the Spens formula in limiting flexibility in project termination, and on hedging risk.

Spens Formula

9.30 The Spens clause, which applies to listed bonds in the UK only, provides for a termination payment that compensates the bondholders for lost risk margin when a bond is terminated. This will only be an issue in extremely rare circumstances and for the small proportion of PFI projects financed by bond issues.

9.31 The Government is concerned that the Spens related payment represents an unnecessary extra cost of termination for a PFI project over a traditionally financed project in the rate circumstances where it wishes to voluntarily terminate due to major changes in the public sector's requirements which cannot otherwise by accommodated. The Government is content to retain the Spens payment in circumstances of authority default and force majeure.

9.32 The Government is aware that a change in the application of the Spens clause would be considered a major change to the way bond investors preserve their long term interests when they invest in PFI projects. The Government also recognises that the circumstances in which it wishes to voluntarily terminate without the Spens clause are extremely rare, and should be limited to major changes in public service needs. It intends to enter into consultation with issuers and investors over the next six months to see in what circumstances investors would be willing to voluntarily forego this protection in these limited circumstances.

Hedging

9.33 As outlined above, the key role of Government in the private finance raised by PFI projects is to set the terms of the PFI competition. In setting these bid requirements, the public sector sets out its approach to the unitary charges to be paid, and provides a formula for any permitted changes in these charges over the life of the contract. In doing this, the public sector determines in advance some restrictions on the financing options which will be feasible to the PFI contractor. For example:

- if unitary charges are only permitted to increase annually by the rate of inflation, this is likely to lead a PFI contractor to fund its project through an index-linked bond issue, which relates changes in inflation; or
- if unitary charges comprise a mixture of a fixed element, equal to the amount needed to service the finance raised for this project, and a second element which varies with inflation (usually relating to operating costs) this will lead a PFI contractor to fund its PFI project with a fixed rate of interest by way of a bond issue or, if it chooses to use bank finance, the introduction of a hedging instrument to mitigate the interest rate risk normal with such bank financing.

9.34 The key choice for the public sector regards its preferred approach to unitary charges. Guidance has been given on these matters, but the Government believes an alternative approach to interest rate risk is now possible, given the large number of projects now in operation, which could improve value for money futher.

9.35 The Government will review the current approach to managing interest rate risk under a PFI. To date, interest rate risk and its management primarily lies with the PFI contractor, which raises two issues:

- where it is necessary to terminate a PFI contract to ensure flexibility for delivery of public services in the circumstances described above, the cost of breaking the hedging contracts put in place by the PFI contractor are typically passed back to the Government; and
- it is also difficult to ensure that the process of agreeing a fixed interest rate at financial close is sufficiently transparent and cost effective.

9.36 The Government is now in a position to consider its exposure to interest rate risk in PFI contracts in the context of its PFI programme as a whole, securing better value for money than through continuing to require the private sector to put in place such hedging itself.

9.37 The Government therefore plans to review whether its current approach to requiring the private sector to hedge interest rate exposure offers best value for money. It will consult on these issues with both public and private sector participants in PFI on whether an alternative approach can be found which offers better value for money.

A Annex A – Public Sector Comparator Reform

CONTEXT FOR THE REFORMS AND THE GREEN BOOK

A1 As set out in detail in Chapter 7, Assessing Value for Money, the government proposes to introduce a new framework for value for money appraisal for PFI procurement. This Annex sets out in more detail some of the criteria that could be examined under each stage of the new value for money appraisal process. The criteria included are indicative, and will be laid out in more detail in future guidance on which the Government will consult.

APPRAISING VALUE FOR MONEY IN THE INVESTMENT PROGRAMME ASSESSMENT

A2 Examples of the criteria that could be included in the value for money appraisal at the stage the decision is made on how to procure investment projects as part of a programme are:

- outline of the objectives of an investment programme and definition of a successful outcome, financial and non-financial, including for example, social outputs and skill development;
- public equity, efficiency and accountability reasons for providing the service directly;
- whether the service is contractable on a long-term output specified basis. The outputs should take into account, inter alia, the potential need for changes and requirement for flexibility during the contract terms, including for example, whether output levels could be affected by technological change in the short to medium term;
- the experience and track record of similar projects that have demonstrated the wider value for money and costs savings that PFI can deliver. The analysis will need to consider the benefits and costs of other procurement routes compared with a PFI route such as the costs of a complex procurement process, and the scope for risk transfer;
- identification of the potential distributional implications of the various options across society and how the costs and benefits might accrue across different socio-economic groups;
- assessment of the benefits and costs in relation to employment issues under each procurement route. For example, options being considered should take into account the need for flexibility in the delivery of public services and the ability to pursue PFI, for example, without full workforce transfer (retention of soft services); and
- establishment of central departmental (or agency) management arrangements to support the procurement programme and potential transaction costs of the programme.

A3 This appraisal will be aided by appropriate quantitative analysis to ensure transparency and robustness. At the stage that decisions are taken on how to allocate capital, the analysis is likely to focus on the following:

- preliminary assessment of projected operational and capital costs for investment programmes;

- broad transaction and financing costs of different procurement routes, where such information can be extracted from experiences to date from the sector;
- assessment of the potential tax impact for each route;
- accounting for optimum bias on the overall investment programme for capital costs, duration of works, operational costs and benefits – which in the public sector has historically been caused by both inadequate project definition and poor project management. Optimism bias within private sector bids should also be factored into the overall risk analysis, such as the level of variation claims (which impact price), using the information available from actual experience from projects. The application of optimum bias to PFI project appraisals will require further development and the Treasury will work with Departments to develop project or sector specific methodology;
- distinct from optimum bias, quantification of uncertainties surrounding the public sector's ability to estimate the cost and benefits of a public sector alternative, for example, the value in a fixed price contract offered by private sector compared with relying on internal estimates to price the contracts. This may be less of an issue where similar transactions exist for comparison but may be applicable for unique or more complex projects;
- preliminary appraisal and quantification of benefits and costs arising across the different sectors and across income groups, such as improved productivity of workers, loss of workforce and environmental improvements of each procurement route. The Green Book suggests use of multipliers or indexes to differentiate the potential impact across the different sectors or socio-economic groups; and workforce issues; and
- potential for alternative revenue streams such as third-party revenues generated or cost savings by or to other programmes based on experience from previous similar projects.

APPRAISING VALUE FOR MONEY AT THE PROJECT LEVEL

A4 Below are some examples of the criteria that should be considered as part of a value for money appraisal of a PFI project in a reformed PSC at outline business case stage and before procurement commences, at the project stage:

- the scale, nature and scope of the project. For example, adding a new wing to an existing hospital (that has not been procured under PFI) would be an unlikely candidate for PFI procurement, whereas expansion of Design, Build, Finance and Operate (DBFO) road is likely to be more suitable;
- build on initial quantitative assessments, including confirmation of capital values and operational costs of the project, factoring in target service and usage levels;
- identification and quantification of the key risk transfer elements, potential tax impact, and optimum bias estimates specific to the project. As details on projects are developed, Departments will need to look to producing greater detail on appraising the benefits and costs of the relevant value for money issues, for example, for a pathfinder PFI, broader benefits including the workforce, strategic or environmental impact will need to be considered;

- identification of non-market impacts where feasible, such as strategic considerations, timing implications, health benefits, design quality, approach to innovation, and health and safety;
- assessment of the affordability of options, including upfront transaction costs, in addition to the economic costs and benefits;
- early establishment of an approach to project and risk management, and an evulation of the make-up and experience of the project team;
- assessment of the financing costs of a PFI scheme and competition issues, including preliminary expectation of competitive interest and quality of potential bidding parties having considered the current market situation;
- updating the framework for pre-tender dialogue; a key evaluation approach is to ensure a level playing field for the competition to facilitate the appraisal and decision making process and flexibility to take into account of bidder input during the bid process.

A5 The supporting financial analysis will include:

- cost estimates. This will assist future sensitivity analysis;
- adjustments for optimism bias. The Green Book recommends that optimism bias adjustments should be made to each major category identified based on the best empirical evidence relevant to each stage of the appraisal;
- the quantification and probable impact of the different taxes, such as stamp duty, VAT, employment, corporation tax liabilities and other relevant tax regimes; and
- identification of the benefit categories, financial (for example, operating costs reduction) and non-financial (quantitative, such as reduction in road accidents, and qualitative, improved staff skill level).

VALUE FOR MONEY APPRAISAL DURING THE PROCUREMENT STAGE

A6 At the procurement stage the value for money appraisal should focus on the effects of market conditions and competition issues on the bids received, and will not be an evaluation of PFI as a procurement route, which will have been tested using the reformed PSC. This assessment is different from the full bid evaluation process to determine which bid offers the best value for money. Instead, the aim of the assessment is to ensure that the preferred PFI bid offers a value for money PFI scheme.

A7 Additional factors relevant to the procurement stage will include:

- the quality of the competition through the expressions of interest received;
- market factors such as the effect of capacity constraints on prices; and
- quality of the proposals received; where the project attracts inadequate quality of responses and may require adjustment as to scope and timing.

B

Annex B – Reporting and Accounting Issues

B1 The Government's publication of statistics on the PFI programme to date has used a very broad definition covering several different types of private investment in public services and there are a number of areas where there are benefits in making changes to the statistics that are reported. Specifically:

- statistics have not distinguished between investment undertaken under PFI and under other very different PPP transactions or arrangements with the private sector like the Channel Tunnel Rail Link (CTRL);
- some departments report annual expenditure by the private sector in the year it is actually intended to occur, while some have aggregated the full capital value of investment undertaken by the private sector into the year the project contract was signed; and
- there is some overlap in the figures for 'on-balance sheet' PFI investment in the ONS published statistics on PSNI and the figures for the PFI programme.

B2 The Government intends to treat the publication of statistics on PFI differently in future, beginning with the Autumn 2003 Pre-Budget Report (PBR). The aim is to present more comprehensive statistics that are transparent with regard to the kind of transaction – PFI contract or PPP joint venture – to which they refer. This will include publishing biannually, in the Budget and PBR, more data on:

- signed projects;
- future PFI transactions;
- the level of expected payments to the private sector under unitary charges; and
- other information which could be of use to all participants in PFI.

Sources of Information

B3 The Government has routinely published a range of statistical information on PFI. The Financial Statement and Budget Report sets out:

- departmental estimates of the capital investment in public services to be undertaken by the private sector under PFI, PPP and other similar contracts signed to date;
- the estimated aggregate capital value of projects which have reached preferred bidder stage; and
- estimated payments to be made by government under PFI contracts signed to that date. As the Financial Statement and Budget Report points out, actual expenditure will depend on the payment mechanism and deductions for poor performance in each individual contract.

B4 The Office of Government Commerce (OGC) has maintained a database of PFI and PPP signed projects and the capital values involved. Responsibility for this database transferred to HM Treasury on April 1st 2003. The publicly available electronic database will transfer from the OGC website to the HM Treasury website in the early Autumn.

B5 The Government has published a detailed regional breakdown of PFI and PPP contracts. These regional maps illustrate the distribution of projects across the country, their capital value, the date the project scheme was finalised and work begun, and some details on what the project will provide.

B6 Other sources of information include:

- published Departmental Investment Strategies;
- a list of approved local authority PFI projects, available on the ODPM website;
- the NAO database "PFI and PPP/Privatisation Recommendations", and
- regular presentations of information to Parliament in response to specific requests.

PPPs and PFIs

B7 The use of two terms – 'PPP' and 'PFI' – to refer to Government relationships with the private sector can cause confusion, with the terms often used interchangeably. However, there is an important purpose in having two terms: to make it possible to differentiate between two different types of transaction. Specifically, to differentiate between PFI as a procurement tool, and PPP as an ownership structure.

B8 This distinction is especially important in financial reporting. The vast majority of PFI contracts represent a liability for a stream of payments that stretches over the long term, and which the Government will have to meet from revenue expenditure in the year in which they are liable. In a PPP deal by contrast, the Government owns an equity stake in a company, an asset, and this is therefore different in kind from a PFI transaction.

B9 It is important to highlight this distinction when considering aspects of the public finances, and the Government intends to ensure the transparency of information presented in the future by isolating and identifying, where appropriate, data on PFI projects and PPP transactions. Consequently, the data presented in the report focuses on PFI investment and the liabilities associated with it, and excludes PPP transactions and other kinds of Government relationship with the private sector.

B10 The data presented in the report therefore includes the early forerunners of PFI, such as the Queen Elizabeth II bridge which commenced before the formal launch of the Private Finance Initiative on 12 November 1992, because these early projects are functionally similar to PFI in that they too involve long-term payments to the private sector in return for provision of a public service asset.

B11 Investment in other kinds of Public Private Partnerships, such as the National Air Traffic Control PPP and the Home Office Airwave PPP are not included.

LUL and CTRL

B12 Two major transport transactions, the Channel Tunnel Rail Link and the London Underground Limited PPP, are sufficiently significant in size to require a separate account of their treatment. LUL and CTRL are reported in the Financial Statement and Budget Report 2003 in the following way:

- the annual capital investment being undertaken by London and Continental Railways on the CTRL is included in the departmental estimate of capital spending by the private sector under the Department for Transport;

- the total capital value of the first 15 years of infrastructure investment under the Tube Lines London Underground contract is reported in financial year 2003-04. The expected unitary charge service payments to be made under the contract are reported in the estimates of future revenue payments under PFI contracts; and
- the total capital value of the first 15 years of infrastructure investment under the Metronet London Underground contracts is reported as part of the Department for Transport's estimated aggregate capital value of projects at preferred bidder stage in 2003-04. (These contracts have now been signed.)

B13 The data on the PFI programme differs from that represented in the Financial Statement and Budget Report due to the different treatment of CTRL and LUL. Specifically:

- capital investment undertaken by London and Continental Railways on the CTRL is not included in the data, as the investment does not occur under a PFI contract. CTRL is not a PFI because the Government has no fixed contractual liability for set values of future service payments to the private sector, but instead guarantees CTRL bonds. The risk transfer involved in the project is therefore different in kind to a PFI contract, utilizing a different transfer mechanism;
- the PFI contracts for the modernisation and maintenance of London Underground are included in the data. Under the Tubelines and Metronet contracts, the Government has incurred fixed price service payment liabilities into the future (with the contracts reviewed every seven and a half years) in return for a guaranteed level of service. It has transferred risk in the same way as in other PFI contracts;
- to maintain an approach consistent with previous reporting, LUL PFI contracts are reported at their value estimated over a 15-year period in the year in which they were signed (as the contracts are reviewed periodically, the actual capital investment undertaken may vary); and
- to improve transparency in the figures, the proportion of capital investment represented by the London Underground contracts is indicated in data for the capital value of signed PFI contracts.

THE GOVERNMENT'S APPROACH TO ACCOUNTING FOR PFI PROJECTS

Overview

B14 The Government accounts for PFI investment according to accounting principles set by the independent Accounting Standards Board (ASB). The accounting treatment of PFI projects entered into by central government bodies are then audited by the independent Comptroller and Auditor General on behalf of Parliament.

B15 The Government uses PFI where it delivers value for money in public services, not for balance sheet reasons. Approximately 57 per cent of PFI capital expenditure is scored on the public sector's balance sheet.

Independently written, independently audited principles

Principles of accounting by Government

B16 The Government is committed to increasing the accuracy and availability of information about the public sector's assets and liabilities. Accurate, transparent and credible accounts allow the public to judge the scope, direction and sustainability of public spending and investment. The Government has undertaken to use best practice accounting methods in the production of its accounts. This commitment is enshrined in the Code for Fiscal Stability and the Government Resources and Accounts Act 2000 (GRAA 2000).

B17 In accordance with the GRAA 2000 Government accounts are required to follow UK generally accepted accounting practice (UK GAAP), adapted as necessary for the public sector context. These accounting practices and principles are independently set and independently assessed in their application. Accounting standards are set and developed by the Accounting Standards Board (ASB). The Government is required by the GRAA 2000 to take advice from an independent advisory board – the Financial Reporting Advisory Board (FRAB) – on the application, timing and introduction of these standards, and the FRAB can highlight any departures or modifications in its annual report to Parliament.

Treatment of PFI

B18 The specific accounting treatment of the Government's PFI investments also follows UK GAAP developed by the independent ASB. The accounting standard most applicable to PFI is the ASB's 'Financial Reporting Standard 5 (FRS5) – Reporting the Substance of Transactions: Application Note F – Private Finance Initiative and other similar contracts.' This reporting standard is followed, supplemented by a Treasury Taskforce Technical Note (TTN1 Revised) that sets out how Application Note F is to be followed in the public sector. TTN1 Revised reflects extensive consultation with the ASB, the accounting profession and contractors. The Technical Note was also approved by the FRAB.

Independent audit

B19 With a few exceptions Government accounts are audited on behalf of Parliament by the independent Comptroller and Auditor General (C&AG). The C&AG can qualify his audit opinion on the accounts of any Government body if he believes either that accounting guidance has not been properly complied with or that the accounts do not present a true and fair view. The C&AG's most recent report – the General Report for 2001-2 – made it clear in relation to PFI that:

"where he considers that the liabilities arising from financing arrangements are not correctly reflected in the financial statements of the bodies that he audits he will qualify his opinion and report to Parliament accordingly. He has not yet had the need to do so".

Principles of PFI accounting

Property vs. services

B20 Accounting treatment draws a distinction between property – which may be booked as an asset – and services, which are accounted for as current expenditure. It is not generally accepted practice to account for future service payments under a contract as an asset by, for instance, capitalising their present value. The issue of importance when accounting for PFI projects, therefore, is whether, on balance, to regard the resulting property as an asset of the Government or to report the stream of unitary charge payments as expenditure in the year in which they occur.

FRS5 – balance of risks

B21 The overall principle set out in FRS 5 is that a party must account for the economic substance of a transaction, rather than simply its legal form. In order to reflect this economic reality, the financial reporting standard insists that a party that will reap the benefits and bear the balance of risks of ownership of a property 'has an asset of the property' and must report this on its balance sheet.

B22 When a property has been built through conventional procurement methods, the public sector is almost always considered to bear the risks of ownership, and the capital invested in that property is booked as an asset in the Government's accounts. Future maintenance and other service charges associated with the property are, of course, not booked but expensed in the year they are incurred and no disclosure of those likely future costs is made.

B23 PFI provides value for money to the Government by transferring the risks associated with a capital project – risks around design, construction or ownership – to the party best able to manage them. This transfer of risks is reflected in the terms of the PFI contract, and in the payment of an annual unitary charge across the life of the contract with deductions made when the property is unavailable (for instance if unfinished) or for poor performance. If, as a result of this transfer of risks, the Government did not enjoy the potential rewards accruing from ownership (not merely use) of the property – for example from renting out unused space to a third party – nor did it bear the risk associated with owning the property – for example the risk attached to the anticipated value of the property at the end of the contract term – then it would be inaccurate for the Government to book that property as an asset.

B24 It is important to note that the risks of ownership are only a subset of the risks that may be transferred under a PFI contract. For example, FRS 5 does not take into account whether a party bears the risks involved with building a property. So it may be that a PFI contract delivers value for money through transferring significant risk to the private sector, but that the accounting principles require the public sector to score the property concerned on its balance sheet.

C Annex C – PricewaterhouseCoopers Rate of Return Study

Cost of private finance

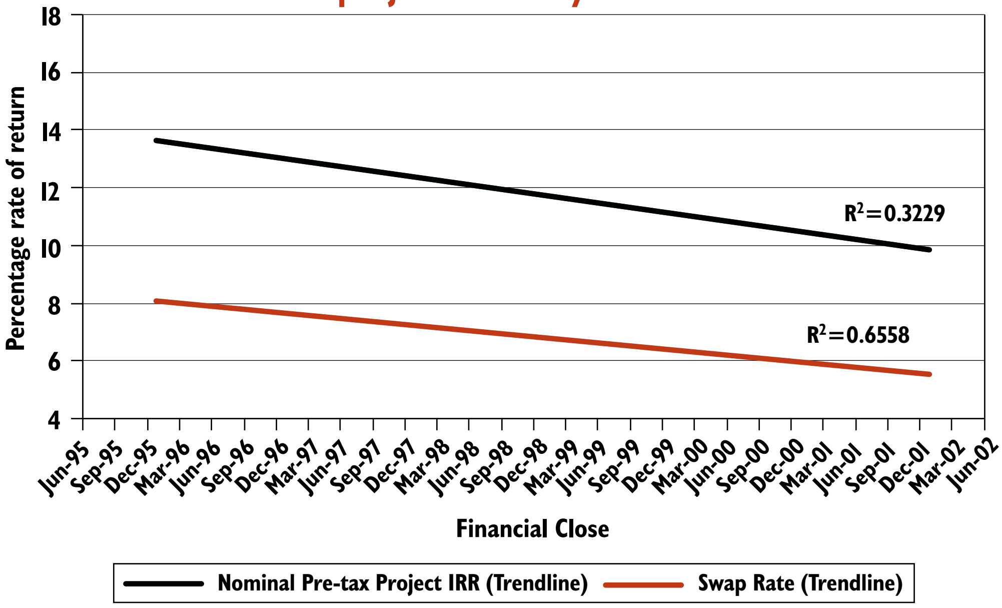
Pricewaterhouse-Coopers study

C1 PricewaterhouseCoopers (PwC) have published alongside this document a report which seeks to assess the rates of return bid by private sector participants in the PFI market since 1997, and to assess such private sector return expectations against appropriate industry benchmarks. This report was commissioned by OGC in July 2001. A full copy of this study is available on the web site of PwC. This Annex is a brief extract of some of the data, analysis, and conclusions set out in this report. The study should be read in full for a clear understanding of its analysis and conclusions.

C2 PwC analysed 64 projects that reached financial close between 1995 and 2001, covering a wide sample of activities, such as health, education, office accommodation, prisons, transport, defence and water projects, but excluding IT projects. The total construction value of the sample was £4.4 billion, representing 23 per cent of the total value of transactions closed by the end of 2001, with the average capital value of transactions being £70 million.

C3 A PFI scheme's cost of finance is the combined cost of its debt and equity, taking account of the proportion of equity in the scheme, usually being ten per cent of the total. The PwC study provides data which is useful in assessing the expected overall cost of capital which is usually referred to as the Project Internal Rate of Return (Project IRR). This is usually equivalent to the cost to the project of the debt, equity return and tax paid thereon. As Chart C1 illustrates, since 1995, this "all-in" cost of private finance has fallen from 13.5 per cent to just under 10 per cent by 2001.

Chart C1: Pre-tax project IRR analysis



Source: PricewaterhouseCoopers study, Academic adviser Professor Julian Franks.

The price of risk

C4 Typically, the private sector takes account of risk by using higher rates of return to compensate. Whilst the Government accepts that this is a valid approach by the private sector, and fully supports the point that the risks associated with public projects should be properly quantified, its preference is to separately evaluate and quantify such risks. This approach to measuring risk is set out in the Green Book and discussed more fully in Chapter 3. It is therefore inappropriate to compare a "risk free" cost of gilts with the cost of private finance, which is set by the private sector to take account of project risks, without also considering the benefits of the private sector's capacity to absorb risk. Box C1 cites some of the comments in the PwC study which address this issue.

Box C1: Public versus private sector cost of capital: PwC study

"There are two common assertions made to justify the claim that the private sector cost of capital exceeds the public sector cost of capital:

'Governments can borrow at a risk free rate of interest'

This is not the case, there is a risk premium either way, it is just explicit in the price of private capital. Where gilts are used, tax-payers effectively underwrite the associated risk and the price reflects this fact. The taxpayer takes on the contigent liability, and where the risk materialises, they carry the cost as a result. If the taxpayer were to be compensated it would be equivalent to paying the risk premium at the point of raising the capital, making the public and private sector's cost of capital equivalent.

'The government are better at diversifying the risk than the private sector'

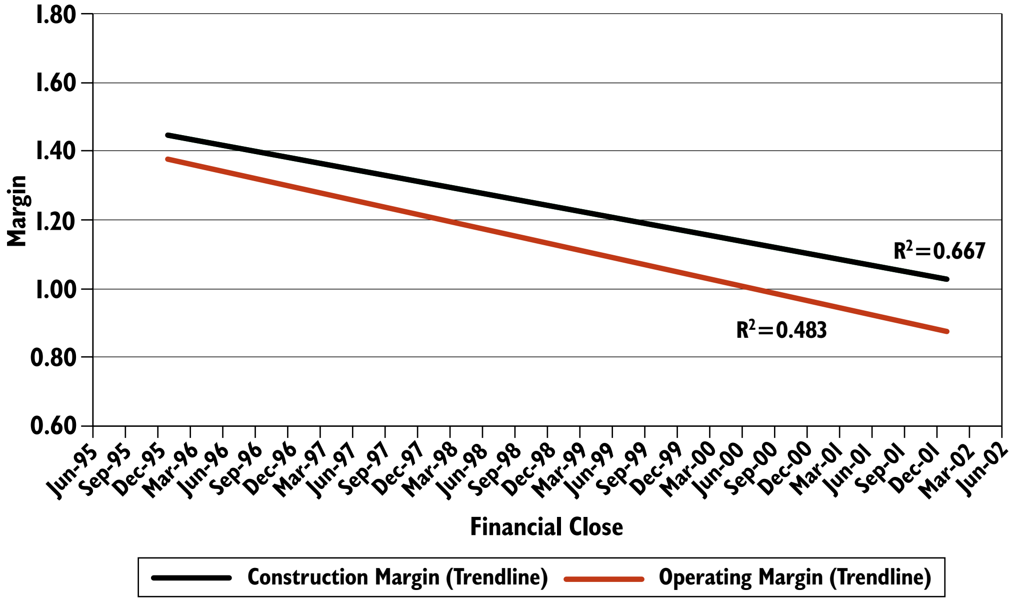
This assertion is based on the Arrow-Lind theorem, an academic theory which assumes that project returns can be treated as wholly independent of National income. In fact this is rarely the case as public investment is not risk free".

Cost of debt

C5 The PwC study also analyses the specific costs of the debt finance used in PFI schemes, which have also been improving from the public sector's perspective over the period of the PwC study. The cost of debt comprises of the margin paid for credit risk taken, the requirement lenders have for equity, which is reflected in cover ratio calculations, and levels of financial gearing and front end fees. Key results of PwC's analysis are laid out below.

C6 The length of the average final maturity of debt achieved for PFI schemes has increased to approximately 30 years, with margins declining 20-30 basis points.

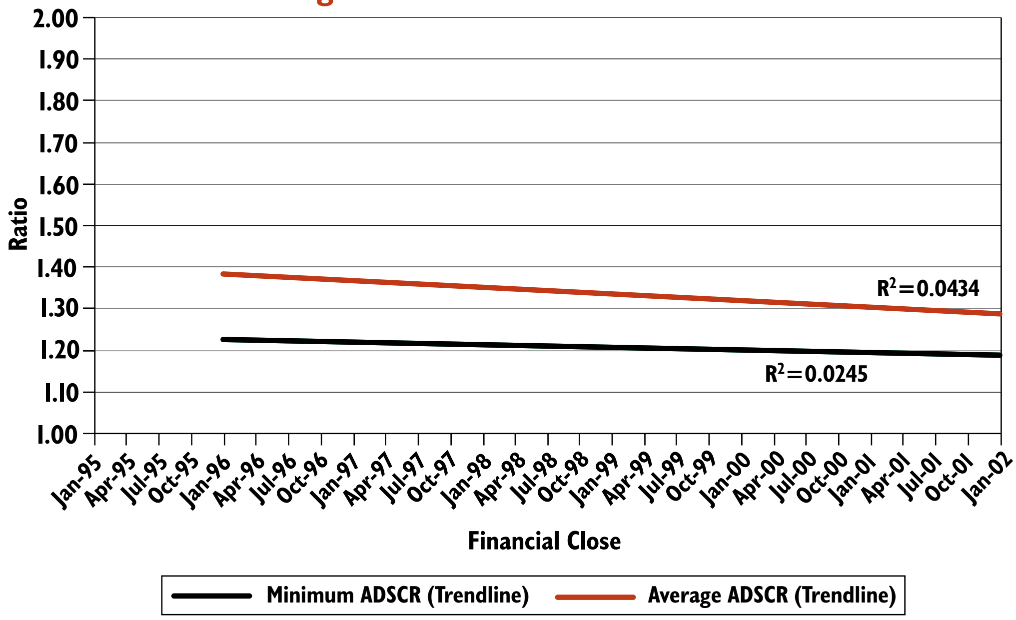
Chart C2: Debt Margin Analysis



Source: PricewaterhouseCoopers study, academic adviser Professor Julian Franks.

C7 This improvement has been accompanied by a fall in cover ratios from 1.40 to 1.25.

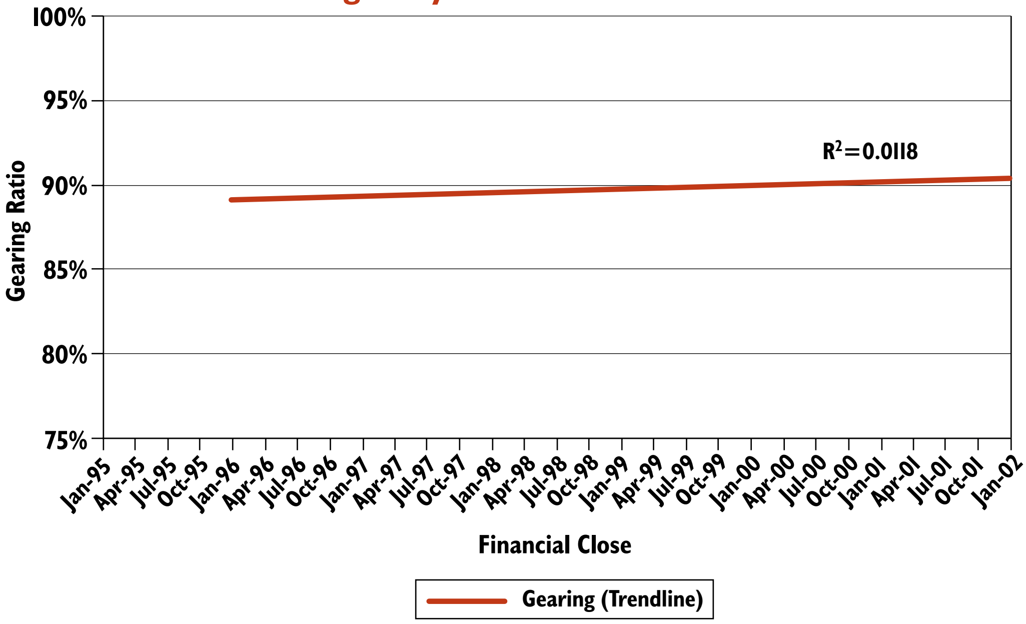
Chart C3: Average debt service cover ratio



Source: PricewaterhouseCoopers study, Academic adviser Professor Julian Franks.

C8 Gearing levels have also increased in part due to the banks' acceptance of lower cover ratios.

Chart C4: Gearing analysis



Source: PricewaterhouseCoopers study, Academic adviser Professor Julian Franks.

Cost of equity

C9 PwC, based on a small number of projects sampled, assess that the nominal equity return bid over the period of the study has declined from over 15 per cent to circa 13.5 per cent, with the average value across the sample analysed being 14.5 per cent per annum.

Core analysis

C10 The PwC study takes the returns that the private sector expected to make when bidding for the PFI contract as the key benchmark for its calculations. PwC focus on the nominal, post-tax, Project IRR as projected in the cashflow forecasts prepared by the private sector at financial close of the project. The Project IRRs compared with its calculation of the Weighted Average Cost of Capital (WACC) for each project.

C11 This WACC is calculated as the return that "should" be expected from a project by a diversified investor, taking account of the project's risk, calculated in accordance with the Capital Asset Pricing Model (CAPM) used in conventional corporate finance theory. Using CAPM, it is possible to derive an appropriate cost of equity for a project and, by adding the cost of debt for each individual project, produce a rate of return equivalent to the WACC. This approach is possible provided an appropriate benchmark is established for the type of project and risks taken by the equity investor. The study suggests that the most appropriate benchmark to use for the WACC is the regulated utility sector. Further assumptions used in the study are the risk free rate of return, being the long term government bond yield, and the equity market risk premium, which is assumed to be 5 per cent.

C12 There are certain aspects of the study which need to be carefully considered in interpreting its results as the future experience of investors may differ in practice from that posited in the report. The PwC study:

- looks at "ex ante" results. This is the rate of return bid by the private sector participants, not the returns actually received from their PFI projects. As yet, insufficient data is available to either private sector participants or observers on the returns actually achieved over 15-30 year contracts to estimate whether the rate of return bid is likely to be matched by the actual outturn;

- compares bid returns with a calculation of WACC using the CAPM, which uses various assumptions and benchmarks which may not prove an accurate benchmark for PFI's real risks; and

- uses the water and gas utilities sector as a benchmark, citing this as a comparable sector. This analysis of the relative riskiness of a PFI project to a regulated utility may not be shared by all private sector participants in the PFI market and may not be a true estimate of PFI's riskiness.

C13 The conclusions set out in the PwC study are set out in Box C2, but in summary, the PwC study calculates that taking account of various factors, the rate of return bid seems to be 1.7 per cent p.a. above what one would expect, given the benchmarks used. The report shows this conclusion can vary given small changes in some key assumptions, one being the effect of bid costs on bidders behaviour.

Box C2: Conclusions of PricewaterhouseCoopers study

- **"The average spread between the project IRR and benchmark WACCs has been some 2.4 per cent in total;**
- **on our assumptions about unsuccessful bid costs this reduces to between 1.1 per cent and 1.7 per cent - say 1.4 per cent. To the extent that the assumptions on bid costs are changed it affects conclusions on the allocation of the spread but not the total figure of 2.4 per cent;**
- **some 0.7 per cent of the spread is explained by swap costs;**
- **after considering other factors, we believe the other 0.7 per cent indicates excess projected returns to investors, and that this is due to structure issues that limit competition in the PFI market;**
- **bidders' target equity returns average 14.5 per cent over the period before adjustment for bid costs, whereas the cost of equity implied by a traditional WACC calculation is in the range 8.3 per cent - 9.4 per cent depending on the assumptions used;**
- **there is some evidence that spreads were increasing until 1998 but that since then this has reversed;**
- **changes in the general capital market environment – such as declining interest rates and margins – have been reflected in PFI financings to the benefit of the public sector; and**
- **we expect the trend towards reduced returns to continue. The effects of steps already taken to standardise processes and share market information have not yet been fully reflected in closed deals because of the length of the procurement process."**

C14 The PwC study identifies certain features of PFI which could give rise to such a spread:

- the risks of political intervention given the novel nature of this form of contract, the long term nature of the commitment and perception of political risk;
- corporate investors may use corporate hurdle rates, based on for their core business on pricing their investors, which in PwC's view will nearly always be higher than is appropriate for PFI projects;
- returns may be influenced by the requirements of debt funders and their cover ratio requirements;
- long periods of negotiation which result in financing terms being agreed early, but closed at a later date after financial markets have moved favourably.

Policy implications

C15 The PwC study represents a useful contribution to the debate about the costs of private sector finance. It points out the importance of taking account of risk in comprising public private finance costings, the reduction in the cost of private sector finance over time and a number of factors which may keep bid returns higher than ideal.

C16 However, it remains to be seen whether in practice the outturn returns achieved of PFI schemes match the rates of return bid at their inception. It will take time for more evidence to emerge before a judgement can be made about whether:

- the risks of PFI Special Purpose Vehicles (SPVs) match those of regulated utilities; and
- the actual returns achieved differ significantly from those bid.

Future actions **C17** There are, however, a number of important findings of the PwC study which suggest further evaluation:

- the costs of hedging interest rate risk may be high – see Chapter 9 for proposals to review this;
- the connection between bid costs and equity returns reinforces the need to improve the procurement costs of PFI; and
- the actual outturns of PFI schemes should be regularly assessed (see Chapter 8).