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Treasury Committee

Private Finance Initiative

Seventeenth Report of Session 2010–12

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The Treasury Committee

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Summary

Numerous reports have been done looking into the use and history of the Private Finance Initiative. We have not attempted to do a definitive study of PFI; instead we have aimed to provide a piece of work, relevant for likely early changes in policy, in timely fashion. We hope that this Report will aid the Treasury in the work they are doing to reform PFI, which they are expected to report on in the autumn.

Private finance has always been more expensive than government borrowing, but since the financial crisis the difference between the costs has widened significantly. The cost of capital for a typical PFI project is currently over 8%—double the long term government gilt rate of approximately 4%. The difference in finance costs means that PFI projects are significantly more expensive to fund over the life of a project. This represents a significant cost to taxpayers.

We have not seen clear evidence of savings and benefits in other areas of PFI projects which are sufficient to offset this significantly higher cost of finance. Evidence we studied suggests that the out-turn costs of construction and service provision are broadly similar between PFI and traditional procured projects, although in some areas PFI seems to perform more poorly. For example we heard that design innovation was worse in PFI projects and we have seen reports which found out that building quality was of a lower standard in PFI buildings. PFI is also inherently inflexible, especially for NHS projects. This is in large part due to the financing structure and its costly and complex procurement procedure.

There remain significant incentives to use PFI which are unrelated to value for money:

- The majority of PFI debt still does not appear in government debt or deficit figures;
- Government departments can use PFI to leverage up their budgets without using their allotted capital budget—the investment is additional and not budgeted for.

These incentives unrelated to value for money need to be removed. Stricter rules and guidelines governing the use of PFI must be introduced. In our view PFI is only likely to be suitable where the risks associated with future demand and usage of the asset can be efficiently transferred to the private sector. We recognise that this may, over time, sharply reduce the aggregate value of PFI projects but the higher cost of capital that remains will be easier to justify to the taxpayer. For reasons discussed in this Report the Government should be looking to use PFI as sparingly as possible until the VfM (Value for Money) and absolute cost problems associated with PFI at present have been addressed. Consideration should be given to using more direct capital investment—this will not directly affect the fiscal mandate as it is borrowing for investment, not for current spending.

1 Introduction

Overview of PFI

1. In November 1992 the then Chancellor of the Exchequer Norman Lamont made an announcement in the Autumn Statement about "ways to increase the scope for private financing of capital projects."[1] This was the beginning of what was to become known as the Private Finance Initiative (PFI), under which groups of private investors manage the design, build, finance and operation (DBFO) of public infrastructure. PFI was expanded under the Labour government, which came to power in 1997. The current coalition government, formed in May 2010, has confirmed that it remains committed to the Private Finance Initiative as a way of delivering investment in infrastructure.[2] In total, 61 new PFI projects were being procured as of March 2011, with a total estimated investment value of £7 billion.[3] This is additional to over £60 billion of capital investment (at 2010 prices) already committed by private investors under signed PFI contracts.[4]

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

3. The PFI is one form of procurement for the public sector. There are examples of public sector procurement projects which have performed both poorly and well. For the most part we have not focussed on specific cases as we believe that it can be misleading to focus on high profile and often complex procurements when trying to assess the costs and benefits of different approaches. A large body of reports and research has been completed on PFI and public sector procurement by the National Audit Office and others. As well as drawing on the evidence submitted to the Committee, where appropriate we have drawn on this research. In particular we have considered reports which include samples of projects rather than reports which examine just one high profile project. Where possible we have also looked to work which has compared procurement approaches. We hope that this Report can build on what has already been done by others. The Report is not an exhaustive examination of all the details of PFI and public procurement—we have instead aimed to

1 HC Deb, 12 November 1992, col 998

2 HM Treasury, Public Private Partnerships – Technical Update, 2010

3 HM Treasury, PFI projects in procurement, March 2011

4 Committee analysis of HM Treasury, PFI signed projects list, March 2011

produce a report in a timely fashion which can inform work already being done by the Treasury in examining the use of PFI.

4. In April 2011 the National Audit Office produced a report[5] which drew on the significant body of work they had done in the past on PFI. This report detailed some of the potential benefits and disadvantages that PFI could bring. A slightly adapted version of a table from the report is reproduced below:

Table 1: Theoretical benefits and disadvantages of PFI

Potential benefits include...	Potential disadvantages include...
Encouraging the allocation of risks to those most able to manage them, achieving overall cost efficiencies and greater certainty of success. The delivery of an asset which might be difficult to finance conventionally. Potential to do things that would be difficult using conventional routes. For example, encouraging the development of a new private sector industry. Delivery to time and price. The private sector is not paid until the asset has been delivered which encourages timely delivery. PFI construction contracts are fixed price contracts with financial consequences for contractors if delivered late. The banks providing finance conduct checking procedures, known as due diligence, before the contract is signed. This reduces the risk of problems post-contract. Encouraging ongoing maintenance by constructing assets with more efficient and transparent whole-life costs. Many conventionally funded projects fail to consider whole-life costs. Encouraging innovation and good design through the use of output specifications in design and construction, and increased productivity and quality in delivery. Incentivising performance by specifying service levels and applying penalties to contractors if they fail to deliver. Fewer contractual errors through use of standardised contracts.	Higher cost of finance which has increased since the credit crisis. The prospect of delivering the asset using private finance may discourage a challenging approach to evaluating whether this route is value for money. Reduced contract flexibility – the bank loans used to finance construction require a long payback period. This results in long service contracts which may be difficult to change. The public sector pays for the risk transfer inherent in private finance contracts but ultimate risk lies with the public sector. Private finance is inherently complicated which can add to timescales and reliance on advisers. High termination costs reflecting long service contracts. Increased commercial risks due to long contract period and the high monetary values of contracts.

Source: Adapted from NAO, Lessons from PFI and other projects, Figure 1

Other issues with respect to PFI of which the Committee was made aware include: reliance on often poor-quality procurement methods by public sector clients, over-complexity, over-specification, transfer of risk inappropriate to private sector and raised construction costs.

5 C&AG's report, *Lessons from PFI and other projects,* HC 920, 2010-11

Assessing the Value for Money of PFI

5. The benefits and disadvantages listed in Table 1 will each have differing impacts on the overall value for money of a project and some of them may not materialise. Some of the points listed in Table 1 (both positive and negative) may also apply to other forms of procurement. The key question to consider is whether or not the actual benefits unique to PFI outweigh the disadvantages unique to it.

6. **The use of PFI has the effect of increasing the cost of finance for public investments relative to what would be available to the government if it borrowed on its own account.** This disadvantage, unique to PFI, is the most easily identifiable and measurable. The additional cost has two main components: a higher transaction cost and a higher return to investors. A principle behind the PFI contractual model is that it allocates risk to the party that is best able to understand, control and minimise the cost of the risk. The cost saving potential of PFI can be seen to be directly linked to benefits derived from improved risk allocation. Where a firm bears a risk, it has an incentive to manage it and take steps to avoid any adverse impact from it. Better management of a risk may result in greater cost efficiency and in certain circumstances this may lead to a lower cost for the public sector. The case for PFI therefore rests on the model's ability to:

- allocate risks more effectively than conventional procurement; and
- ensure the public sector gains from the resulting savings (relating, for example, to tasks such as construction, maintenance and service provision).

7. Where such savings offset the model's higher financing costs, PFI may offer greater cost efficiency than conventional procurement (i.e. it will produce the required outputs at a lower cost to the public sector) or as the Office for Budget Responsibility explain in its recent *Fiscal sustainability report*: "As long as the higher cost of capital is offset by greater efficiencies elsewhere, such projects still offer value for money for the public sector."[6] Insofar as cost efficiency is the key policy objective, the future role of PFI should be determined by its proven capacity to deliver such savings and efficiencies. In gathering evidence we wanted to understand whether the PFI theory, or "theology"[7] as one witness put it, stood up to scrutiny. In particular was PFI being used because it provided better value for money, or were there other incentives at play which led to it being used?

Our inquiry

8. We are grateful to Richard Abadie, Steve Allen, James Barlow, Andy Friend, Dieter Helm, Anthony Rabin, James Wardlaw and Joanna Webber who gave evidence to the Committee. We are also grateful to all those who submitted written evidence.

6 Office for Budget Responsibility, *Fiscal sustainability report*, July 2011, p41, para 2.46

7 Q 4

9. We would like to thank Mark Hellowell, Lecturer at the University of Edinburgh, and John Willman, Editorial Consultant, for their expert advice with the Report.[8]

8 Relevant Interests of the Specialist Advisers are as follows: Mark Hellowell – no interests declared (recorded in Committee's formal minutes on 27 April 2011). John Willman has done editorial consultancy work for a number of clients including PwC, HM Treasury & CBI (recorded in Committee's formal minutes on 24 March 2011). The Committee's formal minutes and full details of all declared interests can be found on the Committee's website. http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/formal-minutes/

2 Accounting and budgetary incentives

Treatment of PFI debt in the National Accounts

10. One possible incentive for the use of PFI that we explored in our inquiry was the treatment of PFI debt on an organisation's balance-sheet and in the National Accounts. Evidence we received was in agreement that PFI should not be used for off-balance sheet[9] reasons. A joint submission from KPMG, John Laing and Lloyds Banking Group explained that:

> The decision as to whether to proceed with a PFI deal should be based on rigorous qualitative and quantitative value for money evaluation of all the procurement options available. Balance sheet treatment should not be a part of this evaluation.[10]

The CBI also agreed:

> PFIs should be on-balance sheet and the value delivered by a scheme in terms of certainty and risk reduction should not be skewed by its accounting treatment.[11]

This is and has been the position of the Treasury for many years:

> The decision to undertake PFI investment, once affordability has been confirmed, is taken on VfM [Value for Money] grounds alone. Whether the investment is on or off-balance sheet is a decision taken by independent auditors and is not relevant to the VfM of the procurement route.[12]

11. Although the official line has always been that PFI should not be used for accounting reasons, Andy Friend, who is the Chairman of InfraMed and was previously the Chief Executive of John Laing, told us that:

> There were clear examples earlier in the decade—many of the written submissions to you refer to that—where there was distortion in the structuring of deals in order to achieve a particular accounting treatment.

Although he added that "Hopefully, we are moving beyond the world in which the off balance sheet tail was wagging the value-for-money dog".[13] Richard Abadie of PricewaterhouseCoopers agreed that the classification of debt had driven behaviour.[14]

12. Professor Dieter Helm of Oxford University was more explicit. He said that PFI had succeeded as "an exercise to get investment off the public balance sheet so that the debt

9 Off balance sheet debt is debt that does not appear as a liability on the balance sheet of an organisation's financial accounts.

10 Ev w30 *[Note: references to 'Ev wXX' are references to written evidence published in the volume of additional written evidence published on the Committee's website]*

11 Ev w33

12 HM Treasury, Value for Money Assessment Guidance, November 2006, p10, para1.17

13 Q3

14 Q5

numbers look better than they otherwise would have done".[15] As part of our request for evidence we asked whether PFI would have been used as frequently had all PFI debt been on-balance sheet. Professor David Heald told us "The answer is categorically 'No' ".[16]

13. Professor David Heald explained in his evidence that the "accounting arbitrage ended with the adoption of International Financial Reporting Standards (IFRS) from 2009–10" with the "bringing of PFI on balance sheet to the public sector client" but there were still other issues which had not been resolved:

> The crucial point to note is that there are two separate types of accounting for government activity: that for financial reporting (now IFRS, as modified by the Treasury's Financial Reporting Manual and approved by the Financial Reporting Advisory Board) and National Accounts (ESA 95 being the governing regulation).

He explained that the "PFI financial reporting problem—arbitrage being rife—has now been resolved in the United Kingdom" although he did add that "alertness is required to ensure that PFI schemes are not modified to escape from the remit" of financial reporting standards. However in the terms of the National Accounts Professor Heald explained there was still a problem:

> [...] the satisfactory resolution in relation to financial reporting (almost all UK projects are rightly on-balance sheet) will not be matched by National Accounts treatment.

He pointed out that

> [...] the Treasury announced in June 2009 that Spending Review 2010 would be conducted on a National Accounts basis, exploiting the lax criteria in the Eurostat (2004) rules. All that is required to keep PFI projects off the National Accounts public sector balance sheet is the transfer of construction risk and availability risk to the private sector consortium.

He considered that this would create a new phase of project distortions with:

> (a) PFI being preferred to conventional procurement for 'accounting' rather than VFM reasons, and
>
> (b) PFI schemes that satisfy the Eurostat rules for off-balance sheet treatment being preferred to those which do not.[17]

Professor Ron Hodges also noted that the current fiscal environment would be likely to add to the allure of PFI:

15 Q 1

16 Ev w130

17 Ev w130

> In periods of austerity off-balance accounting may be particularly attractive to governments as a means of accessing finance without having to record the underlying obligations.[18]

The NAO also noted that the favourable treatment of PFI debt may encourage its use:

> There remains an incentive to use private finance over other procurement options, however, as the rules still exclude PFI from statistical calculations of Public Sector Net Debt.[19]

14. In 1997 the Labour government stated it would have two fiscal rules. These were summarised by the Institute for Fiscal Studies as:

> **The golden rule**: over the economic cycle, the government will borrow only to invest and not to fund current spending [...]
>
> **The sustainable investment rule**: over the economic cycle, the ratio of net public sector debt to GDP will be set at a 'stable and prudent' level, defined by the Chancellor as no more than 40% of GDP.[20]

The current coalition government also has fiscal rules, referred to by the Office for Budget Responsibility as the fiscal mandate and the supplementary target. The OBR explain them as follows:

> **Fiscal mandate**: "total public sector receipts need to exceed total public sector spending (minus spending on net investment) after adjusting for the temporary effect of any spare capacity in the economy."
>
> **Supplementary target**: "public sector net debt as a percentage of GDP to be falling at a fixed date of 2015–16" [21]

The current fiscal mandate should not incentivise the use of PFI or other additional or off-balance sheet financing methods instead of direct capital spending and similarly the golden rule of the previous government should not have encouraged the use of PFI. This is because both fiscal rules allow borrowing for investment. However the current supplementary target could provide an incentive to favour PFI or similar schemes rather than spending funded directly from government borrowing and the sustainable investment rule could have also had this effect in the past. This is because in the short term a PFI scheme would result in less government borrowing and therefore a lower level of Public Sector Net Debt. PFI projects which replace direct capital investment could be used in 2015–16 to ensure that the headline level of debt reduces so that the supplementary target is met. Similarly in the case of the previous sustainable investment rule if the net public

18 Ev w64

19 C&AG's report, *Lessons from PFI and other projects,* HC 920 2010-11, p20, para 2.17

20 Institute for Fiscal Studies, *The Government's Fiscal Rules*, April 2001 (updated November 2006), p2

21 Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2011, p154, para 5.5&5.6

debt level was approaching 40% of GDP one way of reducing it in the short term would have been to transfer more direct capital investment towards PFI schemes.

15. As well as fiscal rules at a national level there are also rules at the European level. The Maastricht Treaty obliges member states to avoid excessive budgetary deficits. In particular it set out that governments' annual deficit and debt should not exceed certain reference values.[22] These values were defined in the *Protocol on the Excessive Deficit Procedure* as:

> (a) 3% for the ratio of the planned or actual government deficit to gross domestic product at market prices;
>
> (b) 60% for the ratio of government debt to gross domestic product at market prices.[23]

These European fiscal rules make no distinction between borrowing for investment and borrowing for current spending. They therefore both incentivise the use of PFI or other methods of off balance sheet financing rather than direct capital spending funded through government borrowing. One of the written submissions to the Committee noted that "Greece, Spain, Portugal and Ireland have all in recent years been very active in PFI/PPP."[24] In 2005 for example Greece introduced a new 'PPP law' and two new government bodies were set up to encourage and expand the use of Public Private Partnerships.[25] The use of other off balance sheet financing methods deployed by governments to circumvent fiscal rules have been noted. The Financial Times reported that in 2002 Goldman Sachs had helped Greece raise off balance sheet finance "by arranging a massive swaps transaction aimed at reducing the cost of financing". The press report explained:

> Because it was treated as a currency trade rather than a loan, it helped Greece to meet European Union deficit limits while pushing repayments far into the future.[26]

The article added that other European Countries had used derivatives and methods such as securitisations to flatter their national accounts.

16. A recent report by the Office for Budget Responsibility notes that many PFI deals are not recognised in the National Accounts. They note that:

> As well as lacking transparency, this has fuelled a perception that PFI has been used as a way to hold down official estimates of public sector indebtedness for a given amount of overall capital spending, rather than to achieve value for money.[27]

The report details the scale of the problem noting that "at March 2010, PSND [Public Sector Net Debt] included about £5.1 billion (0.4 percent of GDP) in respect of PFI deals

22 Office for National Statistics, Statistical Bulletin: Government deficit and debt under the Maastricht Treaty, 31 March 2010, p4, para 1

23 Official Journal of the European Union, *Protocol on the Excessive Deficit Procedure*, Article 1,16 December 2004

24 Ev w18

25 DLA Piper, European PPP Report 2009, Country Section – Greece, p55-56

26 *Financial Times*, Athenian arrangers, 17 February 2010, p7

27 OBR, *Fiscal sustainability report*, July 2011, p41, para 2.47

that were recorded as on balance sheet in the National Accounts." However the OBR considered that "the total capital liability of on and off balance sheet PFI contracts was closer to £40 billion (2.9 per cent of GDP)."[28] They estimate therefore that if PFI contracts were all recognised as debt in the National Accounts this would increase the level of debt by around 2.5% of GDP.[29]

17. **The introduction of IFRS (International Financial Reporting Standards) in 2009–10 has resulted in nearly all PFI debt being included in the financial accounts of government departments for financial reporting purposes. However so long as certain risks are deemed to be passed to the private sector on a PFI project then the project is, by contrast, recorded off balance sheet for National Accounts and statistical purposes. As a result, most PFI debt is invisible to the calculation of Public Sector Net Debt (PSND) and is therefore not included in the headline debt and deficit statistics. If all current PFI liabilities were included in the National Accounts then the OBR estimates that national debt would increase by £35 billion (2.5% of GDP). Therefore there has been, and continues to be, at least a small incentive to use PFI in preference to other procurement options, as it results in lower headline government borrowing and debt figures in comparison to other forms of capital investment.**

18. **Efforts to meet fiscal rules at a national and European level may have contributed to the misuse of PFI. Rules designed to promote fiscal sustainability have had the paradoxical effect of incentivising the use of off-balance sheet finance—which is likely to prove less sustainable. Given the salience of the public debt statistics in the current political climate, the attractiveness of the PFI method for any government has been evident whether it provides value for money or not.**

Treatment of PFI capital expenditure in a Departmental budget

19. Just as the capital values of most PFIs are invisible to the national debt statistics, the capital expenditure that PFI delivers will similarly not impact on Departmental capital budgets. Depreciation charges to Departmental current budgets will also be avoided in such cases. The benefit of using PFI for capital investment which does not score in capital budgets is clear to organisations who use PFI. Kent Police noted that "capital sums do not have to be identified along with financing arrangements"[30] as the first point in their list of PFI strengths in a written submission to the Committee. A PFI deal will have a smaller (but much longer lasting) impact on the current budget of an organisation whereas a conventionally procured capital project will result in a significant one-off hit to the capital budget. In the short term the use of less of an organisation's budget will provide an incentive to use PFI rather than other forms of procurement.

20. As with the calculation of debt and deficit, the level of capital expenditure continues to be measured according to the ESA (European Standard Accounts) definition, and in most cases this means the capital expenditure incurred due to a PFI will not be included in

28 OBR, *Fiscal sustainability report*, July 2011, p42, para 2.50

29 OBR, *Fiscal sustainability report*, July 2011, p79, Box 3.3

30 Ev w57

capital budgets.[31] There is therefore a fundamental difference between the way many PFIs are scored in Departmental budgets or DELs (Departmental Expenditure Limits), compared to how they are measured in the financial accounts. For conventionally procured projects, the full investment cost of the project needs to be met from the budget when the asset is created. For projects which are off balance sheet (in National Accounts terms), unitary charges are met from the budget for the year in which they arise, and commitments against future budgets—often well beyond the period for which budgets have been set—are created, effectively constraining organisations' budgetary flexibility for many years, sometimes decades, to come. These long term commitments are not however recorded in budgets as liabilities to government.

21. Government departments and other public bodies will only plan their budgets a few years in advance—generally no longer than the period covered by the latest spending review— so will not be considering PFI payments 20 or 30 years in the future. For example, the latest Spending Review of October 2010 set Departmental budgets for the period up to and including 2014–15. From a budgetary perspective, over this period, a PFI will often seem more affordable than the alternative, although in the long term it could be much more costly. The lack of budgetary and financial control in PFI may lead to poor investment decisions being made. Andy Friend considered that this had happened in the past:

> At the programme level, I believe in certain situations it encouraged over-consumption and decisions to be too lightly taken in terms of procuring very substantial capital assets, perhaps without due consideration of either the alternatives—of which there are many, much less developed in the UK market than elsewhere—or the long term obligations.[32]

22. **If Departments or public bodies do not have a capital budget large enough to allow for desired capital investment, there is currently a substantial incentive to use PFIs which are not included within Departmental budgets (Departmental Expenditure Limits). A PFI deal will have a smaller (but much longer lasting) impact on the current budget of an organisation whereas a conventionally procured capital project will result in a significant one-off hit to the capital budget. In the long term, the PFI arrangement will build up big commitments against future years' current budgets that have not even yet been allocated or agreed. We are concerned that this may have encouraged, and may continue to encourage, poor investment decisions. PFI continues to allow organisations and government the possibility of procuring capital assets without due consideration for their long–term budgetary obligations.**

Removing the accounting and budgetary incentives of PFI

23. As detailed above there are incentives in play which could act to encourage the use of PFI for reasons other than value for money. **If PFI is to be pursued only if it provides**

31 This is because Treasury has determined that Departmental budgets will follow the ESA and National Accounts definitions of balance sheet rather than those used by IFRS and in Resource Accounts.

32 Q 4

value for money it is essential that any incentives unrelated to value for money are removed.

24. **We welcome the Office for Budget Responsibility's decision to include, in their *Fiscal sustainability report*, an assessment of the impact of the PFI liabilities which are currently not included in the National Accounts. We believe that the Office for Budget Responsibility should also include an assessment of such liabilities in its *Economic and fiscal outlook*, which assesses the Government's performance against the fiscal mandate and the supplementary target. We recommend that the Treasury clarify its view of the remit of the OBR to ensure that the OBR include PFI liabilities in all future assessments of the fiscal rules. This would help prevent the use of PFI to 'game' fiscal rules**.

25. **International Financial Reporting Standards (IFRS) require that most PFI projects be scored in an organisation's financial accounts. Capital investment related to PFI projects rarely, however, scores in individual government Departments' budgets (Departmental Expenditure Limits). This is because Departmental budgets follow the definitions used in the European Standards of Accounts (ESA), rather than those set out in IFRS. This is not only confusing, but also creates incentives to use PFIs, rather than direct capital investment by departments. We recommend that the Treasury should consider aligning the treatment of PFIs in Departmental budgets with the treatment in financial accounts. This should mean that most PFIs score within those budgets in the same way as direct capital expenditure. If this change were made it may also require an adjustment to Departmental capital budgets.**

3 Value for money

Cost and availability of finance

26. Private finance is invariably more expensive than direct government borrowing and therefore we explored the difference in the availability and cost of private and government debt in our evidence. Balfour Beatty told us in written evidence that the "financing costs of PFI are typically 3–4% over that of government debt."[33] All witnesses agreed that the differential between government debt and private project finance was significant and that it had increased since the financial crisis. James Wardlaw of Goldman Sachs told us "In terms of the cost of that finance, it is definitely higher [...] the levels were 60 [basis points][34] over swaps at the peak, and now we are talking 250 and more."[35] When we asked him whether or not the upward shift in the cost of capital was locked in for the foreseeable future Mr Wardlaw agreed, telling us "Yes, and also that the willingness of people to finance remains quite short".[36] Richard Abadie explained that the difference between government debt and private debt "will never come down [...] to the levels pre-credit crunch" adding "I do think we are in a world of more expensive debt".[37] Steve Allen of Transport to London also told us "there is a significant premium for the cost of finance through a PFI".[38]

27. A National Audit Office report of 2010 which examined financing PFI in the credit crisis "found that the part of the cost relating to loan margins on PFI deals, which had been 1 per cent or less, widened significantly to around 2.5 per cent on average" and that some "will rise to more than 3 per cent in stages over the project life". The NAO explained that this "resulted in substantial increases to the cost of finance".[39] As well as loan margins increasing the NAO report also showed that since the credit crisis arrangement fees, commitment fees and the 'swap credit spread' had all increased.[40] These extra fees, which were projected to be more than 3% of the total value of the debt drawn down, further increase the difference between the cost of government debt and private finance. The NAO report also noted that "PFI is less likely to be value for money unless there are substantial and credible savings to offset higher financing costs."[41]

28. Some of the reasons for the increased costs and lack of availability of finance were explained in the International Handbook on Public-Private Partnerships published in 2010:

33 Ev 33

34 A basis point is 0.01%(1/100th of one percent). For example 250 basis points is 2.5%

35 Q 9

36 Q 12

37 Q 14

38 Q 122

39 C&AG report, *Financing PFI projects in the credit crisis and the Treasury's response*, HC 287, 2010-11, p9, para 18

40 C&AG report, HC 287, 2010-11, p31, Appendix 2, Figure 31

41 C&AG report, HC 287, 2010-11, p12, para 30

> The global financial crisis has led to a significant increase in the cost of private finance—in particular the senior debt component. Commercial bond finance—hitherto the cheapest form of senior debt for PFI projects—has been unavailable since mid–2008,when many of the big US 'monoline' insurers such as Ambac and MBIA lost their 'triple–A' credit rating in the midst of the 'subprime' mortgage crisis. These institutions had played a key role in the provision of senior debt for large projects, by guaranteeing ('wrapping') repayments to bondholders in return for a fee and thereby reducing overall financing costs. The withdrawal of the monolines' ability to provide a triple–A guarantee has removed commercial bond financing as a low–cost option for the foreseeable future.
>
> At the same time, banking sector liquidity has reduced dramatically as the financial crisis has developed.

The paper also noted that "the size of the increase in margins [...] contains a substantial premium that is unrelated to default risk, and is associated with credit constraints and the oligopolistic nature of the senior debt market."[42]

As well as the increased cost of debt finance it is important not to forget that a PFI is also partly funded by equity. This means that the cost of capital (which includes a return for equity holders) is higher than just the cost of the private debt. The Weighted Average Cost of Capital for a conventional availability-based PFI project in the accommodation sector[43] is now in excess of 8.5%.[44] This compares to the current long term government gilt rate of just over 4%.[45]

Box 1: Private finance comparison with public finance – worked example

Analysis by Mark Hellowell – Specialist Adviser to the Committee

For a PFI to cost less than a conventional procurement, it must deliver savings in construction, maintenance and/or service provision that are, relative to the risk-adjusted costs of a conventionally procured alternative, sufficient to offset the higher financial cost.[46] Therefore, it is important to consider the scale of the difference in financial costs between public and private finance. Here, we examine this by looking at the cost projections relating to the Royal Liverpool and Broadgreen University Hospital NHS Trust's PFI project, which is currently in the procurement phase. These projections are contained in spreadsheets associated with the Trust's Outline Business Case, which was approved by successive governments in 2009 and 2010 respectively.

42 International Handbook on Public-Private Partnerships, Chapter 14: The UK's Private Finance Initiative: history, evaluation, prospects. Mark Hellowell, 2010, p326-328

43 An availability based project is of lower risk as the SPV only has to ensure that accommodation is available. If demand risk is also taken on by the SPV the cost of capital will be higher.

44 Source: Royal Liverpool and Broadgreen University Hospital Trust (2010), A New Health Service for Liverpool - World Class Hospitals, World Class Services, Volume 1 - Outline Business Case

45 Source: Debt Management Office – Long and ultra-long gilt yields were below 4.2% in May and June 2011.

46 In a PFI, the expected costs of project-specific risks are reflected in the expected costs of construction and operations projected by the SPV at the point of financial close (which increases the price charged for delivering these activities). In addition, an assessment of risks will add premia to the cost of debt (related to optimism bias) and the price of equity (related to non-diversifiable project and systematic risk). This raises the question of whether a corresponding adjustment should be made to the cost of government borrowing when considering the cost of finance under conventional procurement. In fact, an equivalent adjustment to the cost of public financing would be inappropriate, for two reasons. First, optimism bias is already accounted for in adjustments to expected costs of projects (as is discussed later in the report). Second, economic theory is clear that the public sector bears only a trivial degree of non-diversifiable or systematic risk, at least in terms of the costs of a project (as opposed to its expected benefits) (cf. Grout, P (1997), 'The economics of the private finance initiative.' Oxford Review of Economic Policy. Vol. 13 (4): 53-66 & Spackman, M (2001), Risk and the cost of risk in the comparison of public and private financing of public services. London: National Economic Research Associates.)

In the version of the spreadsheet used in this analysis, the project is assumed to involve initial capital expenditure of £244 million and the contract is expected to run for 34 years, including a four-year construction period and a 30-year management phase in which the private partner will deliver maintenance services. During the management phase, the Trust will pay to the private partner a periodic unitary charge. This provides the private partner with a revenue stream from which to meet operational costs (primarily maintenance and lifecycle costs, along with the costs of running an office and paying insurance), and financial costs (primarily the costs of making principal and interest payments to "senior" and "junior" debt providers and a return to the owners of equity). The cash-flow to all these investors is called the Project Cash-Flow, and this is the data source for this analysis.

This cash-flow takes the form of a series of expenditure cash-flows (relating to the four year construction period) followed by a series of revenue cash-flows (in which income from the public sector significantly exceeds the private sector's operational costs, thereby providing revenue for distribution to investors). The additional financial cost of PFI can be derived by discounting the stream of cash-flows at the relevant discount rate—which is here taken to be the "gross redemption yield" on government "gilts" of the approximately the same maturity as the PFI loans (i.e. 30 year gilts). The current yield is approximately 4.2%.

Discounting the Project Cash-Flow stream at 4.2% produces an NPV of £175 million. This figure represents the additional financial cost of using private, rather than public finance, to deliver that amount of capital expenditure. **If we assume that the outturn costs of construction, maintenance and services will be the same between the PFI and conventional procurement options, the government could have spent £175 million less, in NPV terms, by borrowing directly from the capital markets, rather than through an SPV intermediary.**

A different way to examine this is to discount the expenditure cash-flow and the revenue cash-flow separately at 4.2%, and then compare the present values of each. On this basis, the present value of the revenue cash-flow is £421 million and the present value of the expenditure cash-flow is £246 million, a ratio of 1.7/1. Had the financing been provided at the gilt rate, rather than at the private finance rate, the ratio would be 1/1.

There are two different ways of interpreting the results of this analysis. The first, as noted, is that the public sector is paying £175 million more than it needs to in order to secure the amount of capital expenditure required.47 This is the NPV of the higher cost of private finance—the cost that the PFI model needs to offset, in terms of efficiencies in construction, maintenance and/or services compared with conventional procurement, to represent a cost-efficient solution. An alternative way to view this is in terms of foregone opportunities for additional capital investment. **Assuming that PFI does not deliver efficiencies in construction, maintenance and/or services then, for the same present value of finance-related payments, the government could have secured 71% more investment by borrowing on its own account.**

Source data: Royal Liverpool and Broadgreen University Hospital Outline Business Case, 2010

47 The difference is financing cost is also reflected in rates of return. The gross redemption yield on 30-year government gilts has fluctuated between 4% and 4.2% over the last two years. In order to provide a conservative analysis, we use 4.2%. The equivalent rate of return projected on this PFI project is 8.6%.

Table 2: Summary of worked example – Financial cost of capital expenditure

	Cost – Present Value (@ 4.2% discount rate)
Private finance	£421 million
Government finance	£246 million
Savings and benefits PFI needs to deliver in other areas to offset the extra cost of private finance	**£175 million**
Potential increase in investment possible if using government financing, assuming no offsetting efficiencies from PFI (%)	71% increase
Potential saving from using government financing, assuming no offsetting efficiencies from PFI (%)	42% saving

Source: Committee Specialist Adviser analysis of RLBUH Business Case – see Box 1 for details

29. To understand better the cost difference between private finance and public finance over the life of a project we asked our Specialist Adviser to perform an analysis (Box 1 and Table 2). As the differential between the cost of government gilts and private sector debt has increased notably since the financial crisis we considered it was important to look at a contemporary example. The analysis undertaken used figures from a 2010 Outline Business Case for a new hospital and showed that there was significant extra cost of using private finance rather than public finance. The higher cost of capital for the PFI option compared to government gilts meant that, without any offsetting efficiencies, the cost of the PFI option would be 70% higher over the life of the project. One other way of looking at the difference in cost is to consider how long it takes government to pay off outstanding debt. If government borrowed directly and followed the same repayment schedule as the PFI charges the government debt could be fully repaid many years before the equivalent PFI liability could be paid off.

30. **Government has always been able to obtain cheaper funding than private providers of project finance, but the difference between direct government funding and the cost of this finance has increased significantly since the financial crisis. The substantial increase in private finance costs means that the PFI financing method is now extremely inefficient. Recent data suggests that the Weighted Average Cost of Capital of a PFI is double that of government gilts. PFI will only provide value for money if this differential in the cost of finance, which has significantly increased, is outweighed by savings and efficiencies during the life of a PFI project.**

31. Analysis undertaken by the Committee's Specialist Adviser suggest that, all else being equal, paying off a PFI debt of £1bn may cost the same as paying off government debt of £1.7bn. This would mean that a 70 percent increase in investment could be achieved for the same long term cost if government funding were used instead of private finance. An alternative way of expressing this is that the cost of paying off a PFI debt would be over 40 percent cheaper if government funding were used. **The current higher cost of finance means there may be a significant opportunity cost from using PFI.**

32. As part of our inquiry we considered if PFI had resulted in a better risk allocation and whether or not this allocation had resulted in savings and other benefits for the public sector which could offset the higher costs of financing. We consider these points in the following sections.

Risk allocation

33. We asked the witnesses if they believed that PFI had resulted in risk being transferred to the private sector efficiently. Professor Helm told us: "In terms of inefficiency, it is quite hard to think of many other aspects of the British economy that are more inefficient than that risk allocation."[48] Andy Friend explained that in the past "PFI theology said you would transfer any risk you could identify". He felt that this had led to inappropriate risks being transferred such as energy risk."How a private sector provider of a capital asset is in a better position to manage energy tariff risk than a public authority with its potential buying power, I don't know."[49] He also highlighted some other specific risks such as insurance and the management of derivatives that he considered could have been better managed by the public sector.

34. Witnesses did however point out that some risks such as construction risk had been transferred successfully. Richard Abadie told us:

> One of the clear benefits of contracting out to the private sector is the transfer of construction risk. Let them build it, let them give you a fixed price for it [...][50]

Andy Friend highlighted a number of examples where construction risk had been transferred, including one which he had direct experience of:

> I was Chief Executive of John Laing Plc when a project that had been entered into in 1998 went badly wrong, the National Physical Laboratory. We booked £68 million of losses on that.[51]

Mr Friend considered that other procurement methods "have involved much greater additional cost in terms of getting those projects operational" although he did concede that "there has been improvement in many of the mechanisms".[52] Mr Friend suggested that once the construction stage had been completed and the operational stage had started there was a case for allowing the public sector to refinance the debt.[53] This would allow the private sector to bear the risk during the construction phase but transfer the risk back to the public sector in the operational phase. The benefits of private finance projects transferring construction risk were made in other submissions to the Committee:

48 Q 3

49 Q 4

50 Q 14

51 Q 17

52 Q 17

53 Q 3

> Construction risk is transferred in PPP [Public Private Partnership] projects from the public sector to the private sector. Fixed price, date certain contracts are the norm with no facility to make new claims on the public sector purse if unforeseen difficulties arise.[54]

Other evidence however noted that PFI and PPP were not the only ways of ensuring that construction risk was transferred:

> The Treasury has acknowledged that on-time and on budget performance can be secured through conventional procurement, so long as the design and build services are procured through a fixed-price, "turn-key" [55] contract.[56]

35. In its written submission Balfour Beatty discussed risk transfer, telling us that "clients, often encouraged by their external advisory teams, are tempted to incrementally increase the risk transferred to the private sector". However it considered that often this was inappropriate, explaining that "these increases in risk transfer are not properly evaluated in terms of the potential impact on value for money". In particular, it pointed out that financial penalties that were used to transfer risk led to higher prices and a deterioration in value for money.

> The payment mechanism is the authorities' main commercial tool to incentivise performance against the expected standard. However, our experience is that over time, increasingly aggressive payment mechanism arrangements result in poor value-for-money as PFI operators build-in risk to avoid the consequences of disproportionate penalties.[57]

The infrastructure company also highlighted four areas where they considered it better value for money for the public sector to bear the risk. These were: insurance; energy; pensions; and demand risk. In terms of energy it believed:

> The public sector should resist the temptation to attempt to transfer risk on tariff which the private sector cannot manage any better than the public sector. Procurement of energy must be more effectively managed by the public sector, which can achieve significant economies of scale compared to the private sector.

It also provided detail about the limited circumstances where it believed demand risk should be transferred to the private sector:

> Except where the private sector is genuinely responsible for generating customers/users, the transfer of demand risk (eg traffic counters on highways projects) should be avoided. Demand risk tends to increase the cost of lending and

54 Ev w75

55 A turnkey construction contract is where the price is fixed at the time the contract is signed. As a result, the construction company is held responsible for exceeding the budget. Turnkey construction contracts reduce the risk to the buyer of the construction services and provide an incentive for the company to stay within budget.

56 Ev w34

57 Ev 35

> result in a sub-optimal project structure which leads to a reduction in value for money for the public sector.[58]

36. Professor David Heald explained in his submission that "it should not be an objective of PFI to transfer risk to the private sector but only to transfer those risks which the private sector is better equipped to handle". He also told us:

> Attempting to transfer inappropriate types of risk will instead lead to excess costs and to potential default, with the materialising costs falling on the public sector. This echoes an important lesson from outsourcing in the petroleum industry: if the responsibility—legal and reputational—remains with the 'principal', the loss of operational knowledge and control may offset the apparent cost savings. Especially in an institutionally fragmented public sector, it is difficult to be an intelligent client and to sustain that through a 30-year PFI.[59]

37. Transport for London had some insights regarding risk transfer. It explained that "risk can be fully transferred only if the procuring authority could abandon a failing PFI concession, which is unlikely ever to be the case", adding that "TfL's experience is that the general public have little appetite for a blame game—clearly to the extent TfL can control its own assets, it can control its performance." It added:

> TfL's view is that the private sector is willing to bear significant risk but only if it is paid enough. The question should be which party is best placed to manage each risk [...] where the private sector can manage risk better than the public sector, it should do so. However, this decision does not necessarily lead to using PFI—turnkey construction or maintenance contracts can be effective in risk transfer.[60]

38. **Allocating risk to the private sector is only worthwhile if it is better able to manage the risk and can pass on any subsequent savings to the client. The main benefit highlighted to us by PFI providers was the transfer of construction risk. However a PFI contract which lasts for 30 years is not necessary to transfer this risk. There are also other methods such as turnkey contracts which can be used for the same ends. We have seen evidence that PFI has not provided good value from risk transfer—in some cases inappropriate risks have been given to the private sector to manage. This has resulted in higher prices and has been inefficient.**

39. **Some of the claimed risk transfer may also be illusory—the government is ultimately accountable for the delivery of public services. Therefore it would not be able to allow a number of services provided under a PFI contract to cease for any length of time.**

58 Ev 35

59 Ev w132

60 Ev 39

Whole life cost and innovation

40. In PFI, the SPV is responsible for both the construction and operation of the asset, and the cost of both (along with the cost of finance) is included in a single price provided to the public authority. Supporters of PFI say that bundling in this way encourages up-front investments that will contribute to cost reduction over the asset's life cycle—i.e. spending more on construction might make sense if this will result in lower maintenance spending in the long term. The Treasury points out that this aspect of PFI distinguishes it from other forms of procurement:

> Unlike other forms of procurement, PFI projects benefit from whole-life costing over 30 years, involving both construction and service delivery [...][61]

However the NAO noted in a paper published in 2009 that there are other methods that can be used to ensure that whole-life costs are considered:

> Private finance is not, however, the only way to ring-fence maintenance funding or consider whole-life costs. The London Borough of Lewisham, for example, has established a sinking fund to ensure its non-PFI schools are maintained to the same standard as its PFI schools.[62]

The Treasury believes that, owing to the benefit of whole life costing, operating costs of PFI projects cannot be bettered by the services tendered as part of a non-PFI procurement or provided in-house. If they do cost less this will be done by "compromising the quality of service" with "sub-optimal investment".[63] They advise public bodies to adjust the PFI cost according to sector experience. This has resulted in the Department of Health recommending an assumption that annual 'life cycle costs' will be 15% cheaper for PFI deals for Trusts considering the different procurement options for a new build hospital.[64]

41. Many of the PFI contractors, investors and advisers that submitted evidence to the committee highlighted the consideration of 'whole life cost' as a major benefit of PFI. PricewaterhouseCoopers told us PFI resulted in "Focusing procurers on the whole-life cost and performance of infrastructure rather than making short term decisions based on short term budgets".[65] Canmore Partnership Ltd explained that "one of the main benefits of the PPP-type provision of public use infrastructure has been the whole-life integration of design, building, maintenance and life cycle costs." It went on to explain:

> This correctly incentivises developers to invest in quality facilities at the outset, thus also increasing the availability of those facilities. At the end of a typical PPP

61 HM Treasury, Meeting the Investment Challenge, p66, para 5.32

62 National Audit Office, *Private Finance Projects: A Paper for the Lords Economic Affairs Committee,* October 2009, p26, para 2.23

63 HM Treasury, Quantitative Assessment User Guide, March 2007, p25, para A90-92 & table A1.5

64 Treasury's Value for Money Assessment for PFI - Guidance for NHS build schemes, November 2008, Table B1, p30

65 Ev 26

concession the public sector will inherit assets which have been properly maintained.[66]

Barclays Infrastructure also pointed out that "PFI procurement encourages whole life costing, whereas traditional procurement focuses mainly on the initial construction costs."[67]

42. If bidders know they can achieve lower whole-life costs and the procurement process is sufficiently competitive, then this should result in lower prices for the public sector. If the benefits of whole life costing are working it would be reasonable to expect that building design would make use of innovations in order to provide higher quality buildings that will last longer in good condition. A previous Treasury Committee's report on PFI in 2000 made this very point and recommended that PFI projects should be monitored for "innovative approaches" that could be "transferred effectively to publicly-funded projects"[68]. Professor James Barlow has done research on innovative design in the health sector and we explored the issue of innovation with him. He was clear that PFI had hindered rather than encouraged design innovations: "I think the way risk was devolved and transferred has meant that it has made very difficult to stimulate any kind of innovative thinking about the design of the buildings".[69] We asked him how this compared to hospital building programmes of the past and he told us: "there was more design innovation in the 1960s and 1970s."[70] However he had not done research on the quality of the buildings and considered that PFI "should drive up quality".[71]

43. Although PFI theory states that the process should drive up building quality to keep long term costs down we received evidence which directly contradicted this. The Royal Institute of Architects told us that "the quality of the buildings delivered through PFI schemes remained poor in many cases". It explained that: "The poor quality of the buildings' design lead to a number of issues, such as rising maintenance costs over the lifetime of the building". One of the reasons it pointed to was "value-engineering by contractors", telling us that there was strong anecdotal evidence that contractors were withholding information from clients. This resulted in "essentially reducing the intended quality and cost of the project compared to that specified by the architect, to the detriment of the finished building, without the knowledge of an unaware client." The reason this was done was to "maintain the contractor's preferred levels of profitability".[72]

44. Where possible it is useful to compare PFI buildings to non-PFI buildings to see if benefits are being realised. The Audit Commission did a report on PFI schools in 2003. Although it found no difference between the construction costs of PFI and non-PFI

66 Ev w26

67 Ev w107

68 Treasury Committee, Fourth Report of Session 1999–2000, *The Private Finance Initiative*, HC 147, para 47

69 Q 93

70 Q 94

71 Q 94

72 Ev w20

schools[73] it did find that the quality of PFI schools was significantly worse than that of the traditionally funded schools. The average score given by the Building Research Establishment (BRE) for the PFI schools was lower than the non-PFI schools in all of the areas tested such as architectural design, user productivity and ownership costs. The report also noted: "The best examples of the type of innovation that can improve fitness for purpose and minimise running costs over a school's lifetime came in traditional schools".[74] In its inquiry on PFI of 2009–10, the Lords Committee on Economic Affairs received a written submission on design quality from academics at the University of Edinburgh:

> The NAO commissioned the Building Research Establishment to compare design quality between a group of PFI and a group of non-PFI hospitals. It found that there were "no meaningful differences" in build quality between the two groups. However, it also noted that the average age of the non-PFI hospitals was much older.[75]

There are also other comparisons that have been done between PFI and non-PFI hospitals. A recent Committee of Public Accounts report said that:

> One of the stated benefits of PFI is that it should ensure buildings are maintained to a high standard through the contracts' lives, yet 20% of Trusts were not satisfied with the maintenance service provided within their PFI contracts. In addition, unlike support services, the costs of maintenance cannot be revisited and are not subject to regular benchmarking.[76]

45. The National Audit Office's report *The performance and management of hospital PFI contracts* gave some examples of problems regarding the maintenance element of PFI contracts:

> King's College Hospital was dissatisfied with lift maintenance. Broken lifts meant patients often share lifts with visitors to get to operating theatre. This is an ongoing issue yet to be resolved.
>
> Hull and East Yorkshire experienced poor performance on some maintenance work. A high level of involvement from matrons has since ensured that clinical and maintenance services run smoothly together.[77]

The NAO report found when comparing PFI and non-PFI hospitals that there was no significant difference in the assessment of the environment and little difference in costs charged for services.[78]

46. **It is difficult to establish clear cut evidence in the area of whole life costing. In theory whole life costing should encourage the use of innovative designs in PFI to**

73 Audit Commission, *PFI in schools*, January 2003, para 22

74 Audit Commission, *PFI in schools*, January 2003, para 12&13 & Exhibit 2

75 Lords Select Committee on Economic Affairs, First report of Session 2009–10, Volume II – Evidence, Ev 135

76 Committee of Public Accounts, Fourteenth Report of Session 2010–11, *PFI in Housing and Hospitals*, HC 631, para 12

77 C&AG's report, *The performance and management of hospital PFI contracts*, HC 68, 2010-11, p23, para 2.12

78 C&AG's report, HC 68, 2010-11, Figure 7 & Figure 11

deliver buildings of better quality. These should in turn provide cost savings over the life of the building that can, to some extent, offset the higher financing costs inherent in a privately financed deal. The long term nature of a PFI contract should also incentivise providers to maintain buildings to a high quality thus reducing costs in later life. However we have not been provided with clear evidence to suggest that PFI performs better in this area. Indeed in the area of design innovation and building quality we have seen some evidence to suggest that PFI performs less well than traditionally procured buildings.

To 'time and budget'

47. We received a number of written submissions which presented one of the key benefits of PFI as being the method more likely to deliver to time and budget than conventional procurement methods. The CBI made this point in its written submission:

> [...] transferring financial risk to the private sector partner has contributed to improved performance during the construction phase, with a larger proportion of projects being delivered on time and within budget.[79]

So did PricewaterhouseCoopers:

> At the outset financiers perform detailed due diligence on assets, costs and contracts using technical advisors to ensure the project will be delivered on time and to budget.[80]

The NAO, in a report for the Lords Economic Affairs Committee, noted that: "Most private finance projects are built close to the agreed time, price and specification." However they noted that of their sample of PFI projects over 31% had been completed late and 35% had not been delivered for the contracted price. They explained that "using PFI is not a panacea for solving construction problems."[81]

48. Any improved performance in terms of time and budget is only an achievement if the benefit outweighs any extra cost involved. The BMA considered that there was a 'risk premium' which meant overall the benefit of being on time and budget was not good value:

> [...] research which found that hospital trusts were paying a 'risk premium'—conservatively estimated at 30% of the total construction costs—to ensure projects are running to time and budget. So while it is true that the private sector absorbs the cost of overruns etc, additional charges are written into the contracts to account for this.[82]

79 Ev w33

80 Ev 26

81 National Audit Office, *Private Finance Projects: A Paper for the Lords Economic Affairs Committee,* October 2009, p7 &p25, para 7 & para 2.18

82 Ev w11

A report published by the European Investment Bank estimated that the contracted price was 24% higher for PPP roads than conventionally procured roads. The authors considered that the difference was largely due to cost overruns in traditional procurement meaning that there was little difference in the overall out-turn cost of both methods.[83]

49. If the budget is already 20% higher in a PFI procurement then a budget overrun of less than 20% in a conventional procurement would mean it was still cheaper. It is therefore important to consider how much projects which do not meet their budget exceed it. A National Audit Office report which considered a group of public sector projects that went over budget in 2003 and 2004, reported that the average level of overspend was 4.1%.[84] Any improvement in delivery to time also needs to be seen in the context of the procurement process. Submissions to the Committee recognised that for PFI this process was complex and lengthy.[85] The UK Contractors group told us that "even now the procurement process for a new hospital project in the UK can take over two years before any construction work is undertaken."[86] The NAO reported in 2007 that on average the overall tendering process took over two years for schools and over three years for hospitals.[87] HM Treasury in its document *Meeting the Investment Challenge* recognised this as an issue: "Procuring through PFI can be complex and can involve lengthy negotiations before contracts are signed." It added "Long lead times are a result of a number of factors, some common to all procurement, and some associated with PFI".[88]

50. There are also other reasons why to focus on the baseline of 'time and budget' may be misleading. The price of construction in conventional procurement is agreed at a stage of project development that is equivalent to a much less advanced stage than in a PFI. The risk control mechanisms built into the PFI model are factored into the price before contracts are signed. It is known that contract costs can increase during the preferred bidder stage of procurement, an exclusive stage of bidding in which competitive tension is absent and the public authority is in a weak negotiating position.[89]

51. **The fixed nature of PFI contracts means they are likely to provide more certainty regarding price and time. However there is no convincing evidence to suggest that PFI projects are delivered more quickly and at a lower out-turn cost than projects using conventional procurement methods. On the contrary, the lengthy procurement process makes it likely that a PFI building will take longer to deliver, if the length of the whole process is considered. Proposing that post-contractual price certainty can be taken as a good measure of overall cost efficiency is to use a comparison already likely to favour PFI. This is because the PFI contract price is set at a much more advanced stage in the process. It is evident that a project delivered "to time and to budget" (in post-**

83 European Investment Bank, Economic and Financial Report 2006/01, Ex Ante Construction Costs in the European Road Sector: A Comparison of Public-Private Partnerships and Traditional Public Procurement, 2006, p2

84 C&AG's report, *Improving Public Services through Better Construction*, HC 364, 2004-05, p38, para 2.7

85 Ev 32, w53, w70, w101

86 Ev w68

87 C&AG's report, *Improving the PFI tendering process*, HC 149, 2006-07, p4, para 4b

88 HM Treasury, *Meeting the Investment Challenge*, July 2003, p 49-50, para 4.18& 4.20

89 C&AG's report, *Improving the PFI tendering process*, HC 149, 2006-07, p16, para 3.4

contractual terms) may nonetheless represent poor value for money if the price paid for the risk transfer was too high.

Flexibility

52. One issue that was prominent in both the written evidence we read and from our witnesses was the inherent inflexibility of PFI. Transport for London were clear that its "experience is that PFIs are the least flexible form of contract". It told us that PFI bound "both client and contractor to a series of outputs that have diminishing desirability and/or affordability, with much less scope to negotiate change than under other forms of contract". However this inflexibility did have both pros and cons: "This can be a strength—as client changes are often a significant cause of cost overruns—but is also a major constraint."[90] Steve Allen, the Managing Director—Finance at TfL told us that PFI was "therefore only suitable for procurements where you don't need to change what it is you require over the life of the contract". Mr Allen explained that the financing of a PFI made any changes much more difficult:

> The involvement of the finance in the PFI makes it more inflexible, because it is not just a question of negotiating with the contract who built the asset. Particularly if the change is going to require some significant amount of funding, they are going to negotiate with the equity investors and with the debt holders as well.[91]

Professor Helm agreed that the structure of a PFI made it more inflexible. He told us that a PFI acted to "bundle the finance and fossilise the contract and put in the inflexibility that costs us so much both in terms of the efficiency of the project and in terms of the cost of capital".[92] Barclays Infrastructure also noted that the financial structure was a reason for inflexibility:

> These problems are accentuated by the capital structure used in most PFI transactions, where leverage is ≥ 90% and hence all variations require multi-party involvement and consent. Such leverage results in a low cost of capital but is restrictive to future change as there is little incentive on lenders (who are the dominant capital providers) to facilitate change.[93]

53. Anthony Rabin, the Deputy Chief Executive of Balfour Beatty, told us that the best way to allow for future changes in requirements "would be to have that discussion at the start of the contract to allow the public sector sufficient flexibility".[94] However Mr Allen told us that although some flexibility could be built into a contract there would always be limitations particularly as some issues would only emerge once the work had started:

90 Ev 37

91 Q 125

92 Q 48

93 Ev w107

94 Q 100

> You can build certain amounts of flexibility into the contract that you let if you can foresee what flexibilities you need, but there will always be limits around that, and it will affect the appetite of people to bid and the price that they will bid for that.

He explained that in some cases the only way to resolve problems was to bring a PFI back in house:

> [...] if I go back to the Croydon [Tramlink] example, essentially what we had to do was buy the SPV from the shareholders because there wasn't the flexibility to renegotiate the terms of the contract.[95]

He emphasised that it was the ability of TfL to borrow directly that gave them the flexibility to opt out of the inflexible PFI contracts:

> [...] having the ability to borrow ourselves [...] gives us some flexibility in renegotiating existing contracts in that we can buy the debt back and refinance it on our own terms, and we have had examples of that.[96]

54. We explored the effect of the inflexibility in PFI projects in some detail particularly with regard to the health sector. Professor James Barlow told us "I think one problem is that we have large, highly-specified buildings that are inflexible". He went onto explain that "my concern really is about the inflexibility of these buildings and the impossibility of, over a 30 or 40-year period, predicting what the demand is going to be like for the bed spaces in those buildings". He believed that the "way risk was devolved and transferred" in a PFI meant it was "very difficult to stimulate [...] any real sort of attempt to think about future flexibility".[97] Jo Webber of the NHS Confederation expressed similar concerns about being fixed into long term contracts:

> [...] the most recent sort of direction of travel for care is to have it much closer to home, much more around people in their own communities. It is very difficult to change a very high-value environment like a ward environment into something that is affordable.[98]

55. The British Medical Association considered that the fixed nature of the unitary payments agreed in PFI contracts would mean that efficiency savings would be more difficult to achieve. "The NHS is being tasked to find efficiency savings of £20 billion by 2014-15". It went onto explain:

> [...] at the same time (during the next spending review period from 2011 to 2014) repayments for NHS PFI projects will reach £4.18 billion, an increase of almost £1 billion from current levels. As a legal contract PFI removes discretion in capital

95 Q 118

96 Q 118

97 Q 78

98 Q 77

spending and it is likely that hospitals will be forced to make cuts to health care services to make their ongoing PFI repayments.[99]

Jo Webber told us that meeting PFI payments in the light of other pressures meant that "there will be a big affordability challenge over a long period"[100] adding that it "will become more of a challenge for people over the next few years".[101]

56. **PFI contracts are inherently inflexible. Specifications for a 30 year contract must be agreed in detail at the start of a project. The PFI financing structure also requires negotiation with the equity and debt holders before any substantial changes are made during the life of a contract. Debt and equity holders have little to gain from changing profitable contracts so will be unlikely to agree to changes unless they significantly enhance profitability. We have received little evidence of the benefits of these arrangements, but much evidence about the drawbacks, especially for NHS projects. The inflexibility of PFI means that any emergent problems or new demands on an asset cannot be efficiently resolved. In the case of Transport for London its only option was to buy out the SPV, but most PFI procurers cannot afford to do this.**

PFI and competition

57. If there is healthy competition in the PFI market this should drive down costs and result in better value for taxpayers. We received written submissions that pointed to a lack of competition in PFI. The Royal Institute of British Architects explained that competition was reduced as many architects were unable to bid for work "due to the limited entry routes to the market—the lack of design frameworks, or open competitions". It also pointed out that "the fact that contractors are required to have a design team on-board before bidding for the work, meaning they frequently use their own in-house design teams and a small number of practices that they have worked with previously."[102] Martin Blaiklock considered that one of the disadvantages of PFI was that it "reduces competition: high costs and complexity means only major companies can afford to bid for such concessions"[103]. However Dr James Robertson noted that one of the potential benefits of PFI was that it "may open up domestic markets to overseas competition".[104]

58. One of the issues we explored with witnesses was the procurement process and cost and whether or not this affected competition. Mr Rabin agreed that "relative to other forms of procurement it probably is expensive. It is more complex; there is a whole machinery about PFI that you need to get right, otherwise it doesn't work"[105]. Regarding the competitiveness of the market he added "I would perceive from our side of the table that there is a

99 Ev W9

100 Q 80

101 Q 81

102 Ev w21

103 Ev w16

104 Ev w101

105 Q 90

reasonable amount of competition".[106] When we asked Mr Rabin about how many new school PFIs Balfour Beatty had bid for he replied: "I would guess that one in three possibly we would have bid for, something like that."[107] When we challenged him about the fact that in some areas his company had been the only serious bidder, he told us: "That is not something we were aware of at the time".[108]

59. If costs are too high to bid this will act as a barrier to entry in the PFI market. Mr Friend concurred with the view expressed in a written submission that failed bids cost approximately £2m per school and £12m per hospital.[109] Mr Friend told us "We at Laing thought we were doing well if we won 40% of what we were shortlisted for. So, you are writing off those".[110]

60. In 2007 the National Audit Office noted that "there is evidence that PFI projects are receiving fewer developed bids than previously". A third of the PFI projects they surveyed (between April 2004 and May 2006) had attracted only two detailed bids. In the same period only 20% of the PFI projects received four or more bids—this compared unfavourably to an earlier survey (2003 and before) which showed that 50% of the projects received four or more bids.[111] It noted that the reason for fewer competing bids was "in part due to the cumulative impact of lengthy tendering periods and high bid costs". For example the overall tendering period lasted on average 34 months.[112]

61. **The nature of PFI means that competition is likely to be less intense compared to other forms of procurement. We believe the barriers to entry to be too high, resulting in an uncompetitive market. The long, complex and costly procurement process limits the appetite for consortia to bid for projects and also means that only companies who can afford to lose millions of pounds in failed bids can be involved. The fact that consortia are formed to bid for projects also limits choice and competition. For example an architects' firm may have the best design or there may be one contractor that has produced the best proposal, but unless these designs and proposals are part of the chosen consortium's bid they will not be used. The long term nature and inherent complexity of the contracts also make comparison more difficult for clients, further undermining competitive pressure.**

Assessment bias

62. All PFI projects have to complete a Value for Money (VfM) assessment of the PFI option compared to an conventional procurement option with funding provided by central government known as the PSC (Public Sector Comparator). The recent decision to use a PFI to redevelop the Royal Liverpool and Broadgreen University Hospital is a helpful

106 Q 91

107 Q 95

108 Q 97

109 Q 19, Ev w22

110 Q 19

111 C&AG's report, Improving the PFI tendering process, HC 149, 2006-07, p12, Figure 4

112 C&AG's report, HC 149, 2006-07, p5, para 4a& 4b

example by which to consider the value for money case for PFI. The Outline Business Case shows that the 'VfM assessment' calculated that PFI could provide a value for money benefit of 0.03% compared to conventional procurement.[113] We are surprised about the supposed precision of this comparison given the inherent uncertainty in any long term investment decisions, and we are also concerned about some of the assumptions behind the VfM assessment. Many of these assumptions act to make the choice of PFI more likely—see Box 2 for details.

Box 2: Examples of assumptions in the 'VfM assessment' which made the choice of PFI more likely (Royal Liverpool and Broadgreen Hospital: Outline Business Case)

The Internal Rate of Return: The assessment tested the VFM case for investors who needed a IRR of between 13% and 15%. It was assumed that investors would only demand 13%—the lowest rate of return, which has rarely been achieved in similar projects. At the 14% and 15% level the PFI route was assessed as poor value for money.

The discount rate: "In accordance with Treasury guidance, a real discount rate of 3.5% has been used for the first 30 years of the project"114—this is much higher than the real rate on 30 year index linked gilts which is currently less than 1%.[115]

Whole life costs: Life cycle costs were adjusted down by 15% for the PFI option.[116]

Optimism bias: There is an assumption that the costing of the conventional procurement route will always be over optimistic. This resulted in an upward revision of the PSC option of 19% for the capital expenditure and of 15% for the operational expenditure.[117]

Tax: "An adjustment of 6% has been made" to increase the PSC option – to take corporation tax receipts from the PFI option into account. This adjustment suggests that approximately a quarter of all revenues paid to the PFI provider will be profits subject to corporation tax at the full rate.

Risk transfer: "The discounted value of transferred risk is assessed at 9.78%". This adjustment for 'risk transfer' acts to reduce the PFI cost.[118]

Transaction costs: The same value for transaction costs are used for both the PFI and PSC option. This goes against both the evidence we have taken119 and the Treasury guidance which recognises that a PFI procurement involves "significant transaction costs"[120] which are greater than those of a PSC procurement.

Third party income: The trust estimates that income of £50,000 will be generated under the PFI option but not under the PSC option.[121] If this income had not materialised under the PFI option, the option would not have been assessed as best value.

113 Royal Liverpool and Broadgreen University Hospital Trust (2010), A New Health Service for Liverpool - World Class Hospitals, World Class Services, Volume 1 - Outline Business Case, p 202, para 12.3.18 - 12.3.19

114 RLBUHT (2010), A New Health Service for Liverpool, Volume 1 - OBC, p 147, para 9.26

115 UK Debt Management Office: Press notice, Result of the sale by auction of £1,000 million of 0 5/8% index linked Treasury Gilt 2040, 7 June 2011.

116 RLBUHT (2010), A New Health Service for Liverpool, Volume 1 – OBC, p 200, para 12.3.5

117 RLBUHT (2010), A New Health Service for Liverpool, Volume 2 – OBC, Appendix K1, Input Summary, p391

118 RLBUHT (2010), A New Health Service for Liverpool, Volume 1 – OBC , p 202, para 12.3.15

119 Q 90

120 HM Treasury, Value for Money Assessment Guidance, November 2006, p25, Table 3.1

121 RLBUHT (2010), A New Health Service for Liverpool, Volume 1 – OBC , Appendix K1, Input and Assumptions, p390

63. The vast majority of the costs of this PFI project are related to the capital expenditure and its financing. Analysis (see Box 1 & Table 2) of the financing costs shows that the costs of financing the building of the new hospital were significantly higher (71%) than if the same finance had been raised by the government. It is therefore clear that the discounting of cash flows and other adjustments were significant as they resulted in the PFI option being assessed as better value. Coincidently, around the same time the go-ahead was given for this PFI hospital, a plan from the North Tees and Hartlepool Trust for a publicly funded[122] hospital was cancelled. The publicly funded plan had been originally chosen as it was judged as providing best value for money. Since the cancellation the trust have produced another VfM assessment which indicates that PFI is now best value for money and so it is now the "preferred option".[123]

64. We received submissions about the VfM assessment system. Martin Blaiklock noted in his submission that in 2003 government had reduced the discount rate. Reducing the discount rate meant that PFI projects would be less likely to be assessed as value for money compared to a public sector comparator. He explained:

> To counterbalance this abrupt change, HM Treasury introduced the concept of 'Optimism Bias' to reflect, as they thought, the inherent under-estimation of costs that Government departments had demonstrated over past decades.

He went onto point out "no other government has formalised the over-runs into an 'across the board' regulation as has the UK through the application of Optimism Bias".[124] A written submission from Greg Dropkin and Sam Semoff also raised similar issues:

> "Optimism Bias" is applied to conventional procurement but not to PFI, giving an inbuilt advantage to PFI in the comparison. Yet the Treasury has acknowledged that on-time and on-budget performance can be secured through conventional procurement, so long as the design and build services are procured through a fixed-price, "turn-key" contract.[125]

We received a written submission from JP Heawood, a resident of York, who provided an account of how a York Schools PFI project had come to be approved:

> In the York Schools PFI Project, the executive summary of the Outline Business Case (OBC) gave the PFI cost as £11.1 million, with the projected Public Sector Comparator (PSC) better value at £10.3 million. But of course a bid with those figures wouldn't get public funding [...]
>
> So, as was customary, an "estimated risk" figure of £1.4 million was added to the PSC, which made PFI look better value; York's bid was then accepted [...][126]

122 The debt, which typically is around 90% of the financing, was due to be financed by government with the equity supplied by the private sector.

123 Ev w113

124 Ev w16

125 Ev w44

126 Ev w51

This account was consistent with an Audit Commission report on PFI schools. 9 of the 11 PFI schools that the report considered had relied on a risk adjustment to show they were better value for money than the PSC. It also explained that "where the PSC estimate of construction and running costs was much below the PFI cost, the cost of risk transfer added on was on average higher".[127]

65. **We are concerned that the VfM appraisal system is biased to favour PFI. Assuming that there will always be significant cost over-runs within the non-PFI option is one example of this bias. There is an incentive for both HM Treasury and public bodies to present PFI as the best value for money option as it is often the only avenue for investment in the face of limited departmental capital budgets.**

PFI—Value for Money?

66. HM Treasury has consistently said that PFI should only be used if it is the best value for money route of procurement.[128] We are concerned however that if public sector organisations do not have alternatives to PFI to complete capital projects there is a danger that they will use PFI even if it is not value for money. The British Medical Association felt that this had been the case in the NHS:

> In theory, projects are value tested against what the project would cost under public finance. If this process concludes that private finance does not represent value for money, a public procurement method is supposed to be chosen. In a context where PFI is the only funding available and many NHS hospitals are in need of capital works, managers have faced 'perverse' incentives to 'manipulate' their assessments and subsequently we have seen a proliferation of PFI projects.[129]

One of our submissions quoted the leader of Liverpool City Council being interviewed on BBC radio in November 2010 about the recently approved Outline Business Case for redevelopment of the Royal Liverpool and Broadgreen University Hospitals. He explained in the interview: "I know it doesn't provide Value for Money now or in the future, but its the only game in town".[130] Professor Ron Hodges shared a similar concern: "PFI was seen as the only likely route to obtain funding [...] its result was to promote a view that managers needed to support the PFI route if a project was to be completed".[131]

67. The lack of alternatives to PFI was pointed out in many pieces of evidence. Andy Friend said that his own observations when involved in the market in the past concurred with a "repeated phrase in the evidence before you: it was the only game in town, therefore we went for it".[132] The Foundation Trust Network told us "there should be other alternatives" and that "historically there has been insufficient support for capital

127 Audit Commission, PFI in schools, January 2003, para 57 & Figure 8

128 HM Treasury, Value for Money Assessment Guidance, November 2006, p10, para1.17

129 Ev w11

130 Ev w44

131 Ev w65

132 Q 4

investment and maintenance".[133] The British Medical Association made the point that "governments' preference for PFI means it has been viewed as 'the only game in town' for the last decade".[134] The NHS Confederation also told us in their written evidence that "it is important the debate acknowledges that without PFI there would have been few alternative sources of capital funding for large projects".[135] Jo Webber from the Confederation told us that "101 of the 135 new NHS hospitals have been through PFI between 1997 and 2009".[136] A recent Committee of Public Accounts report also noted that "In many cases local authorities and Trusts chose the PFI route because the Departments offered no realistic funding alternative."[137]

68. The most straightforward alternative to the use of PFI is capital spending direct from a capital budget. The annual budget allocated to every government department and public body is split out between the current (resource) budget and the capital budget. If a Department does not have a capital budget to meet its investment needs the only alternative is to turn to some form of private financing and use the current budget to meet the annual payments. This issue is likely to become more acute in the coming years as the capital budgets of Departments are cut significantly whereas current budgets are reduced to a lesser extent. The October 2010 Spending Review detailed cuts of 29% in real terms to the total capital budgets of departments, compared to a 8.3% cut to their current spending over the same 5 year period.[138]

69. **For too long PFI has been the 'only game in town' in some sectors which have not been provided with adequate capital budgets for their investment needs. This problem is likely to get worse in the future with capital budgets cut significantly at the Spending Review. If PFI is the only option for necessary capital expenditure then it will be used even if it is not value for money. A much–needed reappraisal of PFI needs to be accompanied by a similar reassessment of its effects on overall capital spending in the public sector.**

70. We received evidence from one organisation that did have access to alternative forms of finance—Transport for London. It explained that this "focuses the decision on Value for Money (VfM) rather than being skewed by a desire to access either 'free money' or guarantees of long-term funding to support the PFI payments". It said regarding the East London Line Extension "TfL, on inheriting the project from the Strategic Rail Authority, switched it from being financed privately to being financed by TfL."[139] Steve Allen from TfL explained: "most of the PFI contracts that we have were let, there was no alternative source of finance for the sort of predecessor entities, so there was no valid comparison". However now TfL "have the ability to borrow directly, we do have that comparator, and so

133 Ev w86

134 Ev w11

135 Ev 30

136 Q 111

137 Committee of Public Accounts, *PFI in Housing and Hospitals*, HC 631, 2010-11, para 1

138 HM Treasury, Spending Review 2010, 22 October 2010, p10-11, Table 1&2

139 Ev 37

you can, in a very real sense, assess the value for money of the PFI solution."[140] Mr Allen told us that although TfL's "cost of borrowing is probably something to the order of between 0.5% and 1% above gilt rates" it was lower than the additional cost of financing from PFI.[141] He concluded "I think it is hard to say that if you look across all the projects, overall PFI is value for money against that additional cost of finance."[142]

71. **The price of finance is significantly higher with a PFI. The financial cost of repaying the capital investment of PFI investors is therefore considerably greater than the equivalent repayment of direct government investment. We have not seen evidence to suggest that this inefficient method of financing has been offset by the perceived benefits of PFI from increased risk transfer. On the contrary there is evidence of the opposite. Organisations which have the option of other funding routes have increasingly opted against using PFI and have even brought PFIs back in-house. TfL's cost of borrowing is higher than government's, and yet it still considers this is overall better value for money than PFI. The incentive for government departments to use PFI to leverage up their budgets, and to some extent for the Treasury to use PFI to conceal debt, has resulted in neglecting the long term value for money implications. We do not believe that PFI can be relied upon to provide good value for money without substantial reform.**

140 Q 121

141 Q 122

142 Q 123

4 Future investment

Rules and principles for the use of private finance

72. As mentioned in the previous section of the Report all PFI projects have to undergo a VfM assessment. In a paper for the Lords Economic Affairs Committee the NAO made the following comments about this:

> [...] like any financial model, they [the VfM assessment] cannot be relied upon as a sole source of assurance. They are susceptible to manipulation and we often find problems with their implementation.[143]

We consider some of the possible changes to the current VfM assessment later in the report. **Any financial model, such as the current VfM assessment, can be subject to manipulation so it should never be used alone as a pass or fail test for the use of PFI.**

73. In the 1980s the use of private or additional finance was governed by what were known as the 'Ryrie Rules'. These required that private finance could only be used if:

- there were no favourable risk terms, such as a government guarantee;
- projects yielded benefits in terms of improved efficiency and profit commensurate with the cost of raising risk capital; and
- that use of private finance could not be additional to public finance. In other words, public expenditure would be reduced, pound for pound, in consequence of the use of private finance. [144]

David Heald and Alisdair McLeod went onto explain in their paper on the Ryrie rules that

> The rationale for this provision was that there is little macroeconomic difference between the government borrowing on the market to finance public expenditure generally and the private sector borrowing for essentially public projects. The objective of the Ryrie Rules was to stop ministers from insulating private finance from risk so that it could be used to circumvent public expenditure constraints. [145]

74. The Private Finance Initiative was a departure from the Ryrie rules as it allowed private finance which would be additional to public finance. In 1992 the then Chancellor, Norman Lamont, said in his Autumn Statement:

> [...] we will allow greater use of leasing where it offers good value for money. As long as it can be shown that the risk stays with the private sector, public organisations will

143 National Audit Office, *Private Finance Projects: A Paper for the Lords Economic Affairs Committee,* October 2009, p48, para 4.10

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

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

> be able to enter into operating lease agreements, with only the lease payments counting as expenditure and without their capital budgets being cut.[146]

The importance of risk transfer and value for money were evident as PFI started. In a speech to the CBI Conference on 8 November 1994[147] the then Chancellor Kenneth Clarke emphasised that the guiding principles of PFI were that:

- the private sector must genuinely assume risk without the guarantee by the taxpayer against loss; and
- value for money must be demonstrated for any expenditure by the public sector.

75. As the use of PFI has progressed there has been more detail on the approach in regard to risk transfer. In 1995 HM Treasury noted that "risk should be allocated to whoever is best able to manage it"[148]. This approach is detailed in HM Treasury's document *Meeting the Investment Challenge:*

> 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.
>
> 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.[149]

76. **Evidence we have seen suggests that the high cost of finance in PFI has not been offset by operational efficiencies. Much more robust criteria governing the use of PFI are needed. These should take precedence over the current VfM assessment. If and only if a project is deemed to pass these criteria should the option of private finance be considered. In our view PFI is only likely to be suitable where the risks associated with future demand and usage of the asset can be efficiently transferred to the private sector. We recognise that this may over time sharply reduce the aggregate value of remaining PFI projects but the higher cost of capital that remains will be easier to justify to the taxpayer.**

Different sectors and circumstances

77. When gathering evidence for this inquiry we posed a number of questions. Two of these were: 'Are there particular projects which are suited for PFI?' and 'In what circumstances are PFI deals suitable for the delivery of services?'. We were interested to

146 HC Deb, 12 November 1992, col 998

147 HM Treasury, *Private Finance: Overview of progress*, News release 118/94, 8 November 1994

148 HM Treasury, *Private Opportunity, Public Benefit Progressing the Private Finance Initiative*, November 1995

149 HM Treasury, *Meeting the Investment Challenge*, July 2003, p35, 3.30

understand whether PFI was more appropriate within certain sectors and circumstances. Skanska told us that:

> We believe that PFI is most suitable for the delivery of services that contribute to whole-life costing benefits and which are stable and predictable over the long term. PFI is less suitable for services that need to flex significantly over time to reflect changes in public service delivery, demographics or technology.[150]

Others also expressed the view that PFI was suited to operations where use was predictable over time and less suitable for services that were likely to need change. The CBI told us: "PFI works well when the risks of a project can be identified, quantified and transferred appropriately." It considered that "build and service contracts that have been used to provide schools, simple healthcare facilities and housing have been successful" as had "economic infrastructure projects, which have seen roads, railways and airports built and maintained". However it considered that schemes that "introduce complex technology risk, or in which future outcomes cannot be readily forecast may be less appropriate"[151] for PFI.

78. Transport for London told us that "PFI may be suitable" in circumstances where "the public sector can define its long-term needs and wants a single integrator of the delivery of that service". It also pointed out that projects that were the "least successful were all bespoke".[152] Steve Allen told us:

> If you look at things like roads or new railways, where once you have designed where the transport scheme is going to go, you fundamentally are not going to change it, those have been more successful examples of PFIs than things that are intimately involved with the operations of transport; for example, the experience of the London Underground PPP, where it was much too closely intertwined with the day-to-day operations.[153]

Martin Blaiklock told us that in his opinion "Typically, 'accommodation'-type projects, where the underlying demand and service output over 30 years does not change, are suitable for PFI treatment."[154]

79. **Owing to the current high cost of project finance and other problems related to PFI we have serious doubts about such widespread use of PFI. There are certain circumstances where PFI is likely to be particularly unsuitable, for example, where the future demand and usage of an asset is very uncertain and where it would be inefficient to transfer the related risks to the private sector.**

150 Ev w42

151 Ev w33

152 Ev 37

153 Q 108

154 Ev w19

Re-examining the VfM assessment

80. Prior to commencing the procurement of a PFI scheme, central government guidance requires the sponsoring authority to draw up an *Outline Business Case* (OBC), in which the rationale for the project is presented to ministers for approval. The OBC includes details of a *Procurement Route Comparison*, in which the projected Net Present Cost of the proposed PFI project is compared with that of an identical scheme carried out on the basis of conventional (i.e. non-privately financed) procurement.

81. Despite the significantly higher cost of private finance, the vast majority of projects submitted to the *Procurement Route Comparison* exercise continue to find in favour of the PFI option. To a significant extent, this reflects the incentives that public authorities (and their sponsoring departments) are subject to which favour the PFI methods (see *Accounting and budgetary incentives of PFI*), and the fact that the model is, as the National Audit Office has noted, "subject to manipulation".[155] We understand that the Treasury is making some changes to the guidance which determines the current quantitative element of this system, and will publish these in the autumn, but regards the system as fundamentally sound. **We believe that a financial model that routinely finds in favour of the PFI route, after the significant increases in finance costs in the wake of the financial crisis, is unlikely to be fundamentally sound. The Treasury should seek to ensure that all assumptions in the VfM assessment that favour PFI are based on objective and high quality evidence.**

82. In this report we are not able to examine every part of the VfM assessment in detail. We have therefore chosen to consider just two of the areas in more detail—the 'optimism bias' and the adjustment for tax. In the quantitative assessment component of the procurement route comparison, two models are constructed (one for a PFI and one for a conventional public procurement) where the specification of the facility is the same, as are many of the projected costs and risks. However, risks that in the public authority's view would be borne by them under conventional procurement, but which in the PFI solution would fall on the private sector, are valued and a percentage is added to the costs of the conventional procurement route. In the Treasury spreadsheet,[156] risks transferred to the private sector in this way are identified as 'optimism bias'—i.e. the likelihood that capital and operating costs will prove to be substantially higher than those estimated at the time of the OBC assessment.

83. This uplift is designed to reflect the fact that there is "a demonstrated systematic tendency for project appraisers to be optimistic".[157] This uplift to the estimated cost of the capital expenditure undertaken under a conventional procurement option, for example, is commonly in the range of 15-20%. However, the evidence base on which optimism bias adjustments are made is unclear. The key source appears to be a study published in 2002 by

155 National Audit Office, *Private Finance Projects: A Paper for the Lords Economic Affairs Committee,* October 2009, p48, para 4.10

156 HM Treasury, PFI value for money quantitative assessment spreadsheet

157 HM Treasury, *Quantitative Assessment User Guide*, March 2007, p16, A55

a prominent technical advisory firm within the PFI industry, Mott MacDonald.[158] This study has been called into question by scholars due to methodological concern—specifically, the non-comparability of projects; small sample size and numerous source of measurement bias. They noted that the "PFI sample contained only 11 projects, although 451 PFI construction schemes were completed" and there was an "over-representation of atypical schemes in the conventional procurement sample and under-representation of them in the PFI sample".[159]

84. **The Treasury should ensure that guidance regarding Optimism Bias is based on objective, high quality and, as far as possible, contemporary evidence. The Treasury should not approve the PFI projects of departments or public authorities that fail to produce such evidence in support of their Outline Business Cases. We believe that the comparison of procurement routes should take place on the basis of the PFI model and a public procurement model, in which there is a serious attempt to fix prices and therefore transfer risk.**

85. Hardwired into the Treasury Value For Money Guidance spreadsheet is an assumption that, owing to the use of private finance, PFI will lead to additional tax being received by the Treasury. The current guidance follows advice from the prominent PFI financial advisory firm KPMG[160] that corporation tax which would be received by the Treasury should be deducted from the costs of the PFI option (or added to the PSC, which has a similar effect). At the time of the KPMG report corporation tax was 30%. It is currently 26% and is due to fall to 23% by 2014.[161] The corporation tax adjustment can be between 2% and 22%, of the total costs of a project, depending on the assumptions in the spreadsheet. These projected corporation tax levels are significantly higher than would be expected by the companies involved in PFI projects[162] and assume a level of corporation tax exposure that is likely to be much greater than Special Purpose Vehicles actually pay on average. Corporation tax SPVs are normally a private 'shell' company with no assets, and owned by the shareholders in the project. The SPV typically borrows approximately 90% of the capital required to develop the project, and receives income when the project is operational.

86. As well as the fact that interest paid by the highly leveraged SPV is tax deductable the SPV is also likely to adopt sophisticated tax limitation strategies. Indeed, an SPV that can organize its tax planning efficiently, including the use of transfer pricing and off-shore registration and claim all possible tax allowances, might pay *less* tax than the conventional alternative. For example, the STEPs deal, providing property and premises for the two Departments which were to become HMRC, was negotiated with Mapeley STEPS Limited,

158 Mott MacDonald report for HM Treasury, *Review of Large Public Procurement in the UK*, July 2002

159 Public Money and Management: Pollock, Price & Player , An Examination of the UK Treasury's Evidence Base for Cost and Time Overrun Data in UK Value-for-Money Policy and Appraisal, April 2007

160 KPMG report for HM Treasury, *Report on Identifying and Measuring the Differential Tax Receipts from Private Finance Initiative Schemes for the Purpose of Economic Evaluation against a Public Sector Comparator*, 2002

161 HM Treasury, Budget 2011, p2

162 In 2010 Serco Corporation Tax was 1.3% of revenue and Balfour Beatty's was 0.8%. Source: 2010 Accounts, Income Statement.

a property holding company registered in Bermuda.[163] A study of the early PFI highways projects found higher rates of profit, and low payments of corporation tax, and questioned the assumption that high rates of tax would be paid.[164] Evidence we received shows that ultimate ownership of over 90 PFI projects has moved offshore.[165]

87. **The current 'tax adjustment' is not based on the best available evidence and acts to bias the assessment towards choosing PFI. Private companies entering into contracts with the public sector will quite reasonably seek to minimise their tax liabilities. Governments may also vary tax rates. The assessment exercise which evaluates the value for money of different procurement routes must take this into account.**

88. As part of the Lords Economic Affairs Committee investigation into PFI in 2009–10 the National Audit Office produced a paper which raised doubts about the use of the VfM assessment financial model. In particular the NAO noted that "we have yet to come across robust cost analysis between procurement routes, that tests the assumptions of cost efficiency set out in business cases."[166]

89. **The National Audit Office should perform an independent analysis of the VfM assessment process and model for PFI. It should audit all of the assumptions within the model, and report on whether or not these are reasonable. This test of the VfM assessment model should, where possible, be based on representative and up to date samples of data.**

Investment in public infrastructure

90. The importance of investment in infrastructure was expressed in numerous submissions. Skanska's submission said that there was "a proven need for infrastructure in the UK that is currently unfulfilled".[167] Balfour Beatty also made a similar point and considered that there had been underinvestment in the past:

> Balfour Beatty believes that sustained investment in infrastructure is vital to the future of the economy. From 1999–2008, UK public investment as a percentage of GDP was lower than almost any other OECD country and almost half the average of G7 countries.[168]

This view agreed with a paper of December 2009 from the Institute of Civil Engineers. This noted that:

> The UK suffers from a historic under investment in infrastructure, which the OECD has identified as a major factor holding back our economic performance. This has

163 C&AG's report, *PFI: The STEPS Deal*, HC 530 2003-04, p4-5, para 11-13

164 ACCA Research Report no.84 - Edwards *et al*, Evaluating the Operation of PFI in Roads and Hospitals , 2004, p.99

165 Ev w125

166 National Audit Office, *Private Finance Projects: A Paper for the Lords Economic Affairs Committee,* October 2009, p46, para 4.7

167 Ev w39

168 Ev 32

also been acknowledged by HM Treasury. As a result the World Economic Forum ranks the UK 33rd in the world for the quality of its infrastructure.[169]

Dieter Helm agreed with the need for investment in his additional submission to the Committee: "The UK requires a very significant increase in infrastructure spending, reflecting a combination of new policy priorities and the failure to maintain and enhance existing assets."[170]

91. Balfour Beatty also pointed out in its written evidence that "investment in infrastructure has a higher economic multiplier than other types of government expenditure".[171] The Office for Budget Responsibility own analysis agrees with this—its estimates show that capital expenditure has the greatest impact of the fiscal multipliers.[172]

Table 3: Estimates of fiscal multipliers

	Impact multipliers
Change in VAT rate	0.35
Changes in the personal tax allowance and National Insurance Contributions (NICs)	0.3
AME welfare measures	0.6
Implied Resource Departmental Expenditure Limits (RDEL)	0.6
Implied Capital Departmental Expenditure Limits (CDEL)	1.0

Source: OBR, Budget Forecast, June 2010, p95, Table C8

The UK Contractors Group made the point that "more construction investment would help to stimulate the economy and employment".[173]

92. As investment in infrastructure is so important for the economy it is essential that the most efficient form is pursued and also that any changes should be phased to keep disruption in investment plans to a minimum. The most straightforward way for government to phase out PFI while continuing and even increasing investment is directly to fund capital spending. With the cost of government borrowing at historic lows and at a significant discount to other forms of finance there is a strong argument to be made that this would be the most efficient form of financing and therefore would release higher levels of investment at the same cost.

93. Any increase in direct capital investment would inevitably lead to higher borrowing figures in the short term as debt would be fully transparent—unlike with PFI where most of the liability is not part of government borrowing figures. However it is unclear why this should stop the government acting, particularly if in the long term PFI is less affordable. Dieter Helm considered that continuing with PFI would in effect be imposing a tax on us all:

169 Institute of Civil Engineers, A National Infrastructure Investment Bank: An ICE briefing and discussion paper, December 2009, p2

170 Ev 40

171 Ev 32

172 Office for Budget Responsibility, Budget Forecast: June 2010, p95, C.54-C.55

173 Ev w67

> if [...] the conventional PFI approach continued, the economy and society bears a considerable deadweight welfare loss through the high cost of capital. A rule based and flawed accounting methodology would be in effect imposing a tax on us all.[174]

An increase in government borrowing to replace PFI investment should not make it harder for the Government to meet the fiscal mandate which the Office for Budget Responsibility monitor. As the borrowing is for capital investment it will not increase the cyclically adjusted current balance which the OBR measure. Also if any increase in borrowing occurs before 2015–16 the supplementary target will also be unaffected. The coalition government increased capital budgets at the Spending Review without any direct impact on the fiscal mandate so this shows that such an approach is possible:

> [...] the Spending Review has increased the capital envelope by £2.3 billion a year by 2014-15 relative to the Budget plan in order to ensure that capital projects of high long term economic value are funded. This change has no direct impact on the fiscal mandate, which targets the cyclically adjusted current balance, and will also not alter the year in which public sector net debt as a percentage of GDP begins to fall.[175]

94. **Sustainable investment in public infrastructure is important for the long term health of the economy. We also recognise the paramount importance at the current time of stabilising the public finances. The Treasury will need to consider using more direct government borrowing to fund new investment. Replacing some PFI with direct public sector investment would not necessarily result in a higher financial liability for the Exchequer. It would mean that the debt was more transparent, as it would be held directly by government rather than through the intermediary of an SPV. An increase in government debt to replace PFI investment should also not necessarily make it any harder to meet the fiscal mandate. Continuing to use an inefficient funding system such as PFI is likely in many cases to increase the overall burden on taxpayers for the provision of public sector capital projects. If, rather than using PFI, the lower financing costs of government are utilised, we have seen evidence that investment can be increased significantly for the same long term funding costs.**

95. **PFI is a procurement model where the private sector manages the design, build, finance and operation (DBFO) of public infrastructure. If the public sector funds the investment this changes the financing element of the project but this can still accommodate a high level of private sector involvement. There may be merit in making more use of a design and build (DB) model using a fixed price contract to place risk with the private sector over the construction period. There will be other circumstances where a design, build and operate (DBO) model is most appropriate. Both the DB and DBO model allow government to benefit from its lower cost of funding while transferring significant risk to the private sector.**

174 Ev 41

175 HM Treasury, Spending Review 2010, Executive Summary, p5

Current contracts and existing deals

96. £60 billion worth of capital investment (in 2010 terms) have already been committed to by PFI investors under successive governments.[176] One important question to consider is what is to be done with the PFI contracts that have already been signed and the assets which are already being delivered under PFI agreements. Andy Friend suggested that refinancing was one option: "I think maybe we are now in the territory where the public sector might contemplate having a right to refinance the senior debt and the capital structure of such propositions when you get into the operational stage."[177] Dieter Helm also agreed that there should be a right to demand refinancing once construction risk ends in a contract.[178]

97. Refinancing with government debt would be the most straightforward way to allow renegotiation of contracts, replicating what Steve Allen told us that TfL have been able to do with some of its contracts.[179] This refinancing would result in higher government borrowing figures, but this would only be because the debt was visible rather than hidden. As well as allowing for renegotiation, refinancing with low cost government bonds would significantly reduce the PFI unitary charge and make deals more affordable. The OBR estimate that the "the total capital liability" of PFI deals stands at around £40 billion.[180] If government refinanced this debt at a lower rate of interest then, for every percentage point the interest rate reduced, annual savings of £400 million would be realised for taxpayers.

98. **The most straightforward way of dealing with current PFI contracts is for the government to buy up the debt (and possibly also the equity) once the construction stage is over. This would result in an increase in the headline level of government debt but it would not increase the structural deficit or prejudice the fiscal mandate as this debt would score as government borrowing for investment in the National Accounts. Interest rates on the financing of the deals would fall significantly, releasing savings. Although government debt levels would be higher the public finances would not be any less sustainable. This is because it would become more affordable to service the visible government debt rather than the hidden PFI debt. Every one percentage point reduction in the interest rate paid on the estimated £40 billion of PFI debt would realise annual savings of £400 million.**

99. In most cases, PFI projects involve significant and long–term financial commitments for the public authorities involved. Given the fiscal challenges faced by government, and the degree to which public expenditure is currently being scrutinised for potential savings, there is pressure on public managers to secure a better deal from existing PFIs. A high-profile review of public sector efficiency recommended that the government audit all procurement contracts with a concession value of over £100 million, and explore ways of

176 Committee analysis of HM Treasury, PFI signed projects list, March 2011

177 Q 3

178 Q 42

179 Q 118

180 OBR, Fiscal Sustainability Report, July 2011, p42, para 2.50

breaking contracts where these represent poor value for money. [181] At the time of writing, the Treasury was consulting with major DBFO investors on plans to introduce a code of conduct[182] on reducing the costs of existing deals, and individual public authorities are being encouraged to work with investors to identify where and how reductions in their charges might be achieved.

100. However, it should be recognised that there is a limit to the savings that can be achieved on existing contracts. Any attempt unilaterally to reduce PFI payments could have negative side effects. Mr Friend noted the potential for:

> the hazard that it creates in terms of UK reputation [...] I think these things need to be borne in mind as we play the larger game, which is: how do we finance and fund the nation's infrastructure needs over the next decade?[183]

Mr Wardlaw also noted that:

> I think there is a really important issue here about the perception of political and other risk around the UK and the UK's infrastructure, because those investors, those contractors, those utility companies outside the UK who are making these decisions have alternative places to put their capital.[184]

101. Mr Friend did however consider that it might be worthwhile looking at the contracts on a case-by-case basis:

> What I think is more feasible is a vigorous, taskforce-based approach that would require the Infrastructure UKs, the Local Partnerships of this world and the local authority bodies, on a case-by-case basis to work through: what is the potential for varying scope? What is the potential for increasing productivity? What is the potential for taking back risks that were transferred at a price, like insurance risk, the energy risk I referred to earlier, and literally cutting a deal case-by-case? My perception is that there would be a willingness in the private sector on a case-by-case basis.[185]

Mr Rabin agreed telling us "I think that renegotiation is always feasible and, potentially in some cases, desirable." He added "I do very strongly believe that that should be at a local level between the buyer of services and the provider of services rather than at an omnibus global level."[186]

102. Where the return to an investor is significantly higher than the level projected at the time of contract signature, there may be an opportunity for such gains to be shared. If equities are sold by 'primary' to 'secondary' investors after the risky construction period

181 Efficiency Review by Sir Philip Green, Key Findings and Recommendations

182 HM Treasury: Press Notice, Treasury launches pilot to achieve savings in PFI projects,16 February 2011

183 Q 62

184 Q 63

185 Q 62

186 Q 115

has been completed, this can give rise to a capital gain, the post-tax value of which will under current arrangements accrue entirely to the primary investor. Similarly, it has become evident that the price paid for maintenance (which is agreed when the contract is signed) has often become unrelated to the actual cost for the provider[187], which can also generate significant additional investor cash-flow. Currently, the price paid for maintenance is locked in once the long term contract is signed and is therefore not subject to competitive pressures over its life.

103. We explored the issue surrounding sharing the capital gains on the sale of equity stakes. Mr Friend expressed a concern:

> I think the problem with renegotiating at the equity level, as Richard has referred to, is that I think the current Treasury estimate is that 55%—perhaps slightly more—of the original equity has moved on, and it has been brought across a wide variety of institutions now, and that is the problem.[188]

Canmore Partnership did not believe that "calls to share investors' gains on disposing of their equity interests [...] is reasonable or practical" as:

> these procurements are presumably already deemed to represent better VfM than alternative procurement models (ie Full Business Case approvals will have had to show this to be the case) and so profits on disposals are surely part of investors' reasonable "upside".[189]

104. Where the actual return on private capital is much higher than that projected return it is possible that the government could use its purchasing power to negotiate gain-sharing arrangements without eroding its credibility. There is, indeed, a precedent for this. In 2002, the Office for Government Commerce and several major investors in the PFI programme signed a code of practice[190] which committed the latter to share gains made via refinancing their debt (which significantly accelerates cash-flow and increases investor returns), even though contracts did not stipulate any such sharing.

105. **We welcome the work that the Treasury is doing with the PFI industry on drawing up a code of conduct. We believe that it is in the interest of the PFI industry to cooperate as fully as possible with the government in this regard. In 2002 the government reached a voluntary agreement with industry to share refinancing gains with the taxpayer. Therefore in principle there is no reason why a non-obligatory gain-sharing arrangement could not also be considered in relation to the gains on the sale of equity stakes.**

106. As well as the numerous PFI deals which have already been committed to there are also many deals already in procurement and others are in the pipeline. If the public sector wants to reduce costs it must ensure that the prices and profit margins charged by the

187 C&AG's report, The performance and management of hospital PFI contracts, HC 68, 2010-11,

188 Q 62

189 Ev w25

190 Public Accounts Committee, Twenty-Second Report of Session 2002-03, *PFI refinancing update*, HC 203, p5, para 1

private partner are at the market level at the start of the contract and also that efficiencies can benefit the taxpayer over the life of the contract. These issues are considered in more detail in Box 3.

Box 3: Returns on PFI investment

Analysis by Mark Hellowell – Specialist Adviser to the Committee

There are currently 61 projects in procurement, representing projected capital expenditure of £7 billion. In this context, it is essential that the government ensures that the ongoing revenue costs to the public sector of new PFI projects are minimised. This can be done in two ways: (a) ensuring that the prices and profit margins charged by the private partner are at the market level (and the market should be defined more broadly than PFI alone), and (b) that the likelihood of productivity gains throughout the contract period is recognised in contracts, so that there is a mechanism for sharing such gains. In respect of (a), it is important to consider both operational and financial costs. In terms of operational costs, it is clear that the costs of construction, maintenance and service provision must be benchmarked against best practice in the market more generally. As the National Audit Office has pointed out, this will require the compilation and active use of much better data than has been utilised by departments hitherto[191].

Treasury officials have made the observation that the cost of primary equity was too high as far back as November 2005.[192] However we have seen no evidence that equity rates of return have come down since that date. The cost of equity quoted by major investors in terms of constructing discount rates for valuing their portfolios of PFI projects is typically in the range of 7–9%.193 The rates of return targeted by primary investors are around double those normal on the secondary market, and the risks borne by equity investors during the construction and early operational stage of contracts do not justify this. There is a case to be made for action to be taken to ensure that Equity Internal Rates of Return cluster around their efficient level, which should be close to the cost of equity quoted by PFI investors, and much closer to secondary market discount rates.

In respect of (b), a private company in charge of services over a 30 year contract is likely to find opportunities to reduce costs over this period. Of the services included within the PFI structure, only "soft" facilities management services, such as catering and cleaning, are benchmarked or market tested during the contract period. Currently, there is no mechanism under which the gains from such efficiencies in maintenance can be shared with the public sector–and thus the gains accrue to equity-holders in their entirety. Although maintenance services are subject to competitive tension in the tendering process, the standard PFI structure does not allow sharing from any efficiencies in building maintenance which contractors achieve over the contract's life.

This is because these services are not value tested and contractors do not share with public authorities information on their maintenance spend. This is both undesirable in its own terms, but is also likely to lead to opportunistic behaviour. Currently, because "soft" facilities management services are benchmarked/ market tested, there is an incentive for a bidder (working within the context of a strict public sector budget constraint) to under-price this element of the services at the point of financial close, and over-price the hard facilities management services (i.e. build in a profit margin above the market level). When, in subsequent years, the price of the soft facilities management services are benchmarked, this will lead to the price going up. The public sector will, in this event, pay a market price for the soft services and an above-market price for the hard facilities management, and it will pay this above-market price for the entirety of the contract period.

One option would be to examine the potential for broadening the benchmarking/market testing process to include all services. However this is complex. For example, there would be a need to consider how the price paid for hard facilities management payments interact with the costs of life-cycle replacement. In practice, this may not be possible. A simpler, and likely more effective, method would be to ensure that any free cash-flow (i.e. cash in excess of that required to pay

191 C&AG's report, *Lessons from PFI and other projects,* HC 920, 2010-11, p9, para 23

192 Richard Abadie, as Head of Private Finance Unit, HM Treasury said: "we do want to focus on understanding what an appropriate price is for the primary market. We are seeing primary returns around the 14% to 15% level, and put simply, we think that those primary returns are high compared to the secondary yields. [...] Government is watching with interest to see when primary returns reduce" (City and Financial Conference, 8 November 2005).

193 See, for example, the 2010 annual reports of Carillion, John Laing, Balfour Beatty or HICL.

operational or debt costs) in excess of that required to provide equity investors with the rate of return projected at financial close is shared with the public sector. This would ensure that the private sector retains an incentive to invest in productivity gains in maintenance (as under PFI now) but that the benefits from this are shared with the public sector (as is not currently the case).

It may also be useful to examine the experience of the "hub" private finance model in Scotland, in which similar principles are in operation.

107. **We recommend that HM Treasury collates and compares data to ensure that it gets a good price on any deals already being negotiated. It should benchmark operational costs of PFI projects with market prices outside PFI. It should also compare the equity returns of investors with other investments with a similar risk profile. It should publish as much of this information as is commercially possible. Far more transparency is required. The Treasury should consider whether this should extend to publishing data and costings on existing contracts, where commercially possible, in addition to what is already published. The Treasury should also consider introducing a mechanism for deals in procurement to ensure that any productivity gains are shared with the taxpayer over the life of the contract. Based on the analysis presented in this Report, we ask the Government to give further consideration before proceeding with the procurement in its present form of the Royal Liverpool and Broadgreen Hospital in particular.**

Improving procurement and project management skills

108. As part of our inquiry we received evidence about the importance of improving procurement and project management skills in the public sector. The CBI pointed out that:

> For complex procurements to be successful it is essential that project teams have the appropriate skills and experience and are adequately supported by central bodies with strategic oversight.[194]

Mr Friend told us that of the many reports written about PFI projects "I reckon a good two-thirds of them refer to the need to invest seriously in commercial skills in the public sector, and I do not believe that we have done that consistently".[195] Dr Chris Lonsdale from the University of Birmingham noted in his submission that "Risk transfer under the PFI, and in public sector procurement generally, has been further affected by limited public sector commercial skills." He noted that there had seemingly been a lack of understanding in the higher levels of the civil service:

> In terms of commercial skills and capabilities, the UK public sector has spent the 20-year life of the PFI attempting to create the necessary capacity. For many years, there

194 Ev w32

195 Q 67

seemed to be too little appreciation in the higher civil service ranks of the extent of the difficulties of complex procurements.[196]

109. TfL's submission pointed out that "TfL invests heavily to ensure that it has the right skills to manage its risks". It considered that there was a case for other organisations to be "supported by others that have the resources and experience, rather than having to buy the experience more expensively from the private sector".[197] Skanska agreed that there should be a "focus on development of public sector in-house skills"; this they believed would encourage "the public sector to take ownership of projects rather than relying on external advisers".[198] The NAO reported in 2007 that the "average cost of external advice for all projects was just over £3 million per project or approximately 2.6 per cent of the capital value of the projects".[199] We asked Mr Abadie how much PwC had received as financial advisors on PFI procurements. He explained that for a school they would "probably get £250,000 to £400,000"[200] and for a hospital it "may be £500,000 to £800,000"[201]. Mr Abadie also told us that PwC often had people on secondment, including himself, to the government.

110. The head of PFI policy at HM Treasury has often, like Mr Abadie (a partner at PwC), come from a banking or accountancy background rather than having design or construction expertise. Many have also been on secondment. Geoffrey Spence who preceded Mr Abadie as head of PFI at the Treasury was seconded from Deutsche Bank in 2001. Mr Abadie was succeeded by Charles Lloyd in 2009—another secondee from PwC. The current outgoing senior official at HM Treasury responsible for PFI is Andy Rose who also has a background in finance. PFI is a DBFO (design, build, finance and operate) procurement method. The expertise of those responsible for PFI policy at the highest levels in government has been primarily on the financing element of the project.

111. **The need to improve procurement and project management skills in the public sector is something that all are agreed on. In some ways PFI may have exacerbated problems in this area. Rather than focussing on improving procurement methods and project management, public sector clients' attention has been diverted to financing arrangements and the other requirements unique to PFI. Owing to the complexity of PFI, the public sector has become too reliant on expensive external advisers. We are also concerned that PFI may have resulted in the balance of expertise within the centre of government being tilted too heavily towards financial skills with less input from those with experience in design and construction.**

196 Ev w115

197 Ev 38

198 Ev w40

199 C&AG's report, *Improving the PFI tendering process*, HC 149, 2006-07, p4, para 4d

200 Q 30

201 Q 31

Other ideas

Infrastructure accounts

112. The need for a national set of accounts was raised by some of our witnesses. Dieter Helm told us "we have no national balance sheet to set against our assets and liabilities"[202] adding that this meant "we are not interested in the question of what level of investment we should carry out to set against so we can set assets against liabilities".[203] He explained in his written submission in further detail the benefits of this:

> A national balance sheet would enable rational decisions to be made about borrowing and investing, and hence allow the low public cost of debt to be translated into lower costs of capital for infrastructure projects. The absence of proper balance sheet accounts therefore has a real deadweight welfare cost: the higher cost of capital on highly capital-intensive projects. The private returns on PFIs reflect this deadweight loss to society.[204]

He explained that without national accounts "I have no idea what our financial deficit in this country is, because I don't know whether we have just been eating up assets and depleting our infrastructure or not."[205]

113. Other evidence we received agreed that a set of national accounts would be an positive step. A joint submission from KPMG LLP, John Laing PLC and Lloyds Banking Group said:

> We believe government should invest in systematically collecting and analysing evidence on the comparative performance of all procurement approaches.[...]
>
> The single biggest step in this regard would be the institution of a set of national infrastructure accounts, which would show both asset investment and asset depreciation. Such accounts would provide a starting point for inquiries such as this to get under the skin of the infrastructure challenge and to compare like with like, and would force the public sector and its partners to think long-term.[206]

We asked Professor Helm how easily a set of national asset accounts might be created. He said that if you want a "perfect set of accounts, then it is really difficult". In his opinion it was therefore "best to just get on with it". He added "Let's have a look at what has happened to the oil. Let's see what electricity networks looks like. Let's have a look at the water networks. Do it pragmatically." This he explained would allow government to get a "handle on the big items pretty quickly and we can tell whether we are depreciating rapidly or not. So, the answer to that is it is not difficult."[207] In a recent Committee hearing on the

202 Q 1

203 Q 2

204 Ev 40

205 Q 40

206 Ev w28

207 Q 60

Bank of England inflation report The Governor emphasised the importance of understanding both assets and liabilities. He explained that the sustainability of the public finances should "be judged in the context not just of future liabilities, whether it be pensions, PFI projects or any other kind of liability, but also assets."[208]

114. On 13 July 2011 the first summary of the Whole of Government Accounts (WGA) was published. This is an unaudited summary report for the year ended 31 March 2010. The audited version of the accounts will be published later in the year. The WGA is a consolidation of the financial accounts of about 1,500 public bodies and therefore does not include a value of all of the infrastructure of the country.

115. **While there is an understandable focus on the current high levels of government debt, the government and the citizens of the country have no proper understanding of the assets which accompany these liabilities—there is no national balance sheet. The audited Whole of Government Accounts will be published for the first time later this year. This will provide further understanding of public sector organisations assets' for financial reporting purposes.**

Infrastructure fund

116. One idea proposed to us to lower the cost of capital for projects was an infrastructure fund or bank. Professor Helm gave a hypothetical example of how such an fund could be beneficial:

> Supposing the Government wants there to be 10 nuclear power stations in this country at £5 billion each. That is £50 billion over the next 10-15 years. Supposing it borrowed a fund called the Nuclear Bond Fund, and it borrowed £50 billion and it just asked the builders of those stations to bid for that money. So, it is the Government borrowing but the private sector is doing the CAPEX and the OPEX thereafter.

He explained that such a scenario would lower the cost of capital significantly:

> It [the Government] would currently borrow probably [...] [at a] negative real interest rate. The private sector [borrowing cost] for a nuclear power station may be 10% or 15% real. It doesn't take first year undergraduate maths to work out there is a colossal difference between those numbers [...][209]

117. A 2009 paper to which both Dieter Helm and James Wardlaw contributed recommended that "The UK should establish an infrastructure bank (UKIB)". In the paper Mr Wardlaw gave some detail about the benefits that this could bring:

> The prize is an institution which facilitates the introduction of private sector capital without crowding it out, finances itself with a government guarantee, aims to break

208 Q 11, HC (2010-12) 1326, 28 June 2011

209 Q 7

> even with any dividends reinvested, and whose liabilities do not score in the National Accounts but whose activities are defined by national priorities.[210]

Another witness, Richard Abadie of PwC, agreed telling us: "I am supportive of an infrastructure bank as well".[211] Healthcare Audit Consultants explained that "Just as the European Investment Bank helped finance the new Barts' and the London Hospital so a UK infrastructure bank could make funding easier for needed capital expenditure within the public sector".[212]

118. We explored the idea with Mr Wardlaw in more detail. He considered that the UK had "suffered" without such a bank:

> Well, I think to some extent we have suffered without. Many other countries in Europe have benefited from having a national infrastructure bank or a state development bank: KfW, Eco in Spain, and CDC in France. I think that it has been an important part of the armoury of tools to enable infrastructure to be constructed in a public sector context.[213]

However he considered that part of the solution was already being planned. He told us: "I think we are sort of getting it. It is called the Green Investment Bank."[214] Dieter Helm however pointed out a difference between the Green Investment Bank (GIB) and an infrastructure bank:

> The GIB is essentially a project finance vehicle, and hence it needs capital injections and equity finance. The infrastructure bank would be a debt vehicle, and would conform to the old-fashioned idea that an investment bank is all about matching savers with investors [...][215]

RAB and LABV

119. One potential avenue for lowering the cost of capital is to use a Regulatory Asset Base (RAB). In a RAB an asset earns a regulated return for the investor. We asked Dieter Helm about this:

> You do your capital project [...] it is finished, and that is the refinancing point. That in the utilities is the point where the asset goes into a regulatory asset base and then earns just a marginal cost of debt, which is very much lower than the marginal cost of debt that is being done in these businesses [...][216]

210 Policy Exchange, Delivering a 21st Century Infrastructure for Britain, September 2009, p 9-10, Recommendation 7

211 Q 53

212 Ev w50

213 Q 56

214 Q 49

215 Ev 41

216 Q 20

He provided more detail in a supplementary submission for the Committee about how the RAB model could apply to PFI.

> There are a number of ways in which the PFI framework could be brought into a RAB-based model. The optimal approach would be to create an infrastructure "bank". The bank's role would be to match savings (in practice largely pension and life funds) with investments in infrastructure projects such as those currently included in the PFI contracts. The bank would "buy" completed projects, put a RAB-wrapper around them, and then sell them onto the pension and life funds.

He explained that this would "would capture the returns from the assumption of the financing requirement, and therefore limit abnormal profits to the construction phase". If however there was not an infrastructure bank he said that another approach would work.

> The obvious starting point is to separate out the PFIs into three separate contractual parts: the construction phase, the operating phase and the financing phase after project completion [...]
>
> For the financing phase (strictly the refinancing phase after project completion), there could be a separate contract, with an associated cost of capital and a repayment profile. This could be subject to a guarantee that the revenues will in fact be forthcoming. [...]
>
> The advantage of the separation out of the contracts is that it provides a focus and opportunity to zoom in on refinancing on project completion. If the private sector demands a high return on the completed asset, then one of two possibilities arises: either the government can clarify the commitment to remunerate the capital; or the government itself could buy-in the completed asset at a lower cost of capital (or some part of it).
>
> Once separated out, the capital cost can be accounted for in the same way as the utility RABs – for that is in effect what they have become.[217]

120. Some evidence also mentioned the possibility of using Local Asset Backed Vehicles (LABVs) to allow local authorities to use their assets to attract long-term investment from the private sector. Skanska explained that the LABVs "are dependent upon the public sector having appropriate land or other assets to transfer into the joint venture vehicle and upon the market value of the land/asset that is available".[218] KBR International Government & Defence believed that LABVs provided "attractive option for outsourcing of non core activities of government departments". They suggested this form of additional financing would:

- Encourage a business management perspective where contracting authority and contractor work together to a common goal rather than creating an adversarial contracting environment. [...]

217 Ev 41

218 Ev w40

- Avoid the lengthy procurement periods and start up costs of PFI models
- Create a business relationship that can cope with a changing and dynamic environment.[219]

Equility Capital suggested an alternative form of financing which would be done "by employing lease-based funding programmes". They explained that the debt "will appear on the balance sheet but, as the funding is lease based, so will the asset." Also "at the end of the lease period the asset reverts in its entirety to the borrower". As the cost of capital would be much closer to the cost of government gilts they calculated the change would release significant savings.[220]

121. **The Treasury should consult on the possibility of using other financing models, including the Regulatory Asset Base (RAB) and Local Asset Backed Vehicles (LABV), as a way of financing capital projects in competition or in preference to PFI.**

219 Ev w72

220 Ev w126

Conclusions and recommendations

Introduction

1. The use of PFI has the effect of increasing the cost of finance for public investments relative to what would be available to the government if it borrowed on its own account. (Paragraph 6)

Accounting and budgetary incentives

2. The introduction of IFRS (International Financial Reporting Standards) in 2009–10 has resulted in nearly all PFI debt being included in the financial accounts of government departments for financial reporting purposes. However so long as certain risks are deemed to be passed to the private sector on a PFI project then the project is, by contrast, recorded off balance sheet for National Accounts and statistical purposes. As a result, most PFI debt is invisible to the calculation of Public Sector Net Debt (PSND) and is therefore not included in the headline debt and deficit statistics. If all current PFI liabilities were included in the National Accounts then the OBR estimates that national debt would increase by £35 billion (2.5% of GDP). Therefore there has been, and continues to be, at least a small incentive to use PFI in preference to other procurement options, as it results in lower headline government borrowing and debt figures in comparison to other forms of capital investment. (Paragraph 17)

3. Efforts to meet fiscal rules at a national and European level may have contributed to the misuse of PFI. Rules designed to promote fiscal sustainability have had the paradoxical effect of incentivising the use of off-balance sheet finance—which is likely to prove less sustainable. Given the salience of the public debt statistics in the current political climate, the attractiveness of the PFI method for any government has been evident whether it provides value for money or not. (Paragraph 18)

4. If Departments or public bodies do not have a capital budget large enough to allow for desired capital investment, there is currently a substantial incentive to use PFIs which are not included within Departmental budgets (Departmental Expenditure Limits). A PFI deal will have a smaller (but much longer lasting) impact on the current budget of an organisation whereas a conventionally procured capital project will result in a significant one-off hit to the capital budget. In the long term, the PFI arrangement will build up big commitments against future years' current budgets that have not even yet been allocated or agreed. We are concerned that this may have encouraged, and may continue to encourage, poor investment decisions. PFI continues to allow organisations and government the possibility of procuring capital assets without due consideration for their long–term budgetary obligations. (Paragraph 22)

5. If PFI is to be pursued only if it provides value for money it is essential that any incentives unrelated to value for money are removed. (Paragraph 23)

6. We welcome the Office for Budget Responsibility's decision to include, in their *Fiscal sustainability report*, an assessment of the impact of the PFI liabilities which are currently not included in the National Accounts. We believe that the Office for Budget Responsibility should also include an assessment of such liabilities in its *Economic and fiscal outlook*, which assesses the Government's performance against the fiscal mandate and the supplementary target. We recommend that the Treasury clarify its view of the remit of the OBR to ensure that the OBR include PFI liabilities in all future assessments of the fiscal rules. This would help prevent the use of PFI to 'game' fiscal rules. (Paragraph 24)

7. International Financial Reporting Standards (IFRS) require that most PFI projects be scored in an organisation's financial accounts. Capital investment related to PFI projects rarely, however, scores in individual government Departments' budgets (Departmental Expenditure Limits). This is because Departmental budgets follow the definitions used in the European Standards of Accounts (ESA), rather than those set out in IFRS. This is not only confusing, but also creates incentives to use PFIs, rather than direct capital investment by departments. We recommend that the Treasury should consider aligning the treatment of PFIs in Departmental budgets with the treatment in financial accounts. This should mean that most PFIs score within those budgets in the same way as direct capital expenditure. If this change were made it may also require an adjustment to Departmental capital budgets. (Paragraph 25)

Value for money

8. Government has always been able to obtain cheaper funding than private providers of project finance but the difference between direct government funding and the cost of this finance has increased significantly since the financial crisis. The substantial increase in private finance costs means that the PFI financing method is now extremely inefficient. Recent data suggests that the Weighted Average Cost of Capital of a PFI is double that of government gilts. PFI will only provide value for money if this differential in the cost of finance, which has significantly increased, is outweighed by savings and efficiencies during the life of a PFI project. (Paragraph 30)

9. The current higher cost of finance means there may be a significant opportunity cost from using PFI. (Paragraph 31)

10. Allocating risk to the private sector is only worthwhile if it is better able to manage the risk and can pass on any subsequent savings to the client. The main benefit highlighted to us by PFI providers was the transfer of construction risk. However a PFI contract which lasts for 30 years is not necessary to transfer this risk. There are also other methods such as turnkey contracts which can be used for the same ends. We have seen evidence that PFI has not provided good value from risk transfer—in some cases inappropriate risks have been given to the private sector to manage. This has resulted in higher prices and has been inefficient. (Paragraph 38)

11. Some of the claimed risk transfer may also be illusory—the government is ultimately accountable for the delivery of public services. Therefore it would not be able to

allow a number of services provided under a PFI contract to cease for any length of time. (Paragraph 39)

12. It is difficult to establish clear cut evidence in the area of whole life costing. In theory whole life costing should encourage the use of innovative designs in PFI to deliver buildings of better quality. These should in turn provide cost savings over the life of the building that can, to some extent, offset the higher financing costs inherent in a privately financed deal. The long term nature of a PFI contract should also incentivise providers to maintain buildings to a high quality thus reducing costs in later life. However we have not been provided with clear evidence to suggest that PFI performs better in this area. Indeed in the area of design innovation and building quality we have seen some evidence to suggest that PFI performs less well than traditionally procured buildings. (Paragraph 46)

13. The fixed nature of PFI contracts means they are likely to provide more certainty regarding price and time. However there is no convincing evidence to suggest that PFI projects are delivered more quickly and at a lower out-turn cost than projects using conventional procurement methods. On the contrary, the lengthy procurement process makes it likely that a PFI building will take longer to deliver, if the length of the whole process is considered. Proposing that post-contractual price certainty can be taken as a good measure of overall cost efficiency is to use a comparison already likely to favour PFI. This is because the PFI contract price is set at a much more advanced stage in the process. It is evident that a project delivered "to time and to budget" (in post-contractual terms) may nonetheless represent poor value for money if the price paid for the risk transfer was too high. (Paragraph 51)

14. PFI contracts are inherently inflexible. Specifications for a 30 year contract must be agreed in detail at the start of a project. The PFI financing structure also requires negotiation with the equity and debt holders before any substantial changes are made during the life of a contract. Debt and equity holders have little to gain from changing profitable contracts so will be unlikely to agree to changes unless they significantly enhance profitability. We have received little evidence of the benefits of these arrangements, but much evidence about the drawbacks, especially for NHS projects. The inflexibility of PFI means that any emergent problems or new demands on an asset cannot be efficiently resolved. In the case of Transport for London its only option was to buy out the SPV, but most PFI procurers cannot afford to do this. (Paragraph 56)

15. The nature of PFI means that competition is likely to be less intense compared to other forms of procurement. We believe the barriers to entry to be too high, resulting in an uncompetitive market. The long, complex and costly procurement process limits the appetite for consortia to bid for projects and also means that only companies who can afford to lose millions of pounds in failed bids can be involved. The fact that consortia are formed to bid for projects also limits choice and competition. For example an architects' firm may have the best design or there may be one contractor that has produced the best proposal, but unless these designs and proposals are part of the chosen consortium's bid they will not be used. The long term nature and inherent complexity of the contracts also make comparison more difficult for clients, further undermining competitive pressure. (Paragraph 61)

16. We are concerned that the VfM appraisal system is biased to favour PFI. Assuming that there will always be significant cost over-runs within the non-PFI option is one example of this bias. There is an incentive for both HM Treasury and public bodies to present PFI as the best value for money option as it is often the only avenue for investment in the face of limited departmental capital budgets. (Paragraph 65)

17. For too long PFI has been the 'only game in town' in some sectors which have not been provided with adequate capital budgets for their investment needs. This problem is likely to get worse in the future with capital budgets cut significantly at the Spending Review. If PFI is the only option for necessary capital expenditure then it will be used even if it is not value for money. A much–needed reappraisal of PFI needs to be accompanied by a similar reassessment of its effects on overall capital spending in the public sector. (Paragraph 69)

18. The price of finance is significantly higher with a PFI. The financial cost of repaying the capital investment of PFI investors is therefore considerably greater than the equivalent repayment of direct government investment. We have not seen evidence to suggest that this inefficient method of financing has been offset by the perceived benefits of PFI from increased risk transfer. On the contrary there is evidence of the opposite. Organisations which have the option of other funding routes have increasingly opted against using PFI and have even brought PFIs back in-house. TfL's cost of borrowing is higher than government's, and yet it still considers this is overall better value for money than PFI. The incentive for government departments to use PFI to leverage up their budgets, and to some extent for the Treasury to use PFI to conceal debt, has resulted in neglecting the long term value for money implications. We do not believe that PFI can be relied upon to provide good value for money without substantial reform. (Paragraph 71)

Future investment

19. Any financial model, such as the current VfM assessment, can be subject to manipulation so it should never be used alone as a pass or fail test for the use of PFI. (Paragraph 72)

20. Evidence we have seen suggests that the high cost of finance in PFI has not been offset by operational efficiencies. Much more robust criteria governing the use of PFI are needed. These should take precedence over the current VfM assessment. If and only if a project is deemed to pass these criteria should the option of private finance be considered. In our view PFI is only likely to be suitable where the risks associated with future demand and usage of the asset can be efficiently transferred to the private sector. We recognise that this may over time sharply reduce the aggregate value of remaining PFI projects but the higher cost of capital that remains will be easier to justify to the taxpayer. (Paragraph 76)

21. Owing to the current high cost of project finance and other problems related to PFI we have serious doubts about such widespread use of PFI. There are certain circumstances where PFI is likely to be particularly unsuitable, for example, where the future demand and usage of an asset is very uncertain and where it would be inefficient to transfer the related risks to the private sector. (Paragraph 79)

22. We believe that a financial model that routinely finds in favour of the PFI route, after the significant increases in finance costs in the wake of the financial crisis, is unlikely to be fundamentally sound. The Treasury should seek to ensure that all assumptions in the VfM assessment that favour PFI are based on objective and high quality evidence. (Paragraph 81)

23. The Treasury should ensure that guidance regarding Optimism Bias is based on objective, high quality and, as far as possible, contemporary evidence. The Treasury should not approve the PFI projects of departments or public authorities that fail to produce such evidence in support of their Outline Business Cases. We believe that the comparison of procurement routes should take place on the basis of the PFI model and a public procurement model, in which there is a serious attempt to fix prices and therefore transfer risk. (Paragraph 84)

24. The current 'tax adjustment' is not based on the best available evidence and acts to bias the assessment towards choosing PFI. Private companies entering into contracts with the public sector will quite reasonably seek to minimise their tax liabilities. Governments may also vary tax rates. The assessment exercise which evaluates the value for money of different procurement routes must take this into account. (Paragraph 87)

25. The National Audit Office should perform an independent analysis of the VfM assessment process and model for PFI. It should audit all of the assumptions within the model, and report on whether or not these are reasonable. This test of the VfM assessment model should, where possible, be based on representative and up to date samples of data. (Paragraph 89)

26. Sustainable investment in public infrastructure is important for the long term health of the economy. We also recognise the paramount importance at the current time of stabilising the public finances. The Treasury will need to consider using more direct government borrowing to fund new investment. Replacing some PFI with direct public sector investment would not necessarily result in a higher financial liability for the Exchequer. It would mean that the debt was more transparent, as it would be held directly by government rather than through the intermediary of an SPV. An increase in government debt to replace PFI investment should also not necessarily make it any harder to meet the fiscal mandate. Continuing to use an inefficient funding system such as PFI is likely in many cases to increase the overall burden on taxpayers for the provision of public sector capital projects. If, rather than using PFI, the lower financing costs of government are utilised, we have seen evidence that investment can be increased significantly for the same long term funding costs. (Paragraph 94)

27. PFI is a procurement model where the private sector manages the design, build, finance and operation (DBFO) of public infrastructure. If the public sector funds the investment this changes the financing element of the project but this can still accommodate a high level of private sector involvement. There may be merit in making more use of a design and build (DB) model using a fixed price contract to place risk with the private sector over the construction period. There will be other circumstances where a design, build and operate (DBO) model is most appropriate.

Both the DB and DBO model allow government to benefit from its lower cost of funding while transferring significant risk to the private sector. (Paragraph 95)

28. The most straightforward way of dealing with current PFI contracts is for the government to buy up the debt (and possibly also the equity) once the construction stage is over. This would result in an increase in the headline level of government debt but it would not increase the structural deficit or prejudice the fiscal mandate as this debt would score as government borrowing for investment in the National Accounts. Interest rates on the financing of the deals would fall significantly, releasing savings. Although government debt levels would be higher the public finances would not be any less sustainable. This is because it would become more affordable to service the visible government debt rather than the hidden PFI debt. Every one percentage point reduction in the interest rate paid on the estimated £40 billion of PFI debt would realise annual savings of £400 million. (Paragraph 98)

29. We welcome the work that the Treasury is doing with the PFI industry on drawing up a code of conduct. We believe that it is in the interest of the PFI industry to cooperate as fully as possible with the government in this regard. In 2002 the government reached a voluntary agreement with industry to share refinancing gains with the taxpayer. Therefore in principle there is no reason why a non-obligatory gain-sharing arrangement could not also be considered in relation to the gains on the sale of equity stakes. (Paragraph 105)

30. We recommend that HM Treasury collates and compares data to ensure that it gets a good price on any deals already being negotiated. It should benchmark operational costs of PFI projects with market prices outside PFI. It should also compare the equity returns of investors with other investments with a similar risk profile. It should publish as much of this information as is commercially possible. Far more transparency is required. The Treasury should consider whether this should extend to publishing data and costings on existing contracts, where commercially possible, in addition to what is already published. The Treasury should also consider introducing a mechanism for deals in procurement to ensure that any productivity gains are shared with the taxpayer over the life of the contract. Based on the analysis presented in this Report, we ask the Government to give further consideration before proceeding with the procurement in its present form of the Royal Liverpool and Broadgreen Hospital in particular. (Paragraph 107)

31. The need to improve procurement and project management skills in the public sector is something that all are agreed on. In some ways PFI may have exacerbated problems in this area. Rather than focussing on improving procurement methods and project management, public sector clients' attention has been diverted to financing arrangements and the other requirements unique to PFI. Owing to the complexity of PFI, the public sector has become too reliant on expensive external advisers. We are also concerned that PFI may have resulted in the balance of expertise within the centre of government being tilted too heavily towards financial skills with less input from those with experience in design and construction. (Paragraph 111)

32. While there is an understandable focus on the current high levels of government debt, the government and the citizens of the country have no proper understanding of the assets which accompany these liabilities—there is no national balance sheet. The audited Whole of Government Accounts will be published for the first time later this year. This will provide further understanding of public sector organisations assets' for financial reporting purposes. (Paragraph 115)

33. The Treasury should consult on the possibility of using other financing models, including the Regulatory Asset Base (RAB) and Local Asset Backed Vehicles (LABV), as a way of financing capital projects in competition or in preference to PFI. (Paragraph 121)

Formal Minutes

Monday 18 July 2011

Members present:

Mr Andrew Tyrie, in the Chair

Tom Blenkinsop	Mr Andrew Love
Michael Fallon	Mr George Mudie
Mark Garnier	Jesse Norman
Stewart Hosie	John Thurso
Andrea Leadsom	

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

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

Paragraphs 1 to 121 read and agreed to.

Summary agreed to.

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

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

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

Written evidence was ordered to be reported to the House for publishing with the Report (in addition to that ordered to be reported for publishing on 17 May 2011).

[Adjourned till Tuesday 19 July at 3.00 pm

Witnesses

Tuesday 14 June 2011 *Page*

List of printed written evidence

List of additional written evidence

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

List of Reports from the Committee during the current Parliament

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Second Report	Appointment of Dr Martin Weale to the Monetary Policy Committee of the Bank of England	HC 195
Third Report	Appointment of Robert Chote as Chair of the Office for Budget Responsibility	HC 476
Fourth Report	Office for Budget Responsibility	HC 385
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Ninth Report	Competition and Choice in Retail Banking	HC 612
Tenth Report	Budget 2011	HC 897
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Twelfth Report	Appointment of Dr Ben Broadbent to the monetary Policy Committee of the Bank of England	HC 1051
Thirteenth Report	Appointment of Dr Donald Kohn to the interim Financial Policy Committee	HC 1052
Fourteenth Report	Appointments of Michael Cohrs and Alastair Clark to the interim Financial Policy Committee	HC 1125
Fifteenth Report	Retail Distribution Review	HC 857
Sixteenth Report	Administration and effectiveness of HM Revenue and Customs	HC 731
Seventeenth Report	Private Finance Initiative	HC 1146
Eighteenth Report	The future of cheques	HC 1147
Nineteenth Report	Independent Commission on Banking	HC 1069

Oral evidence

Taken before the Treasury Committee

on Tuesday 14 June 2011

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon	John Mann
Mark Garnier	Jesse Norman
Andrea Leadsom	Mr David Ruffley
Mr Andrew Love	John Thurso

Examination of Witnesses

Witnesses: **Richard Abadie**, Partner, PricewaterhouseCoopers, **Andy Friend**, Chairman, InfraMed Investment Committee, **James Wardlaw**, Managing Director, Goldman Sachs, **Professor Dieter Helm**, Oxford University, gave evidence.

Q1 Chair: Thank you very much for coming before us this morning. I am sorry that we have started a little bit later than planned. We will try to keep broadly to time. There is a lot of stuff to get through in a short period. We are very grateful to those of you who have also submitted written evidence, and if, at the end of what I hope will be crisp replies to our questions, you have further material you want to add, please don't hesitate to put it in writing.

To begin the session, can I ask each of you whether you feel PFI needs radical change and, while you are thinking about that, whether you think in particular it is sustainable to continue with a 6% discount rate in view of what has been going on in the markets? Who wants to start? Professor Helm is going to make a start.

Professor Dieter Helm: Whether you think the PFI arrangements are well designed and whether you think they are sustainable depends on the question to which you think PFI is an answer. So, if you think it is an attempt to get future generations to pay for the infrastructure that is now being built on their behalf, then the answer is probably no. It is probably an unfair bargain too, because of course our generation has not maintained the infrastructure properly, which the next generation will inherit. That is the first part.

If you think it is an exercise to get investment off the public balance sheet so that the debt numbers look better than they otherwise would have done, it succeeds in that dimension so far, but of course it just reflects the fact that we have no national balance sheet to set against our assets and liabilities. Because we have cash-based national income accounts, essentially we discriminate against the future in favour of the present spending as against investment.

Q2 Chair: So, you are saying it works as an accounting fiddle but not as a sustained and fair way of transferring resources from one generation to another?

Professor Dieter Helm: It just gets national economic decisions wrong because, effectively, what it does is say, "Since we are only interested in cash in national income accounts, we are not interested in the question of what level of investment we should carry out to set against so we can set assets against liabilities".

Q3 Chair: Can this largely be solved by altering the discount rate or do we need to do more than that? Do we need to look at the structure of PFI?

Professor Dieter Helm: The discount rate is the third issue, which is: have you efficiently allocated the risk within the PFI between the state and the market? The answer is reflected in the 6% that is used, and that is almost certainly the wrong answer. What you should do is allocate the political and regulatory risk to the state—that is where they are caused—and the CAPEX risk and the operational risk to the private sector. Then you would have a cost of capital for finance that would be significantly lower than 6%. Do remember that currently, when we are trying to mobilise something like £100 billion of CAPEX before 2020 on the various Government plans we have at the moment, the current real interest rate in this country is minus 5%, and in those circumstances we choose to use a real positive discount rate because we are shifting political and regulatory risk on to precisely those people who can't bear it. In terms of inefficiency, it is quite hard to think of many other aspects of the British economy that are more inefficient than that risk allocation.

Chair: I think that was fairly clear and pretty blistering. Does anybody want to qualify or challenge that? Don't feel obliged to come in if you all agree.

Richard Abadie: I am happy to make just a follow up. I will keep it a lot shorter, I promise. I guess, of your two questions, effectively the first one is: does the model need to be adjusted in any shape or form? I think every form of procurement can be improved, and I think through today you will hear of some changes we can make, and it is particularly around some of the risks that are allocated to the private sector that I think can be improved. It has come through in most of the submissions that you have seen. I can go into that later.

I think, around the discount rates—I have a lot of thoughts, and clearly I don't have Dieter's experience in regulated assets—I would observe that the discount rate is set and has been fixed for some time, but had

come down from a high discount rate of 8% probably back in 2003, I think it was. There is a real discount rate underlying that of 3.5% and there is an inflation assumption of 2.5% implicit in that. Inflation is not running at 2.5% now. I don't know what the long term inflation is; that is not my area of expertise, but if you simply treated the inflation element of that as a variable you would have a discount rate that is higher; more like 8–8.5% in the current market. That is not appropriate either, but I don't think that the discount rate in itself is going to solve or sort out any concerns you have with the PFI. Importantly, that discount rate does not only apply to PFI; it is applied to basic investment decisions made by Government in all sorts of areas. As contained in the *Green Book*, it is not a PFI-specific discount rate, so I think it is a much wider question than just for us in terms of the PFI.

Chair: Does anybody else want to chip in at this stage? Mr Friend.

Andy Friend: If I could go to the more general proposition: do we require radical surgery or more minor evolution? I think my answer, Chairman, would be that we need both at this point in history. Hopefully, we are moving beyond the world in which the off balance sheet tail was wagging the value-for-money dog. I genuinely believe we have done that. There were clear examples earlier in the decade—many of the written submissions to you refer to that—where there was distortion in the structuring of deals in order to achieve a particular accounting treatment. I think, in the position we are in at the moment, there is a raft of things that can be done, for example, in relation to insurance where perhaps inappropriate risk is transferred, where the public sector could act as co-insurer; also in relation to perhaps putting the Debt Management Office into a role in relation to managing the derivatives that enter into these deals. Also, to think beyond that, it is clear that we have had over the last 10 years an evolution in terms of the public sector, first through negotiation and then by contract, sharing in more of the refinancing gains. I think maybe we are now in the territory where the public sector might contemplate having a right to refinance the senior debt and the capital structure of such propositions when you get into the operational stage.

Chair: We will come on to that in a moment. Mr Wardlaw, any comments?

James Wardlaw: I only offer one thought, and that is that PFI has been an important tool in the past for procuring social infrastructure, and I make a distinction between social and economic infrastructure. A lot of the future spend, the future requirement, is going to be increasingly directed towards the economic infrastructure, by which I think we mean energy transport, those kinds of areas, rather than schools and hospitals and buildings. I think that as we look forward to the future, the role of PFI in relation to financing economic infrastructure is much more limited.

Chair: Andy Love, do you have some questions?

Mr Love: I am number 27 or 28.

Chair: Andrea, why don't you come in?

Andrea Leadsom: Same initials. Thank you, Chairman.

Mr Love: We don't look alike.

Andrea Leadsom: No, we don't. We are both relieved about that. Good morning.

Chair: Not as much as we are.

Mr Love: I don't think I can answer that.

Q4 Andrea Leadsom: I am unusually speechless; it is rare for me.

I want to press you a bit more on the off balance sheet financing. Mr Friend, if I get it right, you said you think the off balance sheet tail is no longer wagging the value-for-money dog, and I am still puzzling over that. Is it not the case that one of the biggest drivers for the continuation of PFI is precisely that, that it is still at a national debt level, albeit organisationally it is now off balance sheet? Nevertheless, in national debt statistics it is still off balance sheet. Don't you think that remains a big driver for PFI?

Andy Friend: It may at the national policymaking level. I think what I observed—and I was active in the market up to 2006—was that both at the programme and at the project level, the off balance sheet treatment contributed very much to the repeated phrase in the evidence before you: it was the only game in town, therefore we went for it. At the programme level, I believe in certain situations it encouraged over-consumption and decisions to be too lightly taken in terms of procuring very substantial capital assets, perhaps without due consideration of either the alternatives—of which there are many, much less developed in the UK market than elsewhere—or the long term obligations.

At the deal level, in terms of the single project as opposed to the programme, I think that the lawyers in the early part of the last decade were the sort of guardians of PFI theology. They were often confronted by people in local organisations who had neither adequate senior backing nor necessarily the commercial skill-base that was required, and PFI theology said you would transfer any risk you could identify, so we had things like energy tariff risk being transferred. Now, how a private sector provider of a capital asset is in a better position to manage energy tariff risk than a public authority with its potential buying power, I don't know. I will not bore the Committee by going through all the potential areas, but what I was referring to was that I think that was very much in play in an earlier era.

I think in the last few years my observation is that we have begun to move beyond that. The job of work still to be done is to stack PFI up within an analytical framework, with adequate backup from the centre, to decentralised organisations so it can be compared against joint ventures, municipal enterprise, local asset-backed ventures and the right blend of capital grant and debt raised in the private way, and I think we are quite a long way still, despite repeated recommendations from many committees such as yourselves and many NAO reports, from establishing that transparent framework.

Q5 Andrea Leadsom: Mr Abadie, in the submission from PwC you say, "If Government had previously required all PFIs to count towards national debt, there would have either been fewer projects—less investment in infrastructure—or higher national debt".

So, would you agree that the classification of debt has driven behaviour?

Richard Abadie: I do. I am with Andy on that. I think in the early days of PFI it was seen as an instrument to enable additional investment in infrastructure, and I stand behind the words, clearly, that I submitted. I think that if we had not done it we would have spent less on social and economic infrastructure.

I would touch on—if we jump to where we are today, though, looking forward rather than looking backwards—the Accounting Guidelines, and there are three different things we are concerned about. One is accounting, and that is where the phrase "balance sheet" comes from, really. We are looking at how departments budget, and we are also looking at national accounts, which you referred to, which are really statistical. In the submission I wrote, I did reflect on the national accounts side and the statistical side that the most important reason we prepare national accounts is not for internal UK purposes. We prepare them for European purposes to comply with Maastricht. When we do set the way we account for these on national accounts, it is important that we do set them consistent with the rest of Europe. Currently, the guidelines that are being followed both in the UK and across Europe are a set of guidelines called ESA95. CIPFA have commented in their submission to you that it may change, and I don't think we should jump ahead of that, because we do want comparability around debt across the rest of Europe, and if they do change, let's make sure we change consistently with the rest of the European countries, which is different to balance sheet accounting and budgeting. I am talking specifically because you have focused on that on the national accounting side.

Q6 Andrea Leadsom: Thank you. Professor Helm, if I could ask you: what is to stop, other than the implications for the national debt statistics, the Government from borrowing through Government gilts at a significantly cheaper rate than PFI providers could finance themselves in the private market, and lending the money to those projects? Would you not agree that the public sector is incurring quite a significant increased cost in PFI projects going forward, as a result of Government's requirement to keep this all off the national debt statistics?

Professor Dieter Helm: Let me unpack that. First of all, the important thing when people say "Is this off balance sheet?" is that there is no balance sheet for it to be off. It may be that that is in fact a requirement for the way national income accounts have to conform to EU and international standards. It does not stop you having a national balance sheet and being able to looks to see: what are the assets of this economy? What are the liabilities? Have we been running them down? Have we been depreciating them? Are we giving the next generation a decent set of infrastructure to pass on? Up until PFI, it would have been financed out of tax revenue so that the current generation would have paid, instead of consuming, to carry that forward.

Q7 Andrea Leadsom: Or borrowed it?

Professor Dieter Helm: Or borrowed it, yes, of course. The second thing is that it is not true that the investment would necessarily have been lower had there not been a PFI. The utility model, which is not on the cash terms of the Government, transfers to the state, once assets are completed, the regulatory and political risk and creates in the refinancing a regulator asset base. The water companies have carried out a very large amount of CAPEX, as have other parts of the privatised utilities, so there is a perfectly durable alternative model for doing this. It is just a different way of doing the contracting, but it takes the refinancing point—not the CAPEX risk, but the refinancing point—and takes at that point the risk away from the managers of the project, because there is nothing they can do about it at that stage. I think that is an important component.

You ask a third point which is: could the Government borrow it? Well, if the Government had a balance sheet, the Government could borrow as a liability and set that against an asset. Let me give you a hypothetical example; I am not proposing this, but let me give you a hypothetical example. Supposing the Government wants there to be 10 nuclear power stations in this country at £5 billion each. That is £50 billion over the next 10–15 years. Supposing it borrowed a fund called the Nuclear Bond Fund, and it borrowed £50 billion and it just asked the builders of those stations to bid for that money. So, it is the Government borrowing but the private sector is doing the CAPEX and the OPEX thereafter. It would currently borrow probably the negative real interest rate. The private sector for a nuclear power station may be 10% or 15% real. It doesn't take first year undergraduate maths to work out there is a colossal difference between those numbers, and why would we never even contemplate that possibility? Because it would be called a cash-in number of £50 billion in Government accounts. I am not advocating doing that, and I think my utility model and the revenue asset base avoids having direct Government borrowing for this purpose, because it addressed the central issue, which is the allocation of political and regulatory risk in projects where the difference between the marginal cost and the average cost is enormous, therefore, there are substantive sunk costs, therefore you require a long term contract and it is basically: who takes the risk that this Government or some future Government will behave like the German Government in, say, nuclear power, and simply just change their mind? That is the bit.

Chair: A very quick last question and a quick reply.

Q8 Andrea Leadsom: Yes. Sorry, to come back on that, just to be very clear, you are saying that the only reason why the Government would not do that is because of the impact on Government borrowing? That the only reason for not taking the advantage of Government's excessively cheaper cost of funds is because of the impact on the debt statistics?

Professor Dieter Helm: If it is direct financing, the answer to that is yes. If it is a utility model and creating a regulated asset base for renewables, nuclear and things of that ilk, much of the £200 billion, which is half the £400 billion-plus we need to spend by that

period of time, could be done without, in the current arcane accounting rules, mucking things up, but shifting political and regulatory risk through a duty to finance functions. The effects of this are truly enormous. Capital expenditure is about the cost of capital, the cost of capital and the cost of capital, and we are about to pay an enormous premium—in fact, we already are—on the renewables, the nuclear, and a whole host of other infrastructure, which will be a burden on future taxpayers and future customers.

Q9 John Thurso: Mr Wardlaw, in the paper you contributed: *Delivering a 21st Century Infrastructure for Britain*, you talk about the availability of debt finance. To what extent is the availability or the lack of availability of debt finance, its increased cost and the shortening maturity dates threaten the PFI concept?

James Wardlaw: I think that paper is now nearly two years old. I think we have seen through a number of processes since then that the availability of debt finance is materially improved, particularly on the sale of High Speed 1, which was a mature asset that did not involve any construction risk because it was already built. The level of interest from banks in participating in the backing any of the bidders was enormous and right back to pre-crisis levels. In terms of the cost of that finance, it is definitely higher. In PFI terms—and I have never been a PFI practitioner, I must say—the levels were 60 over swaps at the peak, and now we are talking 250 and more. I think it is very difficult to imagine in the environment in which the banks operate, which you know better than I do, in terms of capital constraints and so on, that it will not go back to those previous levels.

Q10 John Thurso: Would you say there is a shift between the pre-crash model and the post-crash model between bond finance and bank finance towards bank finance?

James Wardlaw: I think it is coming back again, but the appetite and the cost of much longer term finance from the banking community is very, very much more challenged, so the idea of commitments of 25–30 years to PFI projects is a lot more difficult and a lot more challenging for most banks now, and they have to compete for capital with other lending sectors in a way that simply did not operate prior to the crash, and they are having to do that against targets for declining risk-weighted assets as well. The pie is shrinking and they are competing for that.

Q11 John Thurso: Does that explain why the banks have shifted to a club arrangement rather than a syndicated arrangement?

James Wardlaw: The syndicated market will come back and people will be prepared to take—certainly for assets where there are a clear number of precedents, that will come back, but it hasn't yet and people are not comfortable in underwriting their ability to sell on to other participants at prices that don't involve significant losses. It is about confidence in your fellow banker, that he is going to step up to the plate in the same terms as you are.

Q12 John Thurso: The likelihood is that the step change in the cost of capital upwards is probably locked in for the foreseeable future?

James Wardlaw: Yes, and also that the willingness of people to finance remains quite short and, therefore, for the mature assets once they are in—the are post-construction, the desire to get it into the capital markets and funded by institutional investors and money managers, in the way that I have described in the paper, is absolutely the way forward because you will not be able to get that 30-year commitment otherwise. It does raise an important issue in the context of refinancing the risk and the response to the notion that PFI debt is very expensive. One way of getting around that is in a sense to finance, with bank finance, the construction period and, once it is financed, recognise that the risk profile has changed significantly and then refinance that into the capital markets with the institutional market. But the public sector procuring authority is then taking that refinancing risk and the risk that interest rates will be significantly higher at that point in time, even though the spread—the margin—may be significantly lower because you have substantially de-risked it. That is a second order issue relative to the risk that interest rates rise significantly over the next few years.

Q13 John Thurso: The cynic in me, having dealt with a lot of bankers over the last few years, says they will be doing everything possible to make the maximum profit out of the risk they are assuming in the early part, and that that is the real challenge.

James Wardlaw: I think that the first stage period is the most challenging part from a financing point of view, because the number of people who are interested and willing to finance green field construction is a materially smaller number than the number of banks and other financial institutions, institutional investors, who are prepared to finance it once it is constructed.

Q14 John Thurso: Taking on the point that Professor Helm was making earlier, is that not precisely where the fact that Government could be involved—Government can deliver the best possible value because it can make such a material reduction in cost in that early phase—should outweigh the risks? In fact, it is almost impossible to transfer sufficient risk to make a saving for Government.

James Wardlaw: I think, in pure financial terms, that is purely in terms of the cost of debt finance, but I think we should not lose sight of the benefits that come from the procurement process in the early stages, which involves looking at the whole life cost of the asset and a greater focus on what it is that you want to procure before you sign the contract. That has typically been the case in the context of—

John Thurso: Let me come to Mr Abadie, because that is—

James Wardlaw: I think it is more his territory.

John Thurso: Exactly. Let me move on to him, because that is precisely the point that you make in your submission, is it not?

Richard Abadie: I will have to come back just to answer that. James has said quite a lot about the debt markets and the capital markets, and I did not want

to lose one threat that you highlighted, which is the difference between, say, the bond markets and the bank markets. While we are raising finance in the UK for some of these PFI deals and infrastructure deals, most of the organisations that invest or lend to our transactions are global entities. They do this all over the world. I do business all over the world in the infrastructure space, and while James is exactly right that there has been a decrease in debt availability and prices have gone up, most of the projects we are involved in do get funded, so it is not as if there is a massive imbalance between supply and demand for finance.

In the UK, given that we are cutting back on the amount of PFIs we are doing, as you cut back on the amount of demand for debt you are going to find that the supply exceeds the debt and prices will come down. They will never come down—and this is not a PFI issue—to the levels pre-credit crunch. That was a phenomenon that we are never going to experience again, at least in my working career, of credit margins on deals, be they mortgaged deals, be they infrastructure deals, be they corporate loans, in the 20 to 50 basis points. It is not going to happen again. I do think we are in a world of more expensive debt.

The other thing I would just want to touch on is: in terms of the capital markets, a lot of the reason the bond markets were active in infrastructure in particular, and other markets, was around structured products. A lot of the risk that you would have found, for example, in PFI deals pre-credit crunch—if you had capital market investors or capital bonds being issued on the back of projects, the risk was underwritten by the monoline insurers. I am sure this Committee has debated that before. They have gone. There is nobody prepared to take that risk, so we are back into a predominantly bank market. James is spot on; around the world, a lot of the logical way to fund infrastructure is in the bank markets during the build phase, and take it out in the capital markets.

Back to your question, though: doesn't it make sense for Government to fund the asset in the early days? I would hypothesise the inverse, actually. One of the clear benefits of contracting out to the private sector is the transfer of construction risk. Let them build it, let them give you a fixed price for it and if something goes wrong—and Andy has a lot of examples of these. He has personally been involved in—

Q15 John Thurso: One point there: absolutely, you do a design and build to a fixed cost and stand back and say, "Get on with it", and the private sector does that and builds a golf club house. It is what you do. What is special about the fact that you also have to get them to do the financing? Why can't you separate the financing from the transfer of the risk? That is a contractual element.

Richard Abadie: I think that is a very good question. One of your panel members in the next session is Steve Allen from TfL, and he will touch on that. What you need are sophisticated procurers. It is all fine entering into design and build contracts, but you need to be able manage that contract to effectively avoid blowback risk coming back on yourself. We have a number of examples, and the most recent one is the Edinburgh tram project up in Edinburgh, where costs have just gone totally out of control. The asset will not be delivered, if you believe what you read in the press, and it looks like £350 million will have been lost net-net. Design and build would not necessarily have helped, because the procurer was unable to transfer that risk to the private sector and make the risk stick.

Q16 John Thurso: Just to—because you can always come up with one example on one side—look at the NDA contract for the decommissioning of Dounreay and the way in which it is being done, and you have a hopefully very fine procurement, which is driving costs down and shortening the time of decommissioning. It is the mechanics of how you do it, not the finance. That is what I am trying to separate.

Richard Abadie: I will put it slightly differently, and there are key points here. One is: do you have a sophisticated public sector client who can insure the risks that seek to transfer through contracts are borne by the contractor? If you believe that, and I believe TfL is such an entity, you are in a very different place where you can, on balance, leave a lot of the integration risk with the public sector entity because they can manage the risk themselves. When it comes to the finance, the analogy I would draw around PFI is that either the taxpayer bears the risk of something going wrong or the financier does, and it maybe not that binary that it is one or the other, but the difference with the private finance is that if something does go wrong, you at least have somebody else taking the risk besides the taxpayer. There are examples, and I am sure you will appreciate this, if somebody offers you a design and build price and then goes bankrupt, and it is that type of risk that you are trying to head off. It is not only the building risk, the physical infrastructure building; it is the risk of something going wrong with the actual supplier. We have had examples even in the PFI area where people such as Jarvis went into liquidation—they went insolvent. The question is where did those risks wind up. There are examples where the equity and the debt in these infrastructure projects took that risk.

John Thurso: If you look at the banking crisis, you could say it has come back to haunt us.

Chair: It has.

Q17 Michael Fallon: Mr Wardlaw, you distinguished between economic and social infrastructure. Just taking social infrastructure, how much risk transfer really takes place when the Government has taxpayers and voters to hold them accountable for the future of a school or a hospital?

James Wardlaw: I am not sure this is the question best asked to me because I am not a PFI practitioner and therefore in terms of the risk transfer—I think that there are two major risks. Clearly, there is the construction period and the period up to construction, and then once it is operational, then the risks are once it is operating. One can have a view in certain of these situations where you are producing a fairly standardised product that those risks are de minimis and are reduced over time as you do more and more schools and more and more hospitals. I was struck the

other day talking to a fellow at Barclays who mentioned that they had had no problems at all with one of their projects until year eight, when some operational problem blew up and it had a material impact on their economics. So, I don't think we should be dismissive of the fact that there are quite substantial risks even at the low risk, low return end of things. I would not want to suggest that they are completely without risk but, Andy, you and Richard are probably better placed to comment than me.

Andy Friend: I think one of the tests about whether risk has actually been transferred is the corporate history that has in a sense already been referred to. There was a comment in the recent NAO paper, "Lessons from PFI and other projects", which said that maybe the taxpayer was paying for risk transfer that was not being achieved in practice. I think one does need to distinguish between what risks there are. It is not risk in globo, and clearly the risk of procuring the wrong asset for your public service or the risk of in extremis having to step in to make sure that the public service still continues to function cannot ultimately be transferred, but what can be transferred are many of the construction phase or long-term operational risks. I was Chief Executive of John Laing Plc when a project that had been entered into in 1998 went badly wrong, the National Physical Laboratory. We booked £68 million of losses on that. Sir Robert McAlpine, £100 million on Dudley Hospital. One can work down the list of Mowlem, Skanska, various losses, particularly in the sphere of publicly listed company reporting, it is clear where PFI losses have indeed crystallised, but under other procurement forms most likely—and I take the fact that there has been improvement in many of the mechanisms—they have actually been to the public sector account and have involved much greater additional cost in terms of getting those projects operational.

Q18 Michael Fallon: What about the other side? There has been some research on some of the earlier hospital projects that showed significantly excessive rates of return achieved.

Andy Friend: I think that is right, and the research certainly demonstrated that. You will recall I am sure that in the early days of PFI it was only by negotiation at the time of refinancing that the public sector got a share, and that was for deals. I think before 2002, most were about 25%. It then went to 50% and is now more commonly 70% by contractual right. I think that when we talk about PFI, with the benefit of 19 years of experience, the structure of public services has gone through many changes: the contracting industry has changed in many different ways; the interplay between the bank and the bond markets, and in one sense the vintage of experience is very important, and regarding the particular extraordinary gains that were highlighted in the first few years of the last decade, my belief is they are not occurring in the same way now and that there is greater transparency, visibility and contractual rights.

Q19 Michael Fallon: What was the effect of those excessive returns in the early years? If PFI was so profitable then, why didn't we seek more competition for this kind of investment? Why didn't we see those rates coming down more rapidly? Why didn't we see construction costs, which still seem very out of line here compared to other European countries? Why didn't we see those falling?

Andy Friend: If you are sitting on a public company board or even a private company board and you are looking at the equity participation in these projects, you are considering not only the rate of return that you may earn from a particular project but you are also considering the costs of business in terms of participating in that market. So, you are also looking at the cost of failed bids, and I think the CBI submission—or is it the Major Contractors' submission—refers to £12 million for an average hospital bid to £2 million for a school bid. We at Laing thought we were doing well if we won 40% of what we were shortlisted for. So, you are writing off those. I think that there is a history that everybody in a sense must 'fess up to, of a lot of programmes being begun under PFI that were either then radically changed or where projects were cancelled at a very late stage, so we had a number of projects that were cancelled after considerable expenditure of being in the preferred bidder phase when you are doing all the detailed design and mobilisation.

However, pressure of competition did bring equity rates of return down. From my own experience, I know that from what was being bid in the mid teens for an equity rate of return, the pressure of competition was driving people to put in bids at 10% and 11% a few years later. I am not sure how it has evolved since, but that certainly was a progression.

James Wardlaw: I think it is also important that a lot of those refinancing gains were driven by the falling interest rates. In the current interest rate environment it is far more likely, I would have thought, on the balance of probability, that interest rates will start rising again. On the refinancing gains of those early years, the same conditions don't really apply.

Q20 John Mann: I am struggling with your answers, Mr Friend, because if you take the PFI schools, they are all off the peg. They are not bespoke designs. The PFI schools are all off the peg; "Here's what you get". I am struggling to see any risk being transferred in building a school. Professor Helm, perhaps you can correct me, but it looks to me very straightforward: "Here is the school; here is land. Off the peg, here's the design. How many do you want?"

Professor Dieter Helm: I have a lot of sympathy with that question because I think there is a basic confusion going on here. The state will always be using the private sector to do things, whether it be to do cleaning or to build buildings, to build schools or to build hospitals. That is called public procurement. There is a huge amount of public procurement goes on, and if you want a school built then you specify what it is, you specify where it is and the state may be good or bad at doing procuring: it may not specify it properly; it may make it too rigid; it may make it too small; it may make it too big, but you could have endless inquiries into public procurement, and much of the comments we have heard are about public procurement. The PFI is a special kind of public

procurement. It is called private finance initiative, so it is a procurement that requires you to do the financing as well, and it pays you back with a service contract that lasts for the life of the asset. This puts together OPEX, and you might well want to contract out running a school, in terms of cleaning or building maintenance or whatever. You can separate that. You can separate the capital job, and of course the private sector's risk, once it has made a bid and it says, "I will build you this school for £1 million", is to deliver on that budget. The financing bid is what adds to the cost here, and the point that James made is absolutely right. When we start to look at what the total lifecycle returns of these projects are, it depends on exogenous things like whether the interest rate falls. Why? Because refinancing is of the essence of what is going on here. You do your capital project, you try to do it for the budget, you do your project finance, you do all that stuff, and when you have finished, it is finished, and that is the refinancing point. That in the utilities is the point where the asset goes into a regulatory asset base and then earns just a marginal cost of debt, which is very much lower than the marginal cost of debt that is being done in these businesses, and you might take a bonus in it if it turns out the interest rate is lower than you anticipated.

Q21 John Mann: There is an additional downside, isn't there, and the additional downside is that if it was traditional public procurement, if you specify wrongly, you have the control that costs you to re-specify.

Professor Dieter Helm: Yes.

John Mann: So, for example, if in PFI you build a swimming pool that is wrongly designed and, even though it is off the peg, your PFI contractor doesn't spot it either and it is built, you are stuck with that with PFI for 25 years.

Professor Dieter Helm: That is precisely the point, and essentially what PFI does—and even PPP as in the case of the London Underground contracts—is it bundles together lots of different aspects in a project into a fixed project, and the point here is that the Government and the state is such an incredible or non-credible contractor to the private sector. There is always the incentive they might come back and change things differently, but people want a very rigid contract. That is why you get these long periods of contract where you can't do anything about it and if you want to change anything you pay some huge sum for some apparently trivial change in the frame, and there are many examples of that.

The solution to that problem is to take the point of the construction completion. You built your hospital; you built your school. Now, in the more RAB-based model, it reverts to a refinancing where there is an assurance you can finance the functions, and then you have control over the assets. Water companies don't say in the utility model, "Oh dear, we can't change the operation of a sewage works for 35 years or the charging base that falls through to customers because we signed a 30 year or 40 year contract and that is the way we are getting our money back". The other side of this is that when you do a construction of public procurement, the thing costs £1 billion or £1 million and you pay that sum. It is done. In this game you don't get the money back except out of the service costs that come through for some time in the future.

Q22 John Mann: Therefore, that element of risk—the risk that you have your design wrong, say, on the swimming pool—isn't transferred. It is simply lost. It disappears because you can't do anything about it. Isn't the fundamental problem, taking the schools as an example, that the same public servants who would be dealing with public procurement and may well have got it wrong in the past are precisely the same public servants, say, in the local authority, wanting the new schools and getting the credits, who didn't have the expertise or the specialism to do so and, therefore, were getting carried away with, "This is the only game in town. Here's what you have. Here's how much it will cost you, and we're buying off the peg", not understanding precisely what they were doing. Isn't that lack of capacity in public sector procurement a key part of the problem that we have had?

Professor Dieter Helm: I think the point I was making is rather separate from that and I wanted it as a separate structural point about the design of these things, as opposed to the quality of the people making the decisions. There is clearly an issue about how good people are at doing public procurement, but I have no expertise to criticise particular abilities of particular groups to make those decisions. It may or may not be as you describe.

Richard Abadie: Mr Chairman, could I follow up on that? I can't leave some of those comments unanswered. I don't think we have time in this hearing to go into a full debate about RAB versus PFI, but I would like to comment on something Dieter said. We have maybe forgotten that most of the infrastructure in this country, including the assets that have found their way into the Regulatory Asset Base, were built by Government. They were not all built by the private sector. They were privatised at a point in time with a massive asset base and then handed over to the private sector to manage, operate and upgrade. The other thing is that those are customers paying for those assets. At some point in time, school pupils and maybe patients in hospitals will pay for these assets. I don't believe it is going to be any time soon, but when that happens then we can start looking at some of the benefits that Dieter is alluding to.

I would like to come back, though, which I can't let go, about your swimming pool example. Under PFI, Government does not have to pay for that asset until they are happy with the asset. So during the construction phase, if it is badly designed, Government at the end—and they may or may not do so, it is entirely up to them—have to inspect the asset and decide whether they are content with it. If they are content with it, they sign off and they start the payments. Bear in mind they now pay for this asset over 25 years, so for the sake of argument if, in James' example in year eight, it springs a massive leak because of a defect, under the contract the Government can cancel the contract. That does not mean it is without cost, but they can cancel the contract.

Q23 John Mann: They can cancel it if it is a leak, but if it is wrongly specified at the beginning—
Richard Abadie: By whom?
John Mann: By whom?
Richard Abadie: The question is: by whom? You mean the public sector has wrongly specified the asset?
John Mann: Yes, and the contractor has wrongly assessed it as well.
Richard Abadie: Why would they—
John Mann: Why would it happen? Incompetence somewhere, but the point is that with PFI, there is nothing can be done. The risk of that mistake does not transfer anywhere.
Richard Abadie: I guess we may be disagreeing here. In public procurement, if the public sector incorrectly specifies the condition of the pool and the pool leaks later on, the Government has that risk. The Government probably will have to dig up the pool and replace it. We have an example, specifically, I think, in Tower Hamlets, of one construction around a poor piece of infrastructure. Where it was procured, the costs have absolutely blown out and the pool has still not—
John Mann: No, with PFI, in the middle of the contract, you can't do that, and that is the point.
Richard Abadie: You can.
John Mann: No, you can't and—
Richard Abadie: There are variations of contract.
John Mann:—indeed, if you take the eight PFI schools in my area, when precisely these kinds of problems occur because of the nature of the PFI contract, you cannot then re-specify. You are stuck with what you have. If there is a mistake, yes; if there is a hole in a swimming pool, of course you can, but if there was a mistake within it, if the school needs to change size for example, or whatever else, you can't do that within PFI, and that is a weakness within the system.
Richard Abadie: There are variation mechanisms in the contract—and I know because when I was in the Treasury we wrote some of them—that allow you to vary the contract. I think you are touching on—
John Mann: That depends what the various mechanisms are. That is the very point. That is the very point, that you are tied in with PFI, and once you are tied in there is nothing you can do beyond that.

Q24 Chair: Whether or not you accept that the contracts can be altered, do you agree that there has been excessive profitability, Mr Abadie?
Richard Abadie: I would say—and I think I put it into my submission, although I can't remember the exact words I used—that in the early contracts, and I think I used the phraseology of something like the investors of those early contracts have made returns beyond what they could have reasonably expected, and I believe that honestly.

Q25 Chair: But not any more. We are all in signing up plans now, are we?
Richard Abadie: There are two things: one is that there are very few contracts being let but, more importantly, you have a very tightly competed regime. So you have defined contracts, defined risk allocation and, effectively, if you go back to the point that it is well understood what you are bidding for, you have full competition on construction, operating expenses and interest in negative terms.

Q26 Chair: With great respect, you make money selling these projects or advising on these projects, don't you?
Richard Abadie: It is a very small part of our business. I do work on PFI, but as I think I put into the preamble to our return, my business makes money on advising Government on any procurement. PFI is one of the areas we work on. Currently we are working with the Ministry of Defence on fighter aircraft and submarines, which are upgrades that have nothing to do with private finance.
Chair: You did not mention aircraft carriers there.
Richard Abadie: No, no, I avoided that one.

Q27 Jesse Norman: Mr Abadie, how many PFI contracts has PricewaterhouseCoopers advised on in the last 10 years?
Richard Abadie: Globally, it is about—
Jesse Norman: No, in this country.
Richard Abadie: I don't have the number. I can come back to you if it is handy.
Jesse Norman: Is it 10, is it 50?
Richard Abadie: No, no, it is substantial.
Jesse Norman: 100?
Richard Abadie: It will be more than that. I didn't want to give you a number guessing. We and our competitors would have advised the public sector on most of the contracts that have taken place.

Q28 Jesse Norman: So if there have been 600 then, between four of you, you might have done 150 or 200 yourself?
Richard Abadie: Easily.
Jesse Norman: You will be on one side or the other, so if there are 1,200, you might have done 400 contracts?
Richard Abadie: We are not involved in all of them but, yes.

Q29 Jesse Norman: Thank you for that. Could you tell me: how much have those contracts earned for PricewaterhouseCoopers over the last 10 years?
Richard Abadie: Again, I have absolutely no idea.

Q30 Jesse Norman: What would the average value be of a contract to PricewaterhouseCoopers?
Richard Abadie: I can talk about the current environment because it is very current. If there were BSS schools still taking place, the public sector would procure financial advisors and they would probably get £250,000 to £400,000, normally on an incentivised basis, to advise on a school.

Q31 Jesse Norman: On a school, and how much on a hospital?
Richard Abadie: Again, we haven't done hospitals for some time, unfortunately, so I can't give you an answer, but it would probably be more than that. It may be £500,000 to £800,000.

Q32 Jesse Norman: Would that have been the same, say, in 2007?
Richard Abadie: Again, I can't comment. I would have to go back and look at that data. I would emphasise as well, just to be clear, that is over the life of the procurement from business case through financial close, so that is probably over a three to five-year period.

Q33 Jesse Norman: All right, but if there were 400 projects you advised on and, say, they earned £500,000 each, it would be the order of £200 million to £400 million?
Richard Abadie: No. Certainly not.
Jesse Norman: Less than that?
Richard Abadie: Yes, so again, maybe the 400 is wrong. I don't know where you want to go with the questioning, but I am happy to take that if—

Q34 Jesse Norman: No, let me tell you where I want to go. How much have fees declined over the last 10 years?
Richard Abadie: Hugely.

Q35 Jesse Norman: What would they have been 10 years ago?
Richard Abadie: Again, I don't know. What I can tell you is that again, like Government, it has become a sophisticated procurer in the public procurement space, and become very sophisticated as to how they appoint advisors. Our rates in advising the public sector have come down materially. Government, through OGC and other initiatives across Government, have framed their contracts where they complete with their advisors and retain them on agreed rates.

Q36 Jesse Norman: Would you be willing to submit some aggregate numbers for the amounts of money you have earned on PFI in this country over the last 10 years?
Richard Abadie: Probably not. I believe that is commercially confidential. If you would like it in private, and it would not be disclosed otherwise, I would be happy to have that conversation.

Q37 Jesse Norman: That would be helpful and I appreciate that. Would you be willing to work with the Treasury, and encourage PwC as a whole to work with the Treasury, on the Code of Conduct that it is seeking to arrange at the moment?
Richard Abadie: As James would know, we have people on secondment to Government on a regular basis, including myself at a point in time. We had some—

Q38 Jesse Norman: Do you have somebody in Treasury at the moment?
Richard Abadie: We don't have somebody in Treasury. We have somebody in the Ministry of Defence helping them with looking at their contracts and how they can reduce the cost of those contracts.

Q39 Jesse Norman: You would be prepared to talk to them about how fees could be part of that yourselves?
Richard Abadie: If you are specifically referring to the Treasury, we talk to them all the time. That is the nature of the market.

Q40 Jesse Norman: That sounds like a yes. Thank you.
Professor Helm, just very quickly, was it your recommendation that the Government should be looking to set up a proper national balance sheet over a period of time?
Professor Dieter Helm: Yes. I proposed that some time ago, and indeed I have done a little bit of work with the Treasury to try to make progress. I can't say it is going a long way, but the usual objection is, "Well, there are these international standards we have to abide by". My response to that is: it is illustrative to start to construct a national balance sheet to see what the assets and the liabilities are. It tells you, for instance, what our true deficit might look like. I have no idea what our financial deficit in this country is, because I don't know whether we have just been eating up assets and depleting our infrastructure or not. We depleted all the North Sea and that doesn't show on any accounts. The question here is twofold. One is: it would help the Government to understand what the financial position in this country is, but secondly, it would sort out the difference between current spending and capital spending, and it would make a lot of sense for us to engage in the £500 billion of CAPEX that is required. If we are creating assets against that, that is a different kind of problem than our current spending, and I wanted to make one point: nothing that we are currently doing gets anywhere near approximating the level of CAPEX per annum in the infrastructure generally that the Government's plans and the previous Government's plans require. We are adrift by at least a factor of 2, so if you want to carry out the infrastructure, you have to will the means as well as the ends.

Q41 Jesse Norman: Thank you for that. I am conscious of the passage of time, so I would be very grateful for very quick answers. Do you think it would be a good idea to have a right to demand a refinancing at the point that construction risk ends in a contract?
Professor Dieter Helm: Yes.

Q42 Jesse Norman: Thank you. Do you think that the Government's high discount rate historically prejudiced procurement in favour of PFI?
Professor Dieter Helm: Probably.

Q43 Jesse Norman: Thank you. On a regulated asset basis—
Chair: You are doing very well.
Jesse Norman: I am sorry. If you would like to write to us, obviously we would be very grateful for that. You have written very eloquently about regulatory asset bases, and you have talked about it today as a concept. Is it the case that the kind of financing you have in mind would be cheaper than PFI but more expensive than Government borrowing?

Professor Dieter Helm: It would be substantially cheaper than PFI. It is not clear whether it would be at or above Government costs of borrowing.

Q44 Jesse Norman: All right. Can we have some indicative numbers as to the kind of levels you have in mind?
Chair: You can write to us.
Professor Dieter Helm: The answer to that question is: look at the costs of refinancing on regulatory asset bases, which are currently trading at 25% above in the utility sector. That gives you a very clear indicator of the numbers. They are much lower.

Q45 Jesse Norman: Are you comfortable that the regulatory asset base concept could be extended to procurement, which does not involve users as, for example, most utility procurement does?
Professor Dieter Helm: Yes, certainly, and that is why I disagree with Richard very strongly. It is important to distinguish between customers and taxpayers but, ultimately, it is a question of revenue flow and the degree of security that attaches to that revenue flow. The problem in PFI, in many cases, is that the revenue flow depends on Government directly rather than indirectly via a regulated body. I have thought of the institutional structure to overcome that, which is my view about what a national infrastructure bank should look like. It is more serious in the taxpayer case. That is why the gains from what I am proposing would be much bigger in the PFI territory than in the conventional territory that is recommended, and these are very substantial differences and it is the cost of capital that really matters in infrastructure spend.
Jesse Norman: For the avoidance of doubt, it is tens of billions of pounds in the short term, hundreds of billions of pounds.
Professor Dieter Helm: Take my little trivial example about the nuclear power stations. Just do the maths. 1% on the cost of capital on £500 billion is an enormous sum.
Jesse Norman: Even by PFI standards. Thank you.
Chair: One last question.

Q46 Jesse Norman: Thank you for that, Mr Chairman. Is there not a danger, since RAB, as you have described it, would also be off balance sheet, that it could also be used to disguise future costs in the way that PFI has?
Professor Dieter Helm: You say "off balance sheet". There is no balance sheet. When I have my national balance sheet, if ever it was done, so we could look at the state of our economy, you would treat the RAB as part of the assets of the country against which the liabilities are set, so it is the other way round. We are definitely going to put all this lot on the balance sheet, right? It is the national balance sheet, not the national cash position, and we are going to look at the liabilities and we are going to look at the assets, and we are going to see whether this generation is treating the next generation decently in providing for the depreciation of the assets properly—maintaining our roads, our schools and so on—and providing the CAPEX going forward. So it is all on the proper balance sheet.
Chair: This really is Jesse's last question.

Q47 Jesse Norman: Right, but if I may say so, that is an equivocation, because I take the point, but you are surely not tying your recommendation about RAB to the creation of a balance sheet in the national accounts. This could go ahead as it is.
Professor Dieter Helm: Absolutely.

Q48 Jesse Norman: Good. So the question is: could the same kinds of fiscal distortions that we have seen with PFI arise in RAB, given the way the accounting treatment works or the statistical treatment works?
Professor Dieter Helm: The answer comes back to the question that, I think, Mr Mann asked, which is: in the model I am describing, the focus is on getting public procurement right. Can I guarantee that my approach gets public procurement any more right than PFI? Slightly, yes, because I am only doing the procurement and not confusing it with the finance. So it will be better, but will there still be mistakes? Yes, and that is for committees like yourselves to work out how we can do public procurement in general better, but it is a consequence of failure to do public procurement right, not the added specialism of this peculiar kind of public procurement, which is to bundle the finance and fossilise the contract and put in the inflexibility that costs us so much both in terms of the efficiency of the project and in terms of the cost of capital that really matters to this country. Now we really do have to do something about our infrastructure.
Chair: That was not quite as good as your earlier ones, but it was very interesting.

Q49 Mr Ruffley: Thank you, Chairman. Mr Wardlaw, your paper in 2009 for the Policy Exchange talks about a UK infrastructure bank. How would that be an alternative to the PFI deals we have been talking about this morning?
James Wardlaw: I think we are sort of getting it. It is called the Green Investment Bank. It is clearly focused on renewables and green energy, which is a particular requirement of our economic infrastructure at the moment. What I hope for the Green Investment Bank is really the question I think now, two years on, in this respect. That is that I would hope it will play an important role in facilitating private finance, private sector capital, and that it will not just be about how it can dispense or invest £3 billion of its equity. It is about how it can mobilise and facilitate the private sector capital that is required for that investment.

Q50 Mr Ruffley: I am not quite clear, with respect, how that model improves conventional PFI and how it is different from conventional PFI.
James Wardlaw: I think the nature of the assets that we are looking to invest in as a country and create to meet the renewables target and so on has a very different set of risks to—

Q51 Mr Ruffley: Perhaps you could describe those, because I am interested in your proposal.

James Wardlaw: An offshore wind farm is a very different risk proposition to a school, and the nature of the risks that you are entailing as a contractor, both in the construction and the operation, are very substantially different. There is a lot of technology risk in some of the renewable areas, which is frankly unproven. Building a school or building a hospital is again, I am afraid, a very different proposition. The nature of the risks that the private sector would be taking on in that context I think are very different to historic PFI, if I can put it like that.

I do think that in terms of—and I come back to the original comment—the distinction between social and economic infrastructure, the economic infrastructure is really about where public spending is being directed and public sector investment. This Green Investment Bank has an important role to play, I think, in mobilising the private sector to invest capital in this sector.

Q52 Mr Ruffley: How will it differ from the kind of conventional PFIs that we have been talking about this morning?

James Wardlaw: Because of the capital structures, I think the nature of risk transfer is likely to be very different. Your conventional PFI transaction with 25 or 30 years on a 90:10 capital structure with a unitary charge that is payable by public sector authority, that standardised PFI formula, I don't think is necessarily appropriate for early-staged or even developing technologies in the renewable space for offshore wind, or whatever. I don't see the—

Q53 Mr Ruffley: Perhaps Mr Abadie can shed a bit more light. The conventional PFI that we have all been used to and we have been talking about today: is that a thing of the past? Do you think, this infrastructure bank, not just for renewables but for other forms of procurement, is the way ahead? Can you perhaps give us a sense as to what the differences are and what the advantages are, rather than traditional PFI?

Richard Abadie: I would start off by saying I am supportive of an infrastructure bank as well.

Mr Ruffley: Fine.

Richard Abadie: So I have no disagreement with James. At the end of the day, a bank is a source of capital. The question is—back to Dieter's argument about a RAB—what the cost of capital is. It is conceivable that if the Government set up an infrastructure bank, probably owned by Government, so it may count towards Government debt, which is a big question in its own right, it is likely to be able to borrow cheaper than you can borrow money at an individual project level for PFI.

To take us slightly away to PFI to where James was going in the renewable space, banks do not like lending to development renewable assets. I think what you are finding is if we do set up a green—

Chair: Why is that?

Richard Abadie: James touched on it: technology risks and everything else that comes with it.

Q54 Chair: Where are the risks going to go in these schemes that you are planning?

James Wardlaw: Equity, much more equity. A conventional PFI has a 90:10 capital structure. It has 10% equity. I think you will find in a lot of these renewable projects, where there is uncertain technology, you need a lot more equity risk than that.

Richard Abadie: Just to touch on that, James, it is even being done on our big utilities balance sheets right now, so arguably all equities.

Q55 Mr Ruffley: So which other utilities are you referring to?

Richard Abadie: Centrica, EDF. Those are the guys that are developing a lot of the renewable energy that we are creating at the moment on their balance sheet. PFI, to simplify, is a non-recourse structure. People put their money in and if it goes wrong at least there is no recourse to their balance sheets, arguably. On these deals you find the big utilities having to develop renewable infrastructure on their own balance sheets rather than using increasingly highly leveraged structures.

James Wardlaw: The UK banks probably have between 70% and 80% of their lending books in onshore wind. The rest of it is a very small proportion of the total, so the bank debt is a relatively small proportion of the total capital structure of these deals.

Q56 Mr Ruffley: Can I ask you to venture an answer to this question? If it is such a new and welcome model, why has it not been used before in this country, do you think? Mr Wardlaw?

James Wardlaw: Why hasn't the idea of a national infrastructure bank been used before?

Mr Ruffley: Yes.

James Wardlaw: Well, I think to some extent we have suffered without. Many other countries in Europe have benefited from having a national infrastructure bank or a state development bank: KfW, Eco in Spain, and CDC in France. I think that it has been an important part of the armoury of tools to enable infrastructure to be constructed in a public sector context.

Q57 Mr Ruffley: Would you say that HM Treasury are 100% supportive and 100% enthusiastic about the Green Investment Bank?

James Wardlaw: No, but you would have to ask them. You would have to ask them, and I used to work there as—

Q58 Mr Ruffley: You used to work at the Treasury, and I am just asking you to give us an educated assessment as to why, if this is such a great alternative, and you have been advertising its benefits and advantages, it is not being enthusiastically embraced by HM Treasury?

James Wardlaw: This Committee—

Mr Ruffley: No, it is a serious point: the kind of technical objections that a Government Department might have with this proposal and this model.

James Wardlaw: I think that their concerns go to the heart of the issue about regaining control of the public finances. That is fundamentally the issue here. It is about the state of the public finances. £3 billion of equity is a massive commitment to the Green Investment Bank in the context of the state of the

public finances, and I think that that is the primary driver.

Q59 Mr Ruffley: So you think it is a problem with deficit reduction rather than with the actual workings of the model?
James Wardlaw: Correct.

Q60 Mr Ruffley: Final question for Professor Helm: you spoke very eloquently about intergenerational equity issues, and I am very struck by what you said. I just have this question: you are quite right to remind us that we don't have a proper understanding of the assets of the UK right across the piece. How difficult can it be to draw up that set of assets on a national set of accounts in a fairly reliable way? That is the first question. The second question is: have you spoken to Ministers about this? Because I notice that you advise DECC and you advise Defra, and it struck me as a very large lacuna in British policymaking, and I wondered whether it would it be very expensive to do, and what have Ministers said about the concept?
Professor Dieter Helm: It depends whether you want a perfect set of accounts. Then it is really difficult. In practice it is to just get on with it. "Let's have a look at what has happened to the oil Let's see what electricity networks looks like. Let's have a look at the water networks." You just do it pragmatically. We are never going to get a perfect replication of the assets in this economy, but we get a pretty handle on the big items pretty quickly and we can tell whether we are depreciating rapidly or not. So, the answer to that is it is not difficult.
Secondly, have I talked to Ministers and others about it? Yes, I was one of the three advisors to the project set up under the National Infrastructure Plan. It is in there. They would look at extending the RAB-based model; I have been working on that. In some sense it would be quite reassuring to discover that there is some sort of huge flaw in this idea and some reason why you can't pursue it.
Mr Ruffley: Yes.
Professor Dieter Helm: My take on this is nobody disagrees, in principle, it is just they don't like the fact of what it might reveal. Think about it. Supposing it is true, supposing that we have been running down infrastructure for the last 25 years in this country at the same time we have been expanding our public debt, and so on, supposing our electricity system is not fit for purpose, supposing our water system needs to be investigated, supposing our road system needs upgrading, supposing our rail needs to be done, supposing we depleted the North Sea, then what it would reveal is we are much worse off than we thought we were, because essentially our underlying asset base has shrunk but we have tried to keep our spending up higher. This is, in that sense, quite a can of worms for people to look at, because it raises profound questions about how we are, in our generation, tailoring our spending to the needs of future generations. We should hand on the infrastructure. That is the most basic sense of a sustainable economic policy, so I suspect that what it might turn up maybe somewhat alarming to some, but can we do it? It is pretty straightforward. Is there any objection in principle? How could there be? How could you not want to know the answer to this question?
Chair: It is a pretty big can of worms that you are proposing to take a look at. We are going to concentrate on one small bit today and in this inquiry, which is on PFI. I am going to try to bring in Andy Love, finally.

Q61 Mr Love: Finally. I start from the proposition that, even accepting some of the improvements that Mr Abadie particularly was highlighting earlier on, any objective assessment of PFI suggests that, in terms of value for money, it started off poor and has deteriorated significantly, with little prospect—for the reasons outlined about financing—that that is going to improve. In those circumstances, what I want to do is to investigate, first of all, the feasibility of some form of PFI rebate, some renegotiation, to gain for the public sector some of the benefits that have accrued to the private sector. Mr Abadie, you are very much involved in this. Is that practical, feasible and sensible, in the circumstances?
Richard Abadie: It is a question that is clearly on a lot of people's minds in the private sector at the moment. The honest answer is Andy is probably best able to comment on that because he is currently running an investment fund, so he would know the impact.
Mr Love: We will come to him.
Richard Abadie: It is not going to be easy. I will tell you here that, as PwC, we are one of the big suppliers to Government. We were called in by the Minister for the Cabinet Office with a view to giving a "rebate" to Government, which we signed an MOU about and we have done. When you approach all the parties in the supply chain in PFI, be they equity investors, lenders, contractors and operators, they may have different views.
I think a lot of the talk at the moment is about going back to the equity guys and getting a rebate from them, in particular. It will be difficult—and I am not involved in any of these discussions—because many of the guys that originally signed up these deals have moved on, and in their place have come pension funds and third party investors. So, while the PPP company that you are negotiating with architecturally is the same, the investors could well be different in many instances, and I know the Treasury is committed to trying. I am not clear in my own mind how successful they will be. It is a question of the size of the "rebate".

Q62 Mr Love: We will come to that, because I think there are some real concerns about how serious the Treasury are about doing this. The Treasury undertook this role because it was suggested to them by a consulting firm that they appointed that they should received £200 million. As much as £500 million has been suggested in political circles. What do you think, Mr Friend? Can we renegotiate?
Andy Friend: I think the problem with renegotiating at the equity level, as Richard has referred to, is that I think the current Treasury estimate is that 55%—perhaps slightly more—of the original equity has moved on, and it has been brought across a wide

variety of institutions now, and that is the problem. If you look at something like the Lend Lease projects that were done, they have established an infrastructure fund. The principal investor in that is PGGM. PGGM is a Dutch pension fund. Other pension funds from Australia and Canada have invested into intermediate vehicles. Many UK local authority pension funds have invested into, say, the infrastructure funds that Henderson put together that acquired the company that I used to work for, John Laing, and delisted it from the stock exchange. I think at that level, while it is seductive, particularly at a time of national fiscal very severe constraint, it is difficult in practice to implement.

What I think is more feasible is a vigorous, taskforce-based approach that would require the Infrastructure UKs, the local partnerships of this world and the local authority bodies, on a case-by-case basis to work through: what is the potential for varying scope? What is the potential for increasing productivity? What is the potential for taking back risks that were transferred at a price, like insurance risk, the energy risk I referred to earlier, and literally cutting a deal case-by-case? My perception is that there would be a willingness in the private sector on a case-by-case basis.

I think the problem with the blanket approach is everybody gives back whatever percentage is, measuring it, who now owns it and who has paid for what they now own, on a different price basis, and also the hazard that it creates in terms of UK reputation. We have a national infrastructure plan. £160 billion of the £200 billion in the next five years is to be derived from the private sector. If you look at the sale of HS 1, or the four sovereign wealth funds that have come into the Gatwick ownership structure since it was divested from BAA and bought by GIP, the infrastructure fund.

I think these things need to be borne in mind as we play the larger game, which is: how do we finance and fund the nation's infrastructure needs over the next decade? While I absolutely understand why, from your constituents and—

Q63 Mr Love: Well, answer the question that you are hinting at: will this have an impact on future investment in PFI and would it be dramatic? Would it—

Andy Friend: What will have an impact on future investment in PFI is whether the public sector can create both the knowledge base and the skill base to put PFI as one tool in the toolbox against the other public sector procurement options and make conscious decisions that are not driven by "the only game in town", so that it is only used in those situation where you and your colleagues can be convinced that it is value for money and where many of the faults that have been discovered in the prior model have been rectified by change.

Chairman, I come back to your opening statement: does it require incremental change? Does it require radical change? I think it probably requires both. I think it may even require—

Mr Love: I am sorry to cut you short, but I notice that Mr Wardlaw was gesticulating when I talked about whether it would have any impact on the investors and investing community.

James Wardlaw: I was struck by a slide that I saw recently from one of the people at the Infrastructure Planning Commission, which showed that 78% of their applications in their process at the moment basically come from overseas. The implications on the decisions that are made by people who are outside this country and whether to invest in the UK, and in the UK's infrastructure, seems to be an important part of the equation, not just on the slightly narrow impact on future PFI. I think there is a really important issue here about the perception of political and other risk around the UK and the UK's infrastructure, because those investors, those contractors, those utility companies outside the UK who are making these decisions have alternative places to put their capital. That was the only point I wanted to make.

Q64 Mr Love: Can I move on just a second because I am up against a time block, like everyone else? When it was suggested that the profits that were being made were excessive, Mr Abadie, you said that in the early days they were beyond what they would have expected. Now, whichever one of those two it is, is there an argument that since there is market failure here—because clearly, even although there has been high profitability, it hasn't brought in other competitors to reduce that profitability—is there a role for regulation? Should we regulate the returns so that people make a fair return but not the excessive returns that have been happening so far?

Richard Abadie: I take that as two questions. The second one is the regulation one. I do want to comment on market failure. I don't believe there has been market failure in PFI. If you look at the people that used to be bidding—again, we have far fewer projects going forward—for these projects, it is a who's who of international contractors, equity funds, investors and lenders, so I don't believe there is any concern about market failure, in that sense. I believe we have competition and, to give credit to Treasury and all the procuring authorities, they have driven competition very hard. In certain instances—

Q65 Mr Love: So why hasn't the profitability come down? Why doesn't it draw in other competitors? If they are competing, as you suggest, why has profitability remained stubbornly high?

Richard Abadie: I wouldn't say they are stubbornly high, and I don't want to forget your regulation point because I do agree with that. In the mid 1990s to late 1990s, before I became involved in the sector, you used to be able to borrow debt on a 30-year project for 10 years. Now you can borrow for 25 years, so effectively what has happened is that the weighted average cost of capital in PFI has come down. When you are saying costs have stayed stubbornly high, I don't know specifically what element you are referring to, but the cost of capital has definitely come down and stabilised pre the credit crunch. Some would argue it has gone down to unsustainably low levels.

Debt and equity prices: equity prices have gone up slightly post the credit crunch. Debt prices have gone up and margins have gone up quite significantly, as James has alluded to. None of those are based on a non-competitive market. The only thing, if you did want to comment on competition, is that the formation of consortia—multidisciplinary consortia, where you have a contractor, an operator, lender, investor and everything else—may reduce to an element some of that competition because it is a complex asset. You have to group entities together. Most of the projects that we have been involved in have had somewhere between three and five bidders bidding very aggressively in competition for these assets, and ultimately competition drives price.

If I can come back to the regulation point, I do believe in my submission I did comment, and I can't remember exactly what my words were, that there is an argument to say that equity returns—and this is always easy with hindsight—should have been regulated. Just to be clear, that is equity returns going up and equity returns going down, because some losses would have had to have been protected through whatever the regulation of those equity returns would have been. Again, that is probably a discussion for another day—I am conscious of time—but there is some argument that we could have, through the contractual structures we had in place, looked at regulating or providing some fixed return.

Chair: We now have to move on. If you have more you would like to say in writing, please do.

Richard Abadie: Very well.

Chair: Andy has one more quick question.

Q66 Mr Love: Just about whether or not taxation can play a role here. That is something that is very rarely heard and I am not putting it forward as a proposal, but is there a role for some sort of surcharge tax in relation to clawing back the excessive profits that have been made so far? Could it work? Is it practical?

Andy Friend: Again, I can understand, from the public sector interest point of view, why one might advance such a notion, but I go back to, say, a current event: the changing tariffs in relation to solar in Spain. That has contaminated the view of the Spanish market in terms of infrastructure investment across quite a wide spectrum of players, so I think things that are imposed and are unexpected, through the law of unintended consequences, will bring us downsides in other forms.

Q67 Mr Love: So the investor community would take that very negatively?

Andy Friend: In terms of the bigger game, which is projects going forward. I come back to the point I was making. I think there is a willingness in the private sector to address palpable inefficiencies where they can be identified and where the public sector can put in place sufficiently robust management resources, and not by going out to large numbers of consultants and advisors. If you go back through the 130 reports that have been written on PFI since the late Sir Malcolm Bates wrote his first one in 1997, I reckon a good two-thirds of them refer to the need to invest seriously in commercial skills in the public sector, and I do not believe that we have done that consistently. That is the sort of thing we need to be doing together with a case-by-case investigation.

Q68 Mark Garnier: Mr Abadie, can I carry on with this topic of the profitability of the equity elements of PFI contracts? Dexter Whitfield of the European Services Strategy Unit has given us a written submission in which he has analysed 63 transactions involving 154 PFI projects. He tells us that if you look at the average operating profit in the UK construction building activities—there are four major PFI construction companies: Balfour Beatty, Carillion, Costain and Care Group—was 1.5% according to their company annual reports and accounts, so that is the profit they are making on their own projects. Yet, when you look at the sales of PFI equity, between 1998 and 2010, Balfour Beatty's average profit has been 71.4%; Carillion have been amateurs really at 41% and relatively low down the scale; the Lend Lease Corporation, 78.2%; Costain, 43%. These are pretty colossal profits when you compare it with their normal return on investment. Can you explain that?

Richard Abadie: Yes. If you mean technically whether I can explain it or I can try to give a summary as to the perception, on the construction side, the contracting margins, so part of the supplier chain, the builders—the builders' margins in PFI are not materially different to what they do every day of the week. So whether they build a school conventionally or design and build to a PFI contract, you are probably looking at similar construction margins. I think you have Anthony Rabin on the next panel who is a senior director in Balfour Beatty. You can ask him that specific question as well around the construction margins, and you may want to ask him around the equity.

In terms of the equity returns, the question I ask myself—and there is a secondary market angle to this—is: what is an appropriate return for infrastructure as an asset class? That includes PFI and it includes economic infrastructure that James has talked about. How does that compare to property, to private equity and to all the other asset classes at the stock exchange, if you want to invest in the stock exchange? It is current and recent, so it is probably true over the last, at least, five to seven years. The equity returns that investors are looking for from PFI assets, when they bid these assets, and it is transparent through the financial models that they submit, are probably in the region of 10–13%. It is an IRR. So, yes, the cash may go up at the end but on average it is 10–13%. When I look at private equity, which requires 20–25% plus type returns, I am comforted that the returns are not as extravagant as private equity may take. That having been said, private equity is taking a fundamentally different risk in terms of business investment.

On the flip side, is it Government gilts? No, it is not. It doesn't have the riskless nature of the Government gilt, which admittedly is a fixed income instrument that probably yields you, if you are in a fixed income fund, somewhere between 3–5%. I know we talk about profitability of equity. It is a question of trying

to place it in its respective place in all the other asset classes that investors invest in.

Q69 Mark Garnier: Yes, but according to this report, every single profit is way above what you just described. Off the top of my head, the average is probably a lot higher; 60%. If you look at it by sector, you have Health profitability. On 14 PFI transactions that have been transacted, the average profit is 67%. Defence, which is pretty stable now, is only two projects, so it is a relatively small sample, but 134.5%. These are colossally big profits. Presumably, there is an opportunity cost to the taxpayer?

Richard Abadie: Correct. You are right. It came out of the taxpayers' pockets. The opportunity cost is—

Chair: It is good business, isn't it?

Richard Abadie: If you want investors in infrastructure—I mean, I can't remember, and you would have to probably ask some of the other panellists, for example, what the implied equity return is in regulated asset bases, in HS 1 sales. They may be slightly below the 10–13% I was quoting, but I can assure it is not materially different. Just to be clear, on the 10–13% that is per annum.

Now, I think where some of those returns are coming from is that Balfour Beatty, for example—you have mentioned them—will invest in an infrastructure asset through the equity up front, they will build the asset up, they will carry the construction risk, and a little bit like Dieter was referring to about trying to get debt into the asset post construction, Balfour Beatty's business is not to invest in infrastructure equity for the long run. They will try and sell on that equity. If you look in the UK, we have £50 billion worth of PFIs that have been built. Probably 10% of that is equity. It is about £5 billion of equity in this infrastructure asset class. The contractors cannot carry all that equity themselves. They have to recycle that equity to inject into other parts of their business or back into PFI, if that is the case. So, some of those profits would have come from on-selling their investments to infrastructure funds to private equity funds if they are participating in those, maybe selling them to pension funds—

Q70 Mark Garnier: Could you expand on that, because it is something that—

Professor Dieter Helm: Can I explain this bit here? If it is true that there is no market failures in construction then the return on construction will be normal. If it is true there are no market failures in operation then the return will be normal. It goes to the heart of your PFI issue. It all comes from the financing. Then the question is: by bundling this together, is this an efficient way of delivering what, in the financing, should be referring back to what other infrastructure assets might earn once they are at the refinancing point, and that is the huge gap between what the PFI costs and what the utility model costs. That is the gutter. If there are market failures in construction, it would be different.

Q71 Mark Garnier: Yes. So, the PFI is a much more expensive way?

Professor Dieter Helm: Your returns are a function of the fact that the cost of capital relative to what people are refinancing at creates an enormous gulf. It comes back to my point: you might see the returns coming down, but against a world in which the real interest rate in this country is currently minus 5% real. It is an enormous windfall against the setting.

James Wardlaw: I haven't read this paper, it would be interesting to see how much of those returns that you were talking about was accounted for by the differential debt costs, refinancing at much lower interest rates.

Mark Garnier: Well, these are equity sales.

James Wardlaw: Yes, I know, but the equity sale benefits from the—the equity pockets the difference in effect between the interest rates, so in a declining interest rate environment, which we have had through much of that period, a lot of that benefit, if they refinanced, would have accrued to the equity.

Mark Garnier: Yes.

James Wardlaw: So the equity returns that you talk about. Not only that, but those returns are obviously not per annum.

Mark Garnier: No, that is a fair point.

James Wardlaw: So, I don't know, I think it would be quite interesting to see how much of it was made by pure equity returns and how much of it was by debt refinancing, because I think going forward you won't see those debt refinancing benefits.

Richard Abadie: Can I touch on one more issue?

Chair: Very briefly.

Richard Abadie: I am very conscious of the time, Mr Chairman; I will try to be brief. Investors in PFI are very small subsets of the people interested in infrastructure. Not many of the investors in infrastructure want to invest in construction risk, so even if the pricing is higher it doesn't automatically hold that the pricing in some of the other infrastructure asset costs—I would hypothesise that 80- 90% of the money raised to invest in infrastructure is not interested in PFI, and that is speaking directly to the funds.

Q72 Chair: We are very grateful to you for coming before us today. There has been some very interesting and, in some areas, conflicting evidence. I want to end with one question that you can answer with a "Yes" or "No", and if you answer "Yes" we would like to see it, which is: have any of you—and there have been 130 reports mentioned earlier—seen anything written that provides convincing evidence that the benefits of PFI outweigh the financing cost to Government?

James Wardlaw: The 2003 report produced by the Treasury called *Meeting the Investment Challenge.*

Chair: Yes, we have looked at it. That convinced you, did it?

James Wardlaw: That had a—

Chair: Why don't you drop us a line telling us why you were convinced by that document?

Professor Dieter Helm: In aggregate, no, is my answer.

Chair: It seems to me that we are getting pretty scant replies to this.

Professor Dieter Helm: In aggregate, no.

Chair: Thank you very much for coming forward. We are going to take a five-minute break and reconvene at 11.50am, and the second session will last strictly one hour.

Examination of Witnesses

Witnesses: **Steve Allen**, Managing Director, Finance, Transport for London, **Professor James Barlow**, Imperial College, **Anthony Rabin**, Deputy Chief Executive, Balfour Beatty, and **Jo Webber**, Deputy Director of Policy, NHS Confederation, gave evidence.

Q73 Chair: Thank you very much for coming before us this morning. It is still this morning by a whisker. I am sorry we are a bit behind schedule. We are going to try to run this session as crisply as possible. Can I ask any of you who want to answer how much risk is really being transferred in these projects from the public to the private sector? Does risk transfer really take place? Who would like to have a go at that?
Professor James Barlow: I think I can talk about the healthcare sector. Undoubtedly some of the project risks are being transferred from hospital trusts to the private sector, to the SPV, and the operational risks remain with the hospital and the trust. In the case of healthcare PFI, I think that is where a lot of the problems lie, because I think it is extremely difficult to identify what those risks are, given the fast-moving, rapidly changing nature of healthcare, so the whole question of how much risk you shift from one party to the other is rather difficult to determine.
Chair: So there isn't much risk transferring now?
Professor James Barlow: Probably the answer is no, and I was quite staggered by some of the figures given at the end of the last session about the rates of return in healthcare, given the limited amount of risk transfer that has been observed, I think.

Q74 Chair: Does anybody want to dissent from that view?
Anthony Rabin: May I dissent, Mr Tyrie? I think that in principle there are a number of risks that can be transferred under the PFI mechanism. The first and fairly obvious point is the project management of risk associated with a large capital project, which, dare I say it—at least historically—hasn't universally been managed well by other forms of procurement. So, that is certainly one risk.
Chair: So that is the build rather than the management?
Anthony Rabin: Yes. I will go further and say the design and build and its integration with the operational needs of whatever the particular circumstances are.
Chair: What about on the management side?
Anthony Rabin: I think, on the management side, it depends a little on what the nature of the contract is. There is a tendency to split this into what are called hard services and soft services. The hard services, certainly as I see it, are an integral part of what might be deemed to be whole life risk, which is another, I believe, major element that is transferred and is probably in reality rather difficult to do other than through the mechanism of the PFI. I think in relation to soft services, for example, in a hospital, such as cleaning and meals, there may or may not be risk transfer. I don't personally think that they are essential to the debate that this Committee is having this morning.
Chair: Sorry, I didn't understand that last bit. You don't think it matters where the risk is?
Anthony Rabin: No, I said I don't think that the issue of whether or not risk is being transferred in those soft services is necessarily the central issue that appears to be occupying this Committee this morning.

Q75 Chair: Where the risk lies is an important issue, wouldn't you agree?
Anthony Rabin: Certainly, but the essence of the argument lies in the hard services and how they relate to the transfer in relation to design and build risk and then the consequent whole life risk.

Q76 Chair: But you can point to a project which, in your view, a reasonable man would conclude had seen substantial risk transfer?
Anthony Rabin: Yes, I think many of the larger projects have and do see such substantial risk transfer.
Chair: On the management side, not on the design and build?
Anthony Rabin: Yes, indeed.
Chair: Perhaps you would drop us a line with a list of those sometime.
Anthony Rabin: Certainly.

Q77 Michael Fallon: How will the NHS cope when it is locked into 30-year contracts for large hospitals, where more treatment and care is simply moved away from that kind of provision?
Jo Webber: I think this is going to be a challenge, because I think that what has happened is that a lot of people now have large buildings that they are committed to over a long period of time, when the most recent sort of direction of travel for care is to have it much closer to home, much more around people in their own communities. It is very difficult to change a very high-value environment like a ward environment into something that is affordable. Despite what previous witnesses said, I think it is very difficult and expensive to make variations to contracts, and the square footage costs of building wards is very different from the square footage costs of building, say, office accommodation.

Q78 Michael Fallon: Professor Barlow, what will the NHS do with hospitals that it doesn't need?
Professor James Barlow: A very good question. I think my colleague here has stated that it is incredibly difficult to adapt some of these buildings, and I think one problem is that we have large, highly-specified buildings that are inflexible. Undoubtedly we needed new hospital infrastructure at the time PFI started out,

so in that sense, I think PFI was extremely beneficial. It rapidly saw a lot of new buildings built, but my concern really is about the inflexibility of these buildings and the impossibility of, over a 30 or 40-year period, predicting what the demand is going to be like for the bed spaces in those buildings. That is what I meant earlier when I said that a lot of the risk remains with the trust, because they have to carry on paying for these contracts even if the demand is going down, and as we know, it is. How much of that demand risk is contractable—can be written into contracts and shared or transferred—is another matter. I think it is extremely difficult.

Q79 Michael Fallon: But given the particular inflexibility of these contracts for healthcare, would the Government be justified in revisiting these contracts now?
Professor James Barlow: Again, I think the point was made in the last session that on a case-by-case basis, there might be a need to go back and look at how they are performing, yes.

Q80 Michael Fallon: But if that doesn't happen, presumably some trusts are going to get into very severe financial difficulties continuing to pay the rent.
Professor James Barlow: I think we have seen some of that already in some cases.
Jo Webber: Yes, I would absolutely agree that there will be a big affordability challenge over a long period. It will have different impacts on different parts of the country, I think, and I think it is interesting to look at how you might close some acute facilities or downsize some of the services that you deliver from acute facilities when you may have organisations that are too large to fail in some areas or are delivering other things that you can't deliver elsewhere. There may well be a knock-on impact on the non-PFI hospitals of trying to keep the PFI hospitals going, because some of them are too large to fail.

Q81 Michael Fallon: I think there are examples of that at the moment. So, the level of these rental payments and the inflexibility of these contracts is a serious distortion of finance within the health service at the moment.
Jo Webber: I think I should say, having talked to some of our members who are obviously in receipt of PFI contracts, at the moment they are managing to deal with these issues, but you are in a situation where the financial pressures are going to get greater over the next few years, certainly, so it will become more of a challenge for people over the next few years.

Q82 Michael Fallon: The health service is now subject to pretty tough targets on efficiency savings. Those do not apply to the services being provided under PFI. Is that right?
Jo Webber: I am not sure that that is right, because the efficiency savings are on the whole of the hospital or the local health economies and services. The issue is whether financing your PFI debt means that there are some things that you would otherwise have invested in that you now no longer can afford to invest in.

Q83 Michael Fallon: Yes, but the specific search for efficiency savings: the PFI contractor is exempted from that, is he not, because he has his contract?
Professor James Barlow: They would be incentivised to search for efficiency savings inasmuch as they relate to the bits of the contract that they are responsible for, whether facilities management or maintenance of the building and so on.

Q84 Michael Fallon: Are any of you clear about this? Do the efficiency savings targets apply to services provided under PFI?
Anthony Rabin: Perhaps I can contribute here. The contracts themselves may well be several years old and therefore will have their own specifics, and whatever the new regime is that may or may not be applied to the NHS won't apply to them. However, there is nothing to stop them; indeed, some contracts do have built-in efficiency savings. Let me give you one example, which is our schools contract with Hertfordshire, whereby it is a long programme over a reasonable number of years. We commit that over the course of a number of years we reduce the build cost per square foot, so it can be done.

Q85 Michael Fallon: Yes, but that is a construction cost. What I am asking you about is the actual service delivery, particularly in hospitals.
Jo Webber: The efficiency savings apply to the organisation, to the hospital. They are not carved down into efficiency savings in particular services, so it is for the hospital to decide how they get those efficiencies out of the services that they provide.
Michael Fallon: But they can't do that by revisiting any part of the contract.
Jo Webber: They can't do that by revisiting the PFI, unless they can get a variable one.

Q86 Michael Fallon: So, the pressure on the non-PFI side is all the greater because of that. Is that right?
Jo Webber: Yes, I think that is probably right, but it is not an efficiency saving on a particular service. The trust has to make efficiency savings rather than individual services.

Q87 Michael Fallon: So, we have a funding model for hospitals particularly that has been developed by the Treasury and by the last Government without really considering the full implications for service delivery?
Jo Webber: When a lot of PFI projects started, obviously we were in a very different financial situation. The efficiency targets are for the whole of the hospital and arrive basically through the tariff system, so this is about the rate of inflation of the tariff for the services that are provided by the hospital. That is their major source of income. What has happened recently is that the tariff has been held at a particular level so that with inflation working at the same time, what we have is a relative deflation of the tariff, so income is deflating through the tariff, but it is up to the hospital locally to decide, particularly if it is a foundation trust, outside of its designated services, what it is going to deliver with the income that it gets.

Professor James Barlow: To follow on from that, if it was identified that a particular efficiency saving could be had from closing beds and devolving services into the community, then the nature of the PFI payment and contracts may make that difficult. So, yes, it does have an effect.
Michael Fallon: Well, it could be legally impossible.
Professor James Barlow: Possibly impossible.

Q88 Chair: Are these NHS contracts unaffordable because of the characteristics of PFI, because of the high cost of capital?
Professor James Barlow: I think again it goes back to the discussions in the previous session about the cost of borrowing and whether Government can borrow at a lower rate—
Chair: Yes, but what is the answer? This is a fairly straightforward question. Is that the cause?
Professor James Barlow: It is probably more—yes, the cost of capital is higher, certainly, yes.
Chair: The answer is yes?
Professor James Barlow: Yes.
Chair: Okay.
Jesse Norman: Your question, Mr Chairman, doesn't engage with the issue of whether the cost of capital is higher because PFI is the mechanism being used.
Chair: Well, it engages with the differential between the long gilt market and the cost of capital in these projects.

Q89 Jesse Norman: I mean, we have already had evidence that PFI is an intrinsically expensive way to fund systems, so it will undoubtedly have an effect, from what you are saying.
Just to cover some others: in the case of Herefordshire Hospital, which was commissioned in 1998, where my constituency is, there are no efficiency uplifts built into the contract; there are no benchmarking characteristics built into the contract. The contract cannot be unilaterally revisited by the hospital. It is a fixed nut that has to get paid regardless of whatever the costs of other flows or any other costs are on the hospital. That doesn't disagree with your experience in terms of the fixed nature of the cost that has to go to service the PFI annual payment versus the changing nature of the costs and efficiency savings placed on the rest of the hospitals?
Jo Webber: Herefordshire was one of the early PFIs, I believe. It was very close to the beginning. I have to say that the contracts have changed and the experience and expertise of the providers in specifying has changed over the course of it. There has been a lot of learning from the early contracts about how they might be better specified.
Jesse Norman: That is a polite way of saying that it was a bad contract.
Jo Webber: All I am saying is that we have learnt from the experience of the early contracts.

Q90 Jesse Norman: Okay. Can I ask about the issue of procurement of PFI contracts? We have had a lot of testimony that it has been extremely expensive; we have had a lot of testimony that competition has been limited and there is a high level of complexity. Is that something you could comment on, any of you? We have had a lot of testimony separately that the fact that the financing has to be lined up at the point of signature is extremely expensive and that the procurement costs are not included in the unitary payment disguises the true expense. Could you just comment on that? Maybe Mr Rabin.
Anthony Rabin: Yes, sorry. Your points were that it was expensive and that there is limited competition. I am sorry, there was a third point I didn't get.
Jesse Norman: Expensive, complex, limited competition and that the expense specifically was driven up by having a deal ready at the point of signature at the end of the procurement competition, and finally that since the procurement costs themselves were not included in the annual charge, they were in some sense rolled into the capital cost. They were never visible. They were kept separate from the running charge to the hospital.
Anthony Rabin: Perhaps I can take those in turn then. Is the procurement expensive? Yes, relative to other forms of procurement it probably is expensive. It is more complex; there is a whole machinery about PFI that you need to get right, otherwise it doesn't work, so almost by definition it will. I think that the cost of procurement has come down sharply over the past 15 years or so as the public sector and the private sector have learnt that we all collectively can be more efficient. It probably still is.
Is there competition? I think this was your next question. Yes, I think there is. I think there is quite effective competition, and I don't see any evidence that the competition is any less now than it was previously.

Q91 Jesse Norman: Let me give you a piece of evidence. It looks like there are only four advisors who are ever used on the accounting side, and a small number of legal advisors. There doesn't seem much competition in that area.
Anthony Rabin: But neither of those are our particular industry, so it is rather difficult for me to comment on those. I am not sure I am the best person to ask, certainly.
Jesse Norman: But you see these contracts every day. I mean, you must be able to comment on the expense of those or the degree of competition in them.
Anthony Rabin: I would perceive from our side of the table that there is a reasonable amount of competition, but as I said, it is from the other side of the table.
You asked about whether the costs of procurement are wrapped up into the cost of the underlying contract. Yes, they are. The underlying contract ultimately comes out as a unitary charge that does not distinguish between repayment of capital and operating cost—it is a single charge—but almost inevitably will take some account of the underlying cost of the procurement.

Q92 Jesse Norman: Right, so they are capitalised. We never see them at the time they get paid; they just get rolled into the capital?
Anthony Rabin: They will be transparent to the advisors of the relevant public sector organisation, who will scrutinise them carefully to make sure that they are appropriate.

Chair: We are going to have to move on shortly.

Q93 Jesse Norman: Professor Barlow, just to ask a question which I know you want raised, Mr Chairman, do you think PFI has been beneficial for innovation in the National Health Service? Do you think we have more innovative and better hospitals as a result of PFI than we would have had otherwise, or is the opposite true?
Professor James Barlow: I think "no" is the short answer to that. I think the way risk was devolved and transferred has made it very difficult to stimulate any kind of innovative thinking about the design of the buildings, any real sort of attempt to think about future flexibility and so on, certainly in the early PFI projects that we looked at.

Q94 Jesse Norman: Do we have better hospitals that we would have had if we had procured them by some other mechanism, by the extra cost?
Professor James Barlow: In the 1960s and 1970s we had a huge hospital building programme that was centrally driven, and there was a great deal of design innovation, so I will leave that you to decide that.
Jesse Norman: Sorry, your view is there was a lot of innovation in the 1960s and there has not been today?
Professor James Barlow: There was more design innovation in the 1960s and 1970s.
Chair: Your answer was that it stifled innovation.
Professor James Barlow: It stifled it, yes.
Jesse Norman: You are suggesting also the quality of hospitals was less good than it would have been if it had been procured in a different way.
Professor James Barlow: Sorry?
Jesse Norman: You seem to be suggesting the quality is less good overall than it would have been.
Professor James Barlow: No, I was not talking about quality. I mean, the whole life—
Chair: You are talking about innovation.
Professor James Barlow: I am talking about design and flexibility and adaptability. The quality of the buildings is not something I can comment on, but certainly the way in which PFI focused interest on whole life costs, I think, should drive up quality.

Q95 John Mann: Mr Rabin, what percentage of the new school PFIs did your company bid for, approximately?
Anthony Rabin: I'm not sure I have an answer. Over the whole period, I would think a fair proportion of those that were put out for tender we would have bid for. I don't have that number. I can supply you with that number.
John Mann: Hospitals as well. What kind of—
Anthony Rabin: Yes. We would be a major competitor in both hospitals and schools.
John Mann: In virtually all of them?
Anthony Rabin: No, not I think in virtually all, but in a significant number. As I said, I don't have the figures.
John Mann: What is "a significant number"? Is it up to 30, 50, 70?
Anthony Rabin: I would guess that one in three possibly we would have bid for, something like that.
John Mann: One in three?
Anthony Rabin: But that is a guess.

Q96 John Mann: Yes, okay, but let us say it is one in three. I mean, why didn't you bid for more than that?
Anthony Rabin: Because there is a limit to the amount of resource that we have, and when I talk of resource, I mean human resource.

Q97 John Mann: Yes. There are not that many competitors in the field, are there, so this lack of competition: what impact do you think that had on price?
Anthony Rabin: I'm not sure I would agree with you as to the lack of competition. I think that there are a significant number of competitors. It depends a little on what you are talking about. I mean, are you talking about a very large hospital or are you talking about a small school? I think it is rather difficult to generalise, but I think that there are enough competitors such that the public sector does get value for money.
John Mann: When you won the contract for the eight schools in my area, you were the only serious bidder.
Anthony Rabin: That is not something we were aware of at the time.

Q98 John Mann: No, but that is a question: perhaps capacity was such that you are all doing so much work that you could not bid for everything and therefore you did not, and therefore there wasn't a competitive price in it.
Let me ask about how you would vary a contract. I raised the issue earlier of, say, a swimming pool that goes wrong, or wrongly specified. How much would it cost? What is the obstacle? Is there an obstacle? What is the obstacle to fixing something like that that is suddenly identified part-way through the project?
Anthony Rabin: I don't think there are any obstacles in principle, and may I say I am not aware that we have a swimming pool problem in your particular constituency, but—
John Mann: Okay, but your company build a school, for example, where the swimming pool didn't meet the spec because it was architecturally wrongly designed, and the hockey pitch was a foot too small to be competition-level. When that was raised, it wasn't possible to change it, and I am trying to work out why.
Anthony Rabin: I would very much doubt that that would be the case.
John Mann: Well, it was the case.
Anthony Rabin: If things are not according to spec, then inevitably the public sector has the right to demand what it has paid for. That is very simple.
John Mann: No, no, no, if it is specified wrongly. Do not fall into the trap we had before. If it is specified wrongly in whatever way, incompetently, how much would it cost the public sector to fix that?
Anthony Rabin: I think, if it is specified wrongly, as in the public sector said, "I want X and now I want Y" if that is what I understand you to mean, then that is going to be a very individual process that will revolve around what X was and what Y now is. I don't think I can answer that.
John Mann: You see, I am just trying to get my head around the flexibility, because I could give you numerous examples where changes couldn't be made

because the contract had already been let, from lighting to corridors, to some that at great expense were changed, like how many sockets there were, but anything other than sockets couldn't be changed because of the price. I am just interested to see, because that is not my experience of public procurement generally, why that was such a problem and why it was so expensive to change.

Anthony Rabin: I am not aware that it would be any more expensive to change a PFI contract in that respect than it would be if the public sector had procured your example of a swimming pool and then found it wanted a different one. I don't see why.

Q99 John Mann: It would be useful, in that specific example, which is Valley School in Worksop, just to get a note with the swimming pool and why it was impossible to fix it for the Committee just to see, because I remain mystified.

Has public use of the schools that you have built gone up or gone down since you have been managing them?

Anthony Rabin: I believe it has gone up, but once again, I don't have statistics to hand. I am very happy to provide them to this Committee.

Q100 John Mann: That would be very useful. Looking at the future, two issues: if the public sector wanted to bring back in insurance on the basis it could be done more cheaply by the public sector than by you, would you regard that as a sensible and positive potential change for the future? Secondly, on retrofitting, let us say that Parliament, Government, decided to legislate in the next 20 years for retrofitting schools to bring technology, solar panels or whatever, into the National Grid. Who would pay for that, in your view, and who would profit from the proceeds of that?

Anthony Rabin: The answer to your first question is definitely, and I think there is much wastage in the whole concept of insurance at the moment, and I think in not all but in certain circumstances it would be much better value if those risks were borne by the public sector. That, I think, is an answer to your first question.

In respect to specification change halfway through a contract, once again, I think it will depend entirely on what the specification was and what that contract was. It is very different.

John Mann: Yes, but the obvious one that might come from politicians is—let us call it a green retrofit. That is the most obvious one that politicians at some stage might decide to legislate for. How would you see the funding and the profits, if there were some from that, working?

Anthony Rabin: The best way—

Chair: Can we have a crisp reply to that, sorry, because we are going to have to move on?

Anthony Rabin: The best way would be to have that discussion at the start of the contract to allow the public sector sufficient flexibility that it was able to make choices some way down the contract, and indeed, if that is done then the private sector can arrange for such financing to be provided at that future time.

John Mann: Finally, do you have a price on insurance?

Chair: No, I am sorry, John, but we are going to have to move on.

Q101 John Thurso: Can I ask some questions about special purpose vehicles that are used in constructing the finance? Clearly they are necessary in order to undertake the financing, but there are, I presume, pros and cons that come with that. Can I start with you, Professor Barlow? What are the pros and cons?

Professor James Barlow: Of a special purpose vehicle?

John Thurso: That construct.

Professor James Barlow: It is a vehicle for bringing together the various parties that are necessary to deliver the project in a financial and contractual framework. It gets them talking to each other and gets them discussing what the alternative ways of delivering the project are. The cons I would say probably revolve around—certainly in the early days of PFI, there was a lot of talk about the sort of imbalance in knowledge and power between either side of the table, so the SPV and its advisors, and, in healthcare, the trust and their advisors, and the impact that had on negotiations. You may have another view on that.

Jo Webber: I would absolutely agree. I think what has happened over the years is that the public sector body has developed more expertise, either inhouse or by buying in expertise, so that those conversations are more balanced now than they were. Not to say there isn't more there could be done, but it is one way of ensuring that everything is sort of slotted together, not just the design and construction, but the way in which the facility is going to be run afterwards and the way in which a lot of the maintenance contracts and so on are going to be bundled together afterwards.

I have to say, though, certainly in some of the later cases, people are looking at how much they want all of those areas bundled up together, and I know that you have had evidence from North Tees, who are looking to unbundle some of those, some of the maintenance side of that and the fitting-out side of that to both give them some more control within the situation, but also obviously to keep costs down.

Q102 John Thurso: So, one of the cons, clearly, is that you have somebody who is inserted between the provider and the user, and that was a defect in the early days.

Jo Webber: Yes.

John Thurso: Can that defect be remedied?

Jo Webber: Yes, I think it probably can. I think the bottom line is that we have a lot of new buildings in the NHS which we otherwise would probably not have had, or certainly not at the rate of increase that we have done, and that has enabled us to meet some of the initiatives going forward: things like infection control, single rooms and so on. We don't want to lose that on the way forward, but we do need to keep the costs down.

Q103 John Thurso: Mr Rabin, from the other side of the fence, as it were, what do you see as the pros and cons?
Anthony Rabin: I would entirely agree. I think that they are a necessary evil, if I can put it like that; otherwise it is not possible to construct the financing. The real issue for us is: do they get in the way between our clients, our customers and those who provide the services? They shouldn't. They probably have done in the past. We work extremely hard to make sure that they don't.
John Thurso: I like that description: "a necessary evil" required for the financing, which basically both sides you then have to manage.
Anthony Rabin: Yes.

Q104 John Thurso: Mr Allen, TfL do that very successfully, because you have been managing out some of your bad PFIs. What are, in your mind, the pros and cons of the PFI and the SPV?
Steve Allen: We inherited a number of PFIs when TfL was created that had been entered into by predecessor bodies, and with some of those, I guess that we saw that the risks were not well aligned, and as a result, the PFIs were not very successful. A good example would be the Croydon tram link project, where the SPV was, under the original contract, taking revenue risk despite the fact that revenues are part of a London-wide revenue pooling system, so in actual fact, the ability of the concessionaire to influence those revenues was very small. They had difficulty in managing the risks associated with competing bus services and so forth. That was an example of an inefficient allocation of risk, and ultimately we decided to restructure it by buying out the company.

Q105 John Thurso: Is there a lesson to be learnt from TfL in that one of your core competencies is procurement, or should be, whereas that is not necessarily the case in other areas of the public sector?
Steve Allen: Yes. I think because of the size of the organisation, the nature and the complexity of the contracts that we have, both PFI and other contracts, it has enabled us and required us to build up an expertise in letting and managing those sort of contracts that it probably wouldn't be economic for other public authorities to try to build that expertise.

Q106 John Thurso: One last question for you, Ms Webber. In your submission, you have a rather short but fascinating paragraph suggesting an NHS bank. Can you very briefly tell me what that is?
Jo Webber: The concept behind it is that this is funded through capital elements of the the DEL, and is worked almost like a retail bank. A lot of foundation trusts do have money that they can invest short-term or long-term. One thing we would say though is that it would have to be run as a bank and that this would need banking expertise to run it. It is not something that the NHS has done in the past, and neither is it its core business. It would need expertise in to run it, but it could be used for capital refinancing, for capital investment.
John Thurso: Interesting. Is there something more worked up?
Jo Webber: We have some more that we could send to you.
John Thurso: I think that would be quite fascinating to have.

Q107 Chair: You don't use PFI at all at the moment, do you?
Steve Allen: The last PFI contract we let was the extension of the DLR to Woolwich, and we are talking on Crossrail as to whether the—
Chair: So you are examining one use?
Steve Allen: Yes, the rolling stock for Crossrail, maybe.

Q108 Chair: But you think it is too inflexible. That is what your evidence suggests.
Steve Allen: Yes. I think PFI does tend to be an inflexible route of procurement, and is therefore only suitable for procurements where you don't need to change what it is you require over the life of the contract. If you look at things like roads or new railways, where once you have designed where the transport scheme is going to go, you fundamentally are not going to change it, those have been more successful examples of PFIs than things that are intimately involved with the operations of transport; for example, the experience of the London Underground PPP, where it was much too closely intertwined with the day-to-day operations.

Q109 Chair: So it can work on the CAPEX side, but not the management?
Steve Allen: There is clearly a maintenance side on a road asset or a bridge or a railway, but that is obviously a much smaller part of the overall cost of the project.

Q110 Mark Garnier: Ms Webber, in your reply to Mr Norman, you said that you had learnt the lessons of some of the earlier PFI projects. Was Worcester Royal one of those lessons that you learnt?
Jo Webber: I don't know the details of Worcester Royal or the experience around Worcester Royal, I am sorry.

Q111 ***Mark Garnier:*** No, fair enough, I was just wondering. But there is an important point with this. I don't know if you were here in the earlier session, but there was a submission from Dexter Whitfield, who is the Director of the European Services Strategy Unit, and he has done some research into profits from PFI equity sales. What is very interesting is that looking at the ones he has analysed, he has analysed 14 PFI transactions in the health sector with around 18 projects, total value £129.3 million, with an average profit of 66.7%. Doesn't that make you rather annoyed that there is so much profit for the people who are providing PFI for you?
Jo Webber: Obviously we have to look at the amount of efficiencies that we could get out of the PFI contracts. I think it is difficult to see how you extract these. Obviously the point was made earlier about looking at things on a case-by-case basis, and I know there is some work going on within the Treasury around the Romford PFI, trying to look at that and

really extract the information from that. The problem is things like renegotiation costs, like alternative uses, like the extent to which the NHS could afford the rebuilding programme that has been going on without using something like PFI to get private capital in in the amount that it has been to get the projects under way. Some 101 of the 135 new NHS hospitals have been through PFI between 1997 and 2009, so it is a substantial amount, but obviously looking for how you get efficiencies and how you get the most effective contract is something that you need.

Q112 Mark Garnier: You made reference to the NHS bank, which sounds very interesting, and presumably from the NHS and national health economy, that would be extraordinarily useful if you were maintaining or keeping that profit within the health economy, so obviously it would be very helpful if you pass some more details on.
Jo Webber: Yes.

Q113 Mark Garnier: Mr Rabin, keeping with the profits, Balfour Beatty in this analysis have sold five PFI projects with a total value of £37.8 million. You have an average profit of 71.4% on that. You have done very well.
Anthony Rabin: Perhaps I can start by saying I don't have those numbers at my fingertips. I am very happy to provide a breakdown to the Committee if that is what you would like. Perhaps I can address the more generalised point, which is: what is a fair profit? What is a return? Looking at accounting profit, it seems to me to be potentially misleading. Let's round numbers. I could give you a figure of, say, a profit of 60%, but wouldn't you in turn like to know whether I had made that over one year, in which case it would be 60%, or 15 years, in which it would be 4%? The answers are rather different, so it does seem to me a more reliable measure—and I think it is a very important point, and as a taxpayer, certainly I am as exercised as anybody else—that we get value for money. It seems to me it is more useful to look at these things in terms of rates of return.
Now, the NAO I think has looked at this from time to time. The NAO I think has concluded that at least historically, investment rates of return at the point of bid tend to be in the, I think, 13–15% per annum range. It would seem to me that that would be the subject matter of whether that is the right rate, whether it is too high, too low or whatever. I would suggest to you that it is not a particularly high rate given that there are significant risks. Mr Friend alluded to those in the earlier session, that not everybody makes a profit at all out of this. I think it is easy to focus on the profits and to ignore those losses. We, as investors, have to take a balanced view.

Q114 Mark Garnier: Yes. These numbers are obviously the averages, so this is taking an average. No, it is a very fair point. We don't know whether this is over one year or over a period of potentially 12 years, and some of these will obviously be over that, but it would be very helpful if you—I think this is freely available—could have a look at that and get back to us and let us know what it is.
Anthony Rabin: I am very happy to do that.
Mark Garnier: But what I would say though, just as a broader point, is that you are the second-most profitable of the ones on the manifest. Balfour Beatty is the second-most profitable, with Carillion at 41%, John Laing at 59%—and I'm going to just rattle these numbers off—Serco Group, poor fellows, have only made 20%, but then maybe it is just because that is one year, but we don't know. But it would be very helpful. That is fine, thank you.

Q115 Andy Love: Can I come to the issue of possible renegotiation of contracts? I think it has arisen out of the debate we had in the previous sessions, and indeed, in this one, and in the last one we focused entirely on whether there would be a rebate arising from that renegotiation, but perhaps taking on board the point that Mr Fallon made earlier on about NHS contracts, whether creating some greater flexibility within the contract would also be something subject to renegotiation. Can I take the producer point of view first of all perhaps, Mr Rabin, and get your view about renegotiation: whether it is feasible, and how it could be managed?
Anthony Rabin: I think that renegotiation is always feasible and, potentially in some cases, desirable. I do very strongly believe that that should be at a local level between the buyer of services and the provider of services rather than at an omnibus global level. I don't think there is a one size fits all there. We are very concerned to offer our clients the best value for money, and indeed are actively engaging with them in how we can provide that. If that means contract renegotiation, that is fine.

Q116 Andy Love: From the National Health Service Confederation point of view, one of the things that has always mystified us is that we have in the National Health Service a very top-down body, yet in terms of PFI contracts, it has been very decentralised. We are now talking about decentralisation. I would like to ask you: isn't there a role for centralisation in terms of PFI and getting a team together that can do this sort of renegotiation and gain most rather than leave it to individual initiative at each trust level?
Jo Webber: No. I think this is something that has to be done on a contract-by-contract basis, because the contracts are different, because as you go through the history of PFI—

Q117 Andy Love: No, I wasn't suggesting that. I was suggesting that rather than have the contract negotiated by local managers at an individual level, you would have somebody come from the centre as well with the expertise, because clearly one of the issues here has been the quality of the management in terms of the National Health Service in negotiation with the private sector.
Jo Webber: I think you could possibly make the point about a pool of expertise that could be called on. I wouldn't go for somebody coming out and negotiating the contract for you. I think, if nothing else, that expertise needs to be developed inhouse if you are really going to get the right relationship with the SPV and you are really going to get the best out of the

contract. In terms of renegotiation, with the NHS changing at the speed it does, anything that allows contracts to be more flexible and to look at space in a different way and the way in which you use space in a different way would be helpful.

Q118 Andy Love: Can I ask you, Mr Allen, because you have the most experience here of this process. Now, it is much more straightforward, I think, for TfL in the sense that you raise your own finance, so you can purchase, if you like, but how difficult did you find it?

Steve Allen: Certainly having the ability to borrow ourselves directly gives us a lot more flexibility in looking at different procurement approaches, and it also gives us some flexibility in renegotiating existing contracts in that we can buy the debt back and refinance it on our own terms, and we have had examples of that. Fundamentally, it depends on the contract you let at the outset. You can build certain amounts of flexibility into the contract that you let if you can foresee what flexibilities you need, but there will always be limits around that, and it will affect the appetite of people to bid and the price that they will bid for that.

If you are trying to renegotiate something that was a very fixed contract that has perhaps been let in the early stages of PFI, that is extremely difficult, and if I go back to the Croydon example, essentially what we had to do was buy the SPV from the shareholders because there wasn't the flexibility to renegotiate the terms of the contract. So even though it wasn't a very successfully performing contract because they weren't maintaining the asset terribly well, we still to buy the equity back from them in order to put the asset on a proper footing.

Q119 Andy Love: I will come back to you just in a second, but let me just ask Mr Rabin—it arises from that—the private sector hasn't shown itself very amenable in the past to either sharing the financial benefits of PFI or, indeed, in negotiating more flexibility. Mr Allen's example suggests to us that they will be very tough. Isn't there some recognition in the private sector that especially at this time of some limitation in funding in the public services that the private sector through PFI has to make some contribution towards this?

Anthony Rabin: I can only speak for ourselves and I can only speak for my company. As far as my company is concerned, yes, of course we have an absolute recognition that these are difficult times and that we wish to play our part, and as I said earlier, we would be very happy, and indeed, we are in dialogue with some of our clients as to how to assist in making that transition.

Q120 Andy Love: Perhaps we could get some information on that. Can I just ask Dr Barlow: did you want to comment?

Professor James Barlow: Simply to make the point, I am just questioning on what grounds one is seeking a rebate. I mean, if it is simply because the market conditions have changed, there is less money in the NHS and less demand for bed spaces in a given hospital, that is a completely different matter from the swimming pool being too small and wrongly specified. Given that you can't readily specify and measure and guarantee particular levels of demand in the future, I am just wondering whether you might get fairly short shrift from investors in the private sector.

Andy Love: I do accept that point. I don't think what we are here discussing today only comes up in the context of particularly the National Health Service. What we are here to discuss today is whether or not PFI was value for money, and I think it is in that context, and we accept that the negotiations have to go on at a local level individually with each PFI contractor. I think the other point forms a backdrop to that, and some recognition, which I don't think there has been much sign of in the past, that the private sector recognises it as in a partnership of PFI nature, then there needs to be give and take on both sides.

Q121 Michael Fallon: Mr Allen, how does the financial cost of PFI compare with other sources of finance that you could be using?

Steve Allen: I suppose at the time most of the PFI contracts that we have were let there was no alternative source of finance for the sort of predecessor entities, so there was no valid comparison. Now that we have the ability to borrow directly, we do have that comparator, and so you can, in a very real sense, assess the value for money of the PFI solution.

Q122 Michael Fallon: So what is the answer?

Steve Allen: Our cost of borrowing is probably something to the order of between 0.5% and 1% above gilt rates, because we are not Government guaranteed, so we do pay a bit more than gilts. I think somebody earlier was talking about 250—so 2.5%—above swap rates for PFI finance, so there is a significant premium for the cost of finance through a PFI.

Q123 Michael Fallon: Have you identified any particular efficiencies in your sector that you can put against that extra financial premium?

Steve Allen: I think it is hard to say that if you look across all the projects, overall PFI is value for money against that additional cost of finance.

Q124 Andrea Leadsom: Mr Allen, again, can you just confirm that it is the finance that is the difference in the value to the taxpayer, not the construction? Do you fund and procure directly just because it is cheaper, or are there other perceived benefits to you as well?

Steve Allen: I think again, as other people have said, there are the underlying components of the project that you ought to be able to contract for at the same price, so it should not cost you any more to build the asset under a PFI contract; it should be exactly the same as if you procured it. In theory, at least, everything that you can do in procurement terms under PFI you ought to be able to do directly, if you have access to the finance.

Q125 Andrea Leadsom: But can I very specifically ask you, for example, if you procure something—to use Mr Mann's example—and you have specified it wrongly, is it your view that it would be easier to then change your incorrect specification through a direct procurement or through a PFI, or does it not make any difference?
Steve Allen: No. The involvement of the finance in the PFI makes it more inflexible, because it is not just a question of negotiating with the contract who built the asset. Particularly if the change is going to require some significant amount of funding, they are going to negotiate with the equity investors and with the debt holders as well.

Q126 Andrea Leadsom: So it is the bundling up that makes it less flexible?
Steve Allen: Yes, and that was one of the perceived advantages of the PFI in the first place, that one of the major causes of cost overruns in procurements is the variations, is the specifying authority changing its mind as to what it wants, and it was specifically putting something of a straitjacket around that that was a perceived benefit to the PFI.

Q127 Andrea Leadsom: It does seem to me that from the evidence we have heard today, what we have had is really a series of PFI projects that have been poorly negotiated by the public sector that really the private sector, in an oligopolistic fashion—I think there hasn't been enough competition—saw coming. Therefore, it sort of slightly amazes me, Professor Barlow and Ms Webber, that you say that it would not make sense to have some kind of central, at least, contracting expertise. I think you have just said that you think each contract should be negotiated separately. Surely that merely continues the risk that the private sector are going to lock you in to inflexible arrangements, where they may take the profit and you will take the risk.
Professor James Barlow: I don't think I said we should not have some centralised skills.

Q128 Andrea Leadsom: But to what extent is the NHS learning from previous mistakes?
Professor James Barlow: The problem is it has been particularly devolved, decentralised, fragmented compared to what it was like 30 years ago, when we had a central repository of knowledge on how to write contracts, what makes a good design. This has been broken up. It is now back down to ground level—

Q129 Andrea Leadsom: If you could suggest one change, what would it be?
Professor James Barlow: I think that would be one of the major changes I would suggest: simply have a better mechanism for pooling expertise and knowledge on the client side, i.e. the NHS side, and sharing that knowledge so your negotiations are slightly more evenly balanced.

Q130 Andrea Leadsom: What prevents the NHS from doing that right now? Is there some reason why they are unable to share expertise? Ms Webber, you have just said that you think each contract should be negotiated separately by separate teams. What is to prevent the NHS unilaterally deciding to share expertise and negotiate centrally?
Jo Webber: What I said was I think if there is a pool of expertise that is held centrally, fine, but each contract will have to relate to local circumstances, and in an environment where you have increasingly more stand-alone foundation trusts, they would expect to have a lot of control over what that specification was, a lot of control over how their PFI looked, and really to be thinking those strategic thoughts about what they needed in the future out of a building and a set of services that they didn't need in the past, so I would be slightly concerned if what we were developing was a central contract for this, because it does need to be locally flexible.

Q131 Andrea Leadsom: But it seems that those are two different points, aren't they?
Jo Webber: Yes.
Andrea Leadsom: Deciding what you need from your hospital rather than someone else's hospital is entirely different from negotiating terms that mean that if the spec should change there should be flexibility in meeting that spec, and surely that is where the shared knowledge just hasn't happened.
Jo Webber: Where you have a central resource that you could loan out to help and support people locally, that will be fine, but you will also need to develop expertise within the NHS organisation so that the longer-term issues of contract negotiation, of making sure that everything was running, of controlling it, could take place within the trust. We need to build up the expertise at the same time as having some support for people when they are doing the original contract negotiations.

Q132 Andrea Leadsom: But it is not clear to me—just one last thing—I have avoided talking about the cost of it, but obviously if you had some kind of central negotiating, you would also presumably get a better deal on the price of it, but it still isn't clear to me. Why hasn't this happened? We have been doing these PFI contracts for 20 years, so why hasn't the NHS built up this pool of expertise and been as aggressive as anybody in negotiating terms and pricing?
Jo Webber: The vast majority of NHS PFIs have taken place since 1997, and I don't think there were very many before that.
Andrea Leadsom: 14 years; still a long time.
Jo Webber: I think the other thing is that there has been a learning process going forward. I wouldn't entirely agree that we have learned nothing from the last 14 years of contract negotiations, but I agree that going forward we need to get better at it than we are at the moment.

Q133 Andrea Leadsom: Are there plans in place to do that?
Jo Webber: In the current situation with the way in which the reforms of the NHS are going, whatever they look like after today, obviously, I think the issue is how you ensure that you have a system of a lot of

stand-alone foundation trusts clubbing together with support from the centre to get that expertise in place.
Andrea Leadsom: So there is nothing in place at the moment—
Jo Webber: There is nothing in place at the moment.
Andrea Leadsom:—that is creating that move? That is a shame.
Chair: Very depressing evidence we have had this morning, looking at it overall.

Q134 Jesse Norman: A situation like, for example, the one in Hereford is where they are opposite a company, Semperian, which has 106 PFI contracts, so the reality is they have no power to bring that party to the table and negotiate specific contract variations, because the other party can always look elsewhere. What would make a huge difference would be if the Department of Health or the NHS was saying, "We as a group are negotiating with you, Semperian, across 20 hospitals. Now, can we talk turkey?" Do you agree?
Jo Webber: That is one model.
Chair: Thank you for that brief answer, and thank you very much for coming this morning. It has been extremely enlightening, again a very wide range of views. We have learnt a great deal and we are going to go away and consider the evidence that we have had, both orally and in writing. Thanks for coming.

Written evidence

Written evidence submitted by PricewaterhouseCoopers

Introduction and Background

PricewaterhouseCoopers advises globally on capital projects, infrastructure and the procurement of services. In the specific area of PPP/PFI, we have worked with government and the private sector to contract for over $100bn of projects in the last 10 years, involving more than 300 projects. We work across all project stages providing strategy, policy, procurement, financing and implementation advice. When advising governments, as independent advisors we are not tied to the providers of capital or services to the contracts. Our response draws on our global experience in this area, not just that in the UK.

We have detailed experience of a number of structural alternatives available to governments when procuring assets, whether or not they include private finance, including Design Build Finance Operate models, concessions, outsourcing contracts, direct public sector procurement, partnership contracts, PFI deals and other forms of project finance. We therefore will look at PFI and PPP models amongst others when helping our clients determine which model is most likely to deliver best value to the public sector for a particular asset and service.

PFI is therefore is just one approach to procuring assets and services. PFI is a sub set of a concession based approach for procurement which has been commonly been used by the private sector to procure assets and services for decades. While the UK has developed its own bespoke PFI model, similar concession based models are used commonly across the world in sectors such as roads, rail and oil and gas.

PFI models are particularly suited to procuring services when underlying assets have to be built to deliver those services and where transferring life cycle cost risk and maintenance obligations to those private sector parties most able to manage those risks offers the best opportunities to the public sector to deliver value for money. This model has therefore been particularly suited too much of our investment in infrastructure in the UK over the last decade. Through the years, different governments, both Conservative and Labour, have used PPP/PFI to develop the nation's infrastructure. It is conservatively estimated that over £50bn has been invested in infrastructure during this period. The investment has impacted the lives of many citizens and the model has been adopted and adapted by many countries around the world. Recently the volume of PPP/PFI deals contracted in the UK has been overtaken by non-UK markets. The EU's PPP centre, EPEC, estimates that in 2010 the UK represents only Euro 4 bn of circa Euro 18 bn of deals reaching financial close in the year.

PPP/PFI has allowed UK certain industries such as engineering & construction and the services sector, to professionalise, diversify and grow on the back of the commitment to infrastructure investment made by previous governments. The PPP/PFI programme has clearly improved government procurement efficiency, private sector service delivery and increased employment during its time.

There are a number of reasons why a PFI approach has been appropriate and has delivered good value for money to the public sector. These include:

- Transferring key project risks such as construction delay and cost overruns to the private sector away from the public sector and taxpayers
- Ensuring assets are maintained to a government specified standard over a contractually agreed period, reducing the unfortunate "boom and bust" maintenance spending patterns otherwise evident in much of the government-managed infrastructure estate
- Focusing procurers on the whole-life cost and performance of infrastructure rather than making short term decisions based on short term budgets
- Forcing the public sector to specify in detail what services it requires and understand what it can afford at the outset
- The long term nature of PFI contracts allows the private sector to procure efficiently and to invest to deliver services economically, including staff training, life cycle maintenance regimes, asset plans and planned rather than reactive maintenance
- The use of a standardised risk framework by HM Treasury has focused the competition and means there is now a strong competition on an agreed basis
- The PFI sector has developed a detailed contractual structure which apportions risk to several sub-contractors and financiers, so that risk transfer is allocated to subcontractors who are incentivised to perform or bear the consequences of failing to do so
- At the outset financiers perform detailed due diligence on assets, costs and contracts using technical advisors to ensure the project will be delivered on time and to budget

Prior to the onset of the PFI model, the above were seldom prevalent in the public sector. In particular, the lack of clear specification at the outset of projects and low levels of risk transfer means that the public sector's procurement record is poor.

In contrast, the discipline and due diligence that underpin PFIs explain why so many projects are delivered successfully to time and to budget and why, through risk transfer, any difficulties on particular projects are not experienced by the public sector, who only pay for delivered services, although they may result in losses by sub-contractors that are not seen by the public sector or ultimately the taxpayer.

There are several areas where PFIs have come under attack:

— *Cost of finance*—PFI companies are financed from a mix of debt and equity, procured competitively. This blended cost of capital is of course higher than Government's cost of capital, perhaps by two to four percent, reflecting the market's view of the risks inherent in each project, rather than Government's general cost of finance. It is this higher cost of finance that attracts adverse attention. But the Committee should recognise a number of key points:

— The higher cost of finance tends to be only in the early years, during construction, when capital cost and start up risk is high. Most deals get refinanced once the project is operational at far lower cost and the lion's share of any re-financing gain comes back to government; up to 70%normally and even as high as 90% on some deals

— In an illustrative example in the NAO's report "Update on PFI Refinancing and Equity Market Update" dated 21 April 2006, the NAO showed that only 17% of the total PFI payments during the life of the contract relate to private finance returns (above the cost of equivalent government borrowings) whereas 54% went towards construction and 29% to operations. So if PFI delivers efficiencies on construction and operation, these will tend to significantly outweigh the higher finance costs of the private sector. As a result, the public sector's track record in delivering projects and managing their cost thereafter compared to the private sector are more important to consider than the premium paid for private finance

— Any PFI value for money evaluation therefore needs to consider whether the incremental cost of finance outweighs the benefits of risk transfer, cost efficiencies and contractual certainty that the PFI structure delivers

— *Profitability of PFI*—equity investors typically invest 10% of the overall finance of a PFI company and their rate of return is determined under competition. That rate of return bid has fallen steadily over recent years as the market understands PFI risks better and a secondary market has developed in PFI investments which allows the recycling of invested funds

— There has been frequent criticism of the returns equity investors have made on their PFI/PPP contracts. It is true that early investors in PFI have exceeded their own expectations in what they have made from PFI. They argue that they took risk in an uncertain market at the time and therefore warrant the return. Whether or not they are correct, we believe the market today would not afford investors the same level of returns as those early investors. This has resulted from active government intervention in areas such as refinancing as well as a maturing more competitive market

— Some commentators have argued that government should share in the returns earned by PFI equity investors. We believe this would be a complicated and confusing policy objective. Government enters into contracts for many goods and services with the private sector, procured competitively from a wide range of suppliers. Government has not sought to share in the returns earned by suppliers of other goods and services so doing so in PFI would be inconsistent, assuming it were even possible to do so

— It is regrettable that the early policy setters did not foresee the concern later governments would have with the returns being made by investors in PFI as they may have adopted a different model for PFI. If government had wanted to regulate the return earned by equity investors, they could have adopted the principles used to manage returns earned by the regulated utility sectors, although this would have come hand-in-hand with a different risk share and incentive regime, which may have been less attractive

— Many sub contractors to PFI companies have lost substantial sums delivering on their contractual commitments. But precisely because under a PFI the public sector does not pay for that underperformance and the price for the delivery of specific assets and services is fixed, Government is not exposed to these losses. The strength of the PFI model is it creates a market where there are both winners and losers, while the public sector and taxpayer is shielded from this activity which is behind the veil of risk transfer

In our view, and it is a view that is shared by Infrastructure UK, the HM Treasury's Infrastructure Unit, best value is achieved where there is a long term, involatile market where strong competition is very evident and where risk transfer can be achieved. And this means that where projects are successfully delivered, investors should expect to receive contracted returns.

Government is currently consulting with the private sector about sharing in the returns made by the private sector. It has also investigated whether it could unwind some of the deals, either partly or completely. At the same time the government is keen to attract foreign investment, for example into the nuclear and renewable sectors. It is important to realise that international investors are very conscious of sovereign and political risk; more so since the financial crises spread beyond banks into the sovereign sector. The UK government's review

of its feed in tariff regime (following on that of Spain), has certainly concerned investors who have traditionally regarded the UK as a sound investment destination with investor supportive policies and practices. We have heard investors express some reservations about the government's desire to change existing PFI contracts. The attacks on the PFI returns are on the same contractors and investors—including your and our personal pension funds—that are required to underpin future infrastructure investment in the UK. The Committee should fully understand that its behaviour and pronouncements in one concession-based sector will directly impact investor appetite (both pricing and overall interest) elsewhere in UK infrastructure. Its conclusions in its review of the PFI sector will have far wider ramifications.

Lastly, we would note that government procurement of PFI has reduced significantly. This coincides with significant reductions in government capital spending (notwithstanding the announcements made in the National Infrastructure Plan). The reasons for the reductions are understood by government's suppliers as the government looks to reduce its deficit and debt levels. What is less well understood is why in light of the significant reduction in PFI spending and criticism of the model itself, so much political attention is now focused on PFI. UK based contractors, service providers and funds are increasingly looking to foreign markets which are committed to PFI and spending on infrastructure. The Committee's review is regrettably late as its findings will be unable to be implemented in a substantial manner due to the reduction in PFI and infrastructure spend.

Treasury Select Committee Questions

We will now address the Committee specific questions in order.

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

There are a number of public procurement methods ranging from a traditional approach of procuring a pre specified asset, to procuring on an output based basis, use of Public, Private Partnerships and partnering models etc. Each of these models—and there are a number of subsets of each—can be more appropriate for different types of asset and service procurement. The key questions and factors that would determine which model is the most appropriate will include:

- Is there a capital expenditure to be made ie a new asset to be built?
- Are operations and maintenance to be included in the contract?
- Is there a competitive market for the delivery of that asset or service?
- Can government specify the level of services it requires over a long term period?
- The degree of flexibility government requires both during the procurement process and during operation of the facility.
- Time constraints and the need to deliver projects as fast as possible.
- Budget constraints: the need to deliver a particular service within a constrained affordability envelope.
- Size of the procurement: is the project of the size and scale big enough to attract private sector capital on the one hand and not too big to inhibit risk transfer on the other?
- Is it a repetitive procurement; ie one where one or more similar procurements will be forthcoming and therefore a market could be encouraged?
- Does government want private finance to fund the building phase of the project and if so, what level of risk does it want those financiers to take?

The more services eg design, building, operations, maintenance etc, are bundled into a single contract, the fewer interface risks government needs to manage. These are the factors that the public sector should consider when determining the best form of procurement for a particular project and service.

We have not sought to list all the different procurement models and the strengths and weaknesses of them. The models are appropriate under different circumstances.

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

The question is slightly misleading as to date government has yet to produce a whole of government set of accounts. Government has historically followed UK GAAP when accounting for PFI and more lately IFRS. Also for statistical reporting reasons government has adopted ESA95 to report PFI transactions. Across Europe governments are most concerned about the ESA95 impact of PFIs on national debt. PFI deals should be accounted for consistent with applicable international and national standards and regulations. UK GAAP has resulted in many UK PFI projects not counting against national debt, although some have.

If government had previously required all PFIs to count towards national debt, there would have either been fewer projects (less investment in infrastructure) or higher national debt. We do not comment on the social and economic impact of less investment in transport, school, hospital, accommodation, defence infrastructure.

It is our opinion that PFI procurement should only be used where it offers value for money not because the transaction might be classified as off balance sheet.

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

Risk transfer under PFI schemes is very real and is transferred both to the PFI company itself and more importantly through the company by sub contract arrangements across the whole industry. In this way large amount of risk transfer have taken place.

This is evident by the fact that the vast majority of PFI projects are delivered to time and budget as far as the public sector are concerned even though many of them have led to losses within the private sector when meeting their contractual commitments.

The risk transfer has been both at the outset in the construction and start up of particular facilities but also through service delivery throughout and life cycle maintenance costs. The private sector has developed increasing levels of expertise to quantify and price those risks competitively.

The risk transfer to the private sector is of course not total. In extremis, if all of the equity of the PFI company is exhausted as well as all of the contractual commitments, legal damages and rectification costs inherent in the sub contracts, then PFI companies could default. However, in these rare circumstances, the assets are returned to government who only pays the PFI company the value of the returned asset.

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

The PFI structure is particularly suited to projects with a major capital cost element. This is because the value for money is achieved through the introduction of competitive upfront pricing, life cycle risk analysis and all the inherent due diligence that project financed deals entail.

By using a PFI structure, it forces the public sector to be very clear about the services it requires, the type of assets that it needs and whether or not it can indeed afford the services that it has specified. The PFI contractual structure also reduces the tendency of the public sector to introduce large number of change orders during the construction process with inevitable impacts on pricing. Therefore it is more suited to projects where the public sector can be very clear what it wants and what it can afford at the outset.

Specifically the obvious risks to transfer to the private sector are those they are best able to manage and cost. So infrastructure construction risks (delay, price, quality), infrastructure maintenance risks, infrastructure operating risks and infrastructure financing risks are best put to the private sector rather than retained in the public sector. Where it is unclear who is best placed to manage the risk, it makes little sense to transfer the risk to the private sector—it should either be retained by government or shared with the private sector. Examples include demand risk, inflation risk, interest rate risk, insurance risk, change of law risk, change of specification risk.

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

In the UK there are no guarantees either implicit or explicit in PFI deals. If the private sector fails to deliver either assets or services there is no guaranteed pay back from the public sector. The principle the public sector only pays for the services it delivers or fair value for the asset that it receives underlies the whole of the PFI regime.

In other markets, governments may provide explicit guarantees such as is the French "Cession Dailly" process whereby lenders are guaranteed repayment of 80% of their debt once the project completes construction.

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

We believe Box 7.1 (page 79) of HM Treasury's policy document "PFI: Meeting the Investment Challenge" appropriately answers this question.

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.

April 2011

Written evidence submitted by the NHS Confederation

1. About the NHS Confederation

1.1. The NHS Confederation is the only body to bring together the full range of organisations that make up the modern NHS to help improve the health of patients and the public. We are an independent membership organisation that represents all types of providers and commissioners of NHS services.

1.2. We speak for the whole of the NHS on the issues that matter to all those involved in healthcare. We also reflect the diverse views of the different parts of the healthcare system. We are pleased to have the opportunity to submit evidence to this inquiry on the private finance initiative (PFI). The Foundation Trust Network, who we work closely with, has also responded to this inquiry.

2. Recommendations

2.1. Many of the issues identified in our submission are not unique to PFI, but they relate to broader capital issues in the NHS. However, PFI can make problems associated with financing large capital projects worse, especially due to inflexibilities resulting from many PFI contracts. Recommendations we make include:

— A more measured debate about the use of PFI is needed. Otherwise we might discourage future private investors from supplying capital for vitally important large projects.
— We believe the government is right to look at whether any efficiencies can be gained from existing contracts.
— Future contracts need to consider whether more risk can be passed onto investors without significantly raising costs or deterring investment. For example, in most cases investors currently carry the risk associated with designing and completing a building, but not the risk in helping such buildings in the future to change (in terms of their function or redesign) to allow organisations to respond to changes in demand for their services.
— Whatever changes are adopted to contract design for capital projects, it will be necessary to ensure the mechanisms used for paying organisations reflect the true cost of maintaining buildings and replacing them.
— Under the government's proposed health reforms, all trusts need to achieve foundation trust status. Clarity needs to be provided on how trusts with a large PFI debt can meet the financial tests associated with achieving foundation trust status.

3. An Overview of PFI in the NHS

3.1. PFI in the NHS involves a public-private partnership between an NHS organisation and a private sector consortium that makes private capital available for health service projects. All major capital projects are expected to consider whether PFI could represent a value-for-money solution.

3.2. Typically the consortium includes a construction company, a funding organisation, and a facilities management provider. Although they vary significantly in value and size, contracts for major NHS PFI schemes may be for 30 years or more and normally give the private sector partner responsibility for:

— Designing the facilities.
— Building the facilities.
— Financing the capital cost.
— Operating the facilities.

3.3. The majority of PFI schemes in the NHS are for hospitals or particular units or services within hospitals, and these have been the most high profile projects. But there have also been a smaller number of PFI projects for community-based facilities.

3.4. Much of the recent debate has been critical about PFI contracts in the NHS, particularly the large costs involved and whether the private sector has carried proportionate risk. However, it is important the debate acknowledges that without PFI there would have been few alternative sources of capital funding for large projects. Projects financed through PFI have given the NHS a number of vitally important buildings to replace ones which were often in urgent need of repair. Whilst there is a need to ensure contracts are suitably flexible and pass on sufficient risk to investors, there is also a danger that without having a more measured debate about the use of PFI, we could deter future private investors from supplying capital to PFI schemes.

3.5. Although critics have focused on the costs of PFI, it is also important to keep in mind that building costs in the UK appear to be high and costs include operating and maintenance costs.

4. Problems with PFI Projects and Possible Solutions

Contract design and length leading to inflexibility

4.1. PFI creates a fixed obligation: income needs to be maintained to meet costs for the lifetime of the contract. When PFI contracts were planned, future income looked stable. However, under the proposed reforms to the NHS there will be greater competition between NHS organisations, potentially making income less stable. The need for providers to maintain patient numbers and therefore income also makes it harder to change the way care is provided and move care out of hospitals (either to provide better care for patients, to reduce costs, or both).

4.2. Future PFI and non-PFI funded capital projects need to consider whether contracts can be designed to more easily allow organisations to change the way they operate and adapt to a more competitive market. For example, by passing on more risk to the private investor for the life of the building, not just its design and completion. This option would need to be carefully balanced against a potential increase in costs demanded by the investor.

4.3. To avoid these inflexibilities being concentrated in particular geographical areas, future PFI procurements need to continue to take into account the whole pattern of investment across an area and need better contractual methods to deal with the greater level of instability in the new NHS market. However, under the government's proposals to reform the NHS, planning investment across whole geographical areas may become harder to achieve. Due to the emphasis on local-decision making, there will not be a lead organisation managing the local system (a role currently fulfilled by Primary Care Trusts) which will make it harder to co-ordinate future capital projects.

Recovering savings from existing PFI contracts

4.4. Our members are concerned about the cost of existing PFI contracts against a background of potential reductions in activity within the acute sector and potential instability in contracts.

4.5. We have therefore welcomed the Treasury's announcement that it is to assess the potential for savings in a number of PFI contracts[1]. It is right to analyse whether there are any practical ways of squeezing more value out of these deals. These are financially hard times for the NHS and PFI represents a very significant overhead. Tax payers need to see that everything possible is being done to focus resources on patient care.

4.6. It will however be difficult in practice to recover large costs from contracts. Besides the legal difficulties of renegotiating some contracts, it is difficult for NHS organisations to find alternative uses for buildings that maintain income and to allow flexibility on service provision. This is because:

- The PFI costs that need to be covered appear to be high as they include not just the costs relating to the design and construction of buildings, but also long-term service delivery contracts that NHS providers are tied into. Costs also appear to be higher because buildings are designed for clinical use. For instance, hospital floors are designed in a way to make them easier to clean, and some parts of hospitals have air filters or vacuum and suction points that require expensive maintenance.
- Non-NHS uses—for example, turning a NHS PFI-funded building into private sector office accommodation—are deemed too expensive when compared with other commercial accommodation available on the market. In any case, the design of buildings restricts the number of suitable alternative NHS or non-NHS uses.
- In some cases, PFI buildings are in areas with little demand for alternative use of large sites.

Tariffs

4.7. Current tariffs (which are decided by the Department of Health) do not fully reflect the cost of capital as they are based on historic cost which reflects a significant number of fully depreciated buildings or facilities that are not fit for purpose.

4.8. To correct this, a sufficient allowance could be made for the true costs of replacing buildings or other capital in the design of the tariff. However, there are difficulties with designing tariff prices in this way. One reason for this is that tariffs are normally designed for average cost. If these took into account full PFI repayments it could incentivise the system to have high capital costs and it would also financially benefit those organisations without PFI or other capital repayments.

4.9. Some other systems have considered either direct payments or subsidies to organisations with unavoidable differences in their costs. It would also be possible to remove calculations of capital costs from the tariff and to reimburse it directly on a formula basis instead. Designing this system so that it is fair and does not incentivise overuse of capital is technically very difficult, but it should be examined to help organisations manage PFI and other capital costs effectively.

[1] http://www.hm-treasury.gov.uk/press_22_11.htm

Attaining foundation trust status

4.10. Under the proposed reforms to the NHS, the government wants all trusts to attain foundation trust (FT) status. The Department of Health has indicated that PFI may present a challenge to FT authorisation 'given the combination of today's market conditions and Monitor's financial tests [for FT authorisation]'. This is an issue which the Public Accounts Committee has also expressed concern about[2]. Clarity needs to be provided on how trusts with a large PFI debt can achieve foundation trust status.

5. Alternative Funding Models

5.1. Currently some NHS organisations have insufficient access to capital. This could become a greater problem under the reforms where an increase in competition will create both a stronger need for organisations to restructure their services in order to reduce their cost base and make them more competitive creating less stability in future income. Providers' own balance sheets are unlikely to be of sufficient scale to support a wide-ranging investment programme in the medium term.

5.2. One option that we have put forward is for the creation of an enhanced NHS banking function. This could include providing access to investment and working capital based on a commercial rules-based system. This could help with the restructuring of services. Such a banking function would, however, need to be sufficiently distant from the Secretary of State for Health if future foundation trusts are to maintain their independence and freedom.

5.3. In other countries, such as Italy, that use schemes similar to PFIs, organisations are given more control over the service delivery company by having a controlling or significant interest and representation on the Board. This helps organisations to keep greater control of their service delivery costs. This option should be explored.

5.4. Whatever option is adopted the mechanisms used for paying providers must change to reflect the true cost of building upkeep and replacement.

April 2011

Written evidence submitted by Balfour Beatty

Executive Summary

1. PFI has delivered significant benefits by creating a framework which allows considerable investment in our national infrastructure, including a large building programme of new schools and hospitals. However the industry should recognise that there is significant scope to improve the partnership with the public sector and should positively engage with the Government as they seek to do so.

2. Balfour Beatty has proposals to help the Government improve PFI and strengthen the partnership between the public and private sectors, so that it can continue to invest in vital infrastructure and deliver the benefits of PFI whilst reducing costs and eliminating some of the problems. At the same time as recommending changes from the public sector, we recognise that the challenge of improved efficiency is also incumbent on the private sector who need to play their part in delivering more for less.

3. We believe that a model which involves the private sector raising finance to deliver public infrastructure is worth continuing as part of a range of procurement options, provided that the cost of private finance is outweighed by the benefits of applying whole life costing and private sector procurement and management skills to projects.

4. Areas the Committee may wish to explore in terms of the possible reform of PFI include:

- The efficiencies to be made from changing costly, complex and lengthy procurement processes.
- Savings to be made by avoiding the transfer of inappropriate risks.
- Finding a means of injecting greater flexibility into the system.

5. As Government moves from the present model of PFI to a reformed model for financing infrastructure, it is imperative that we maintain investment levels. Sustained investment in our infrastructure is vital to the future of the economy and the country and any hiatus would be particularly damaging in the present economic environment.

Funding Investments In Infrastructure Is Vital To The Future Of The Economy

6. Balfour Beatty believes that sustained investment in infrastructure is vital to the future of the economy. From 1999–2008, UK public investment as a percentage of GDP was lower than almost any other OECD country[3] and almost half the average of G7 countries. Although fiscal restraint is a national imperative, it is clear that there is a positive relationship between infrastructure spend, the level and growth of GDP and stock market indices.

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[2] Public Accounts Committee (April 2011) 33rd Report: *National Health Landscape Review*

[3] Oxera analysis, based on OECD, HM Treasury and Datastream data

7. In particular, investment in infrastructure has a higher economic multiplier than other types of government expenditure. Against other forms of spending, investment in infrastructure can be said to produce:

- low reliance on imports thus resulting in greater additional economic activity in the UK;
- a heavy reliance on an extended and varied supply chain, thus engaging many different parts of the domestic economy; and
- high levels of employment due to the labour intensity of the work.

8. To curtail infrastructure spending severely will produce undesirable outcomes. HM Treasury's recent Infrastructure Cost Review concluded that the *"Stop-start investment programmes and the lack of a visible and continuous pipeline of forward work"* was a key driver of higher cost. Furthermore, uncertainty regarding future infrastructure spend creates a supply chain reluctance to invest and a loss of skills and expertise which will be difficult to reassemble.

9. For these reasons, we believe that as the Government considers the future of PFI it is imperative that any potential new funding model not only sustains, but if possible increases, the overall level of public investment. Moreover, should there be a transition from the present PFI model to an alternative involving private finance, it is imperative that there is no hiatus in infrastructure investment.

PFI Strengths And Weaknesses

10. PFI has been a significant part of the UK's procurement model since 1994 accounting for up to 10% of public infrastructure procurement. In that time a significant number of independent reports have been produced, notably from the NAO, highlighting benefits including:

- Facilitating £28bn of public investment, including large scale school and hospital building programmes.
- As the recent Lords Select Committee concluded, *"There is strong evidence that PFPs have a better record of on time and on budget delivery than traditionally procured projects"*.
- Integrating design, construction, and operation into a single framework leading to efficiencies of whole life costing—as highlighted by a 2003 NAO report on PFI Construction Performance.
- Facilitation of strong customer service orientation through incentives, leading to increased user satisfaction as evidenced by the 2009 NAO Report on PFI which reported high levels of satisfaction from PFI customers.
- A management process that allows the public sector to focus on outcomes rather than requiring it to be involved with the framework of delivery.

11. Against these claims have been criticisms. First, that the process is "expensive" and can be replicated without the use of private finance. Secondly, the length and complexity of the tender process leads to, as well as cost, unnecessary delay. Lastly, that the structure of PFI, with multiple stakeholders and an elaborate governance process, leads to inflexibility, thus restricting the accommodation of progress and change within a long term contractual arrangement. The latter two of these points are undoubtedly true and we suggest solutions for this in the latter part of our submission. The first of these points is complex and benefits from some analysis.

12. The claim that PFI is "expensive" could be based on the following arguments:

- that the elemental cost (principally construction and facilities management cost) is expensive; and/or
- that the risk transfer leads to costs that are not value for money; and/or
- that the cost of finance is expensive.

13. There is no evidence to suggest that the elemental cost of a PFI project is any higher than that of a project procured under a different model. Therefore, we intend to focus on the other two elements—risk transfer and financing costs.

14. In relation to risk transfer, it has become clear over the years that, at times, the tax payer is paying for unnecessary elements and savings can be made. We offer solutions below.

15. The financing costs of PFI are typically 3–4% over that of government debt. The question of whether or not this represents value for money is a value judgment for Government, and this judgment needs to take into account the savings PFI can help to deliver elsewhere in the procurement process, notably in terms of on-time and on-budget delivery, risk transfer, and whole-life management of infrastructure assets. The following paragraphs consider those benefits in more detail.

16. The key benefit of PFI to the public sector is that it transfers whole-life risk from the public to the private sector. As such, the company building the asset is very strongly incentivised to build a piece of infrastructure which is high quality not just on day one, but for up to 30 years later. For a PFI provider the main costs of construction are up-front, but it recovers that investment with payments staged over that 30 year period and dependent on performance. Without the use of private finance (were the public sector to fund the up-front capital cost itself for example) it would be impossible to transfer risk in this way and incentivise performance over a 30 year period.

17. A second key benefit of PFI is that it allows world class construction management to be brought in to manage public infrastructure projects without the duplication and man-marking which often occurs when the public sector "manages" a construction contractor in a traditional model. As the James Review into Building Schools for the Future (BSF) sets out, these sophisticated construction management skills are seldom present in the public sector, with the review concluding that *"A lack of expertise on the client side meant that there was little opportunity to improve building methods in order to lower costs over time, especially for very large and complex projects."*

18. Proving whether the two key benefits of PFI—risk transfer and more efficient project management—outweigh the additional financing costs has so far proved difficult. Although projects funded by PFI have detailed performance data, one of the missed opportunities over the period has been a failure to utilise similar systems of measurement of performance where the public sector itself manages its own assets.

The Future Of Funding Infrastructure

19. The arguments articulated above lead to the following basic conclusions:

- A model which involves the private sector raising finance to deliver public infrastructure is worth continuing as part of a range of procurement options provided that the incremental cost of private finance is outweighed by the benefits of applying whole life costing and private sector procurement and management skills to projects.
- PFI value is diminished by costly, complex and lengthy procurement process.
- PFI value is also diminished by transfer of inappropriate risks.
- A means of injecting flexibility into the system needs to be found.

These issues are examined in turn.

Timescales

20. Often, lengthy procurement programmes coupled with delay during the competitive dialogue process adds to cost. The James Review in fact reached the same conclusion, stating, *"The extremely lengthy pre-procurement and procurement processes were a key driver of both cost and, crucially, risk for the Local Authority, central government, and the private sector. The increase in risk was costed in to every stage of every project by each contractor and sub-contractor."* It seems to us that the principal causes of both the length of programmes and their subsequent delay are lack of preparation by the contracting authority prior to commencing the dialogue process and also changes in personnel or policy during the dialogue process.

21. Balfour Beatty's recommendations for reducing timescales in procurement are:

- No more than 3/4 bidders should be pre-qualified so that the client has sufficient time to conduct dialogue with shortlisted bidders at the preliminary stage.
- Authorities should reduce to 2 bidders as quickly as possible—in most cases we believe that this can be achieved in 4 months from shortlist by ensuring that there are no more than 2 stages to any procurement process after short listing.
- Authorities should tighten authority evaluation periods post-submission by better use of project management.
- We believe that these changes would make the market even more competitive by encouraging potential new entrants, by reducing the sometimes onerous bidding costs.

Project Management

22. Balfour Beatty's experience coincides with several reports into the procurement and management of PFI projects, in particular the recent James Review of BSF that has highlighted weak project management by authorities as a major concern. This is often a function of inexperienced public sector managers, coupled at times with a structural weakness where, in some sectors clear and effective project management is prevented by the plethora of external agencies and experts that are required to be engaged on the client side.

23. Balfour Beatty's recommendations for improving authority project management are to:

- Identify, develop and career plan for effective authority project directors/managers, inter alia by the provision of development programmes.
- Reduce the frequency of key personnel changes during procurements.
- Appoint single sources for professional advice to ensure clarity of message to bidders.

Scope

24. The scale of PFI projects, their long-term nature and the number of participants necessarily involved in any PFI contract makes these projects complex. In these circumstances it is paramount for the authority to simplify the technical and commercial arrangements for the project as far as possible. In our experience, the

more complex the scope of a project the more likely it is to suffer delays in procurement and to suffer from a lack of clarity about what has been agreed when it comes to the operational stage of the project.

25. Balfour Beatty's recommendations for ensuring an effective and efficient project scope are to:

- Avoid the temptation to "integrate" projects in the hope that this will transfer interface risk from the authority to the private sector. In our experience such attempts (eg including ICT under contractors' control in BSF projects) leads to complexity, delay and cost compared with the alternative of the authority managing this co-ordination.
- Ensure that where multiple authorities collaborate to deliver "bundled projects" (which we support—see below) there are effective governance arrangements in place such that the private sector deals with one lead organisation.
- Evaluate more carefully whether there is value for money in transferring existing assets to the private sector as part of the PFI transaction and, where existing assets are to be transferred, ensure that surveys are procured *before or at the earliest stages of procurement* which enable the private sector to assess risk.

Costs

26. The cost of procurement is affected by all these issues: timescales, the calibre of project management and project complexity. In Balfour Beatty's experience there are a number of other areas which significantly add to the cost of procurement or where procurement costs can be reduced.

27. Our further recommendations for reducing the cost of procurement are to:

- Avoid the use of PFI for smaller projects where the transaction costs of PFI do not represent good value for money. It needs to be considered case-by-case, but as a ballpark figure we think PFI should be avoided for projects of less than £20 million.
- Increase the efficiency of procurement and reduce transaction costs by "bundling" PFI projects so that only one project is designed but multiple projects awarded. "Bundling" projects in this way can be an effective way of delivering similar projects across multiple authorities (eg in Fire & Rescue) providing they have previously set up a single procuring organisation (as noted above).
- Develop standard designs or standard design elements where appropriate. Standardisation was a key finding of the HM Treasury Infrastructure Costs Review, which concluded that "Over-specification and the tendency… to apply unnecessary standards, and use bespoke solutions when off-the-shelf designs would suffice" was a key driver of increased costs.

Balancing Risk Transfer with Value for Money—Payment Mechanism

28. Balfour Beatty's experience across a wide range of PFI sectors is that clients, often encouraged by their external advisory teams, are tempted to incrementally increase the risk transferred to the private sector. Often, these increases in risk transfer are not properly evaluated in terms of the potential impact on value for money. The payment mechanism is the authorities' main commercial tool to incentivise performance against the expected standard. However, our experience is that over time, increasingly aggressive payment mechanism arrangements result in poor value-for-money as PFI operators build-in risk to avoid the consequences of disproportionate penalties. Balfour Beatty's recommendations for improving the payment mechanism are to simplify the number of performance measures and put operational management in the lead of payment mechanism deliberations rather than them being led by financial/legal advisors.

Other Risk Transfer Issues

29. Similar to the payment mechanism, other risks have been pushed to the private sector side either in the standard form contracts or as a result of "risk-creep" in various PFI sectors. Balfour Beatty makes a number of recommendations aimed at re-balancing this risk transfer to ensure improved value for money:

- *Insurance*. By requiring the private sector to insure PFI projects the public sector is building in the cost of premiums into PFI charges which significantly exceed the cost of claims. Public sector self-insurance, particularly for material damage and business interruption insurance, could provide significant savings on future projects.
- *Energy.* The public sector should resist the temptation to attempt to transfer risk on tariff which the private sector cannot manage any better than the public sector. Procurement of energy must be more effectively managed by the public sector, which can achieve significant economies of scale compared to the private sector.
- *Pensions*. The temptation to transfer existing public sector pension risk to the private sector should be discouraged. Some authorities attempt to use the opportunity of a PFI project to pass existing pension under-funding and future liabilities to the private sector which is unable to do anything material to manage this risk and consequently prices it in to the detriment of value for money for the public sector.

— *Demand risk*. Except where the private sector is genuinely responsible for generating customers/ users, the transfer of demand risk (eg traffic counters on highways projects) should be avoided. Demand risk tends to increase the cost of lending and result in a sub-optimal project structure which leads to a reduction in value for money for the public sector.

Improved Efficiency from the Private Sector

30. Balfour Beatty recognises that there is considerable scope for the private sector to improve its efficiency when delivering PFI projects, savings which can be passed back to public sector clients. We believe that more use could be made of techniques to drive efficiency in the construction and operations phases of PFI projects. Eg making more use of innovative techniques such as off site system build and assembly can save significant sums through the construction phase. With a sufficient pipeline, economies of scale can be delivered through efficient purchasing techniques (bulk purchasing or on-line auctions, for example) throughout the supply chain, which guarantee quality as well as price. Similarly, the private sector could be incentivised to produce year-on-year savings throughout the lifetime of infrastructure projects by driving continuous efficiency improvements to reduce costs.

Balfour Beatty

31. Balfour Beatty is a British infrastructure company founded in 1909, employing over 50,000 people around the world including over 30,000 in the UK. We deliver services essential to the development, creation and care of infrastructure assets including project design, financing and management, engineering and construction, and facilities management in sectors including transport, power, waste and buildings.

32. Balfour Beatty has been a contributor to the development of PFI in the UK and increasingly overseas. By the end of 2010 Balfour Beatty had invested in over 50 PFI concessions world-wide committing well over £500 million of equity.

April 2011

Written evidence submitted by Transport for London

1. Executive Summary

1.1 Transport for London (TfL) welcomes the opportunity to share its experience both of managing 13 Private Finance Initiative (PFI) schemes and of considering PFI against alternatives for many other large capital projects. Eleven of TfL's PFIs were inherited from other entities. Some of these were "early" PFIs: mistakes made there have been learned from already and applied to more recent deals. Furthermore, some of the circumstances that may have led to the use of PFI will have disappeared given TfL's greater resources. In particular, TfL has access to direct borrowing and a long-term funding settlement with the Department for Transport, something which London Underground (LU) did not have in the 1990s.

1.2 Much has been said on the topic of the failure of the LU Public Private Partnerships (PPPs). TfL considers that the PPPs were sufficiently different to most other PFIs (and scrutinised already) that lessons learned are not particularly relevant to the future of PFI in the UK. The Committee is referred to TfL's contributions to earlier investigations by the House of Lords Economic Affairs Committee and the National Audit Office which considered the failure of Metronet.

1.3 The circumstances where PFI is appropriate will depend on the nature of the project and the circumstances of the public body procuring the assets. In TfL's case, it has extensive experience in procuring complex contracts, managing risk and integrating suppliers: other public bodies may not and PFI would allow them to out-source some of this activity.

1.4 .TfL's submission highlights some of the project circumstances that weigh against the efficient use of PFI, such as upgrades to existing assets, especially assets that need to be in service whilst the capital works take place and/or assets with complex operational interfaces. Size is also a limiting factor: PFIs are not being typically used on Crossrail, other than the rolling stock and depot (which are currently being procured as a PPP). In future, PFIs are most likely to be considered by TfL for new river crossings, new trams and other extensions to the existing network. The common feature of these is that they are relatively separable from operations and are of a size that makes them appropriate for PFI.

2. Background—TfL's Experience of PFI

2.1 TfL welcomes the opportunity to contribute to the Treasury Committee's inquiry into the Future of PFI.

2.2 TfL's experience of PFI extends to 13 existing projects, including some of the earliest (Northern line PFI, let in 1995) and the largest (the three LU PPPs, worth £16bn). Following its formation in 2000 and incorporation of LU in 2002, TfL inherited 11 PFIs and, subsequently, let two more—both Docklands Light Railway (DLR) extensions. More recently, TfL commenced procurement on another (Crossrail rolling stock and depot), but also brought five of its "legacy" PFIs back in-house. (A list and brief summary of these PFIs is appended to this submission for reference.)

2.3 In the same period, TfL has overseen tens of billions of pounds in capital investment in London's transport system though a range of structures, including conventional procurement and leasing as well as PFI. This investment has also utilised a variety of sources of finance, including direct borrowing by TfL, from TfL's operating cashflows, from third parties such as BAA and Network Rail and though PFI private finance.

2.4 TfL's experience and choices have been affected by its particular circumstances. This includes TfL's ability to undertake prudential borrowing for investment; the long-term funding settlements agreed with DfT; TfL's large investment programme and portfolio of projects; the nature of TfL's existing assets (typically old and in constant operation); and TfL's primary role as transport service provider—not just asset owner. The lessons learned below are informed by these circumstances and therefore may not be wholly applicable across the entire public sector and to the future of PFI in general in the UK.

2.5 Much has been made of the failure of the Tube PPPs and TfL has contributed to the investigations undertaken by the NAO and the House of Lords Economic Affairs Committee. TfL believes that the failure of the PPPs was largely due to the unique features of those contracts and therefore this submission focuses on TfL experience of both managing/letting the ten other "standard" PFIs and the factors where PFI was considered by TfL for procurement but not used.

3. Commentary

3.1 TfL has learned a number of lessons, which are highlighted below.

3.2 *One-off projects*. PFIs are complex to procure and require application of large amounts of time and resources by sponsors and bidders. This is an efficient investment where there is going to be a pipeline of projects: lessons can be learned and applied the next time. TfL's most successful PFIs are the DLR series; the least successful were all bespoke. The effect of any mistakes made from "breaking new ground" will be magnified on a PFI that will endure for around 30 years.

3.3 *Uncertain future*. The long-term nature of the contracts means that PFI is inflexible and expensive when required to accommodate change (either foreseen or unforeseen, such as inability to define future sponsor's requirements or changing needs post signing contracts). The LU line upgrades resulted in expensive variations to the Power PFI and the changes to fares and competing bus services led to the need for TfL to acquire the Croydon Tramlink concession to avoid protracted legal dispute and on-going compensation. TfL needed to terminate the Prestige PFI in 2010 because the technology had become obsolete and TfL required higher performance standards than the contract delivered. Even the incorporation of "periodic reviews" of scope and price in the PPPs failed to work satisfactorily. Overall, TfL's experience is that PFIs are the least flexible form of contract, in many cases binding both client and contractor to a series of outputs that have diminishing desirability and/or affordability, with much less scope to negotiate change than under other forms of contract. This can be a strength—as client changes are often a significant cause of cost overruns—but is also a major constraint.

3.4 *Access to alternative funding***.** TfL has a long-term funding settlement with DfT and a borrowing programme to finance investment. TfL direct borrowing is an alternative to the private finance element of a PFI and focuses the decision on Value for Money (VfM) rather than being skewed by a desire to access either "free money" or guarantees of long-term funding to support the PFI payments. This is illustrated on the East London Line Extension where TfL, on inheriting the project from the Strategic Rail Authority, switched it from being financed privately to being financed by TfL.

3.5 *Risk transfer.* Given that public authorities are typically procuring essential infrastructure, they will need to step in if a PFI contractor fails. Thus risks cannot be truly said to be "transferred" and it is better to think of alignment of contractor incentives. Furthermore, there is a natural limit to the types and size of risk that the private sector can bear efficiently. TfL's experience has been that PFIs are better value for "separable" assets (ie works not on existing assets), as shown by TfL's choice of PFI for the two most recent DLR extensions but not for the East London Line, where the largest risk was the asset condition of the Brunel-built Tunnel under the Thames. Similarly, Crossrail is well documented as being simply too big to be able to transfer risk through PFIs, with the exception of the planned rolling stock and depot PPP. Finally, TfL has only been responsible for two PFIs with demand risk: Croydon Tramlink and the A13. The Tramlink agreement was unsuccessful because its revenues were not separate from the Mayoral-controlled fares regime for all London public transport services. The A13 has been more successful although the concessionaire has had problems with traffic forecasts and counting.

3.6 *Operational interfaces*. Most of TfL's assets form part of a complex matrix of different types of asset (trains, track, buildings, etc) and types of activity (maintenance, upgrades, renewal, inspection, train operation, passenger flow in stations). Each of these might be large enough to form a PFI (as is the case with the Power and Connect PFIs) but this carve-out creates new contractual interfaces, which can be difficult and expensive to manage. For example, the Power PFI required extensive variation once the PPPs were let and line upgrades subsequently specified. Then the PPPs themselves treated power as a "free good" leading to skewed decision making. However it is possible to manage these operational/contractual interfaces successfully, as is done on the DLR where most of the extensions are Design Build Finance and Maintain (DBFM) PFIs, the operations outsourced and the original network owned by TfL. Typically contractors find it difficult to assess the risk

inherited asset condition and the close interaction between operational services and upgrading infrastructure on an operating railway is very difficult to manage through an inflexible contracting structure.

3.7 *Risk management*. TfL's business plan contains approximately £1.4bn per annum of capital expenditure covering a vast number of large and small projects and investment. This makes it efficient for TfL to invest in in-house project delivery expertise and also allows TfL to manage risks as part of a portfolio. As a result, TfL can consider whether it values fixed outturn costs (ie PFI) or has financial capacity to participate in the risk and reward of a less certain outturn. In the latter case, PFI is clearly unsuitable.

3.8 *Performance, accountability and control*. TfL's experience is that some PFIs have performed well (eg DLR extensions completed on time/budget). Others have had significant problems, incurring penalties under the payment mechanism. The calibration of this needs to be right: severe penalties will lead to the contractor "handing back the keys" to TfL (eg Metronet) whilst lack of "bite" will lead to TfL ultimately failing to provide adequate transport services to the public. TfL's experience is that the general public have little appetite for a blame game—clearly to the extent TfL can control its own assets, it can control its performance. On systems like the Tube, being run at full capacity, the consequences of asset failure are magnified and very noticeable. In the private sector, business critical activity is tightly controlled—only the less business critical activity is out-sourced.

3.9 *Pricing and market conditions vary.* Although TfL has not let a PFI since the credit crunch, it is aware that the cost of PFI debt has become significantly higher and more restricted in quantum. Similarly, market appetite from bidders can also vary depending on circumstances. Just as the VfM of a PFI will change depending on cost at the time of letting, its VfM will also change thorough its lifetime. TfL's reacquisition/ termination of Prestige, Tramlink and Tube Lines were not forced: they were choices made by TfL in order to reduce costs or generate other benefits. TfL strongly believes that PFI should incorporate flexibility to allow sponsors to make sensible business decisions—and sponsors should not be financially penalised for doing so.

4. Treasury Committee's Questions

4.1 The Committee also asked for evidence on the following points.

— *What are the strengths and weaknesses of different public procurement methods?* This is a very broad question. The main feature of PFI is a fixed (or indexed) cost of buying fixed long-term outputs. In some circumstances, the client's long-term requirements can be adequately predicted but in others they cannot and in the latter case, PFI is unlikely to be suitable (nor for that matter would and long-term contract such as leasing). The other aspect of PFI is the transfer of (out-sourcing of) risk and responsibility, ie the Special Purpose Vehicle (SPV) acts as procurer and integrator of the various capital and maintenance services from sub-contractors, all for a fixed price. TfL's experience is that this can be efficient in some circumstances, particularly separable assets, but would not be in others, such as where the assets' condition cannot be established. This bundling of suppliers can result in some poorer quality sub-contractors being procured.

— *If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much? How should PFI deals be accounted for?* In the early days of PFI there was clearly a pressure to use it in preference to other procurement routes and the accounting treatment appeared to be a driver of that approach. TfL expects that PFI is less attractive to it than other public bodies since TfL has a long-term funding settlement, ability to borrow directly and a large portfolio of projects within which to absorb risk. Both of the PFIs let by TfL have been classified on balance sheet. TfL has no view on the "right" accounting treatment but notes that PFI is not unique in being off balance sheet. Operating leases have always been off balance sheet, as is investment through Network Rail. TfL does believe that it would be helpful for the public sector accounting and budgetary treatment to be clarified by government in light of proposed accounting changes to leases and PFIs.

— *How far can risk really be transferred from the public to the private sector?* As noted above, risk can be fully transferred only if the procuring authority could abandon a failing PFI concession, which is unlikely ever to be the case. TfL's view is that the private sector is willing to bear significant risk but only if it is paid enough. The question should be which party is best placed to manage each risk. In some cases, this is clearly the public sector and TfL invests heavily to ensure that it has the right skills to manage its risks. Clearly, not all public bodies will be in the same position and it may make sense for those bodies to be supported by others that have the resources and experience, rather than having to buy the experience more expensively from the private sector.

— Are there particular kinds of risk which are particularly appropriate for transfer through PFI deals, or particular projects which are suited for PFI? The generic answer is similar to above: where the private sector can manage risk better than the public sector, it should do so. However, this decision does not necessarily lead to using PFI—turnkey construction or maintenance contracts can be effective in risk transfer. Clearly, where PFI is unique is in creating a single source for delivery and long-term operation for a single price. If the public sector can define its long-term needs and wants a single integrator of the delivery of that service (eg a hospital), PFI may be suitable. This is less clear in transport, for many of the reasons outlined in the previous section. Technology risks, where asset lives may be short compared to the typical length of a PFI contract, are often not suitable for PFI contracts.

— What state guarantees are explicit or implicit in PFI deals? This obviously depends on the terms of each deal. The PPPs would have been unbankable without underpinning. The Woolwich DLR is part-guaranteed in certain circumstances but on a basis that improves VfM. Ultimately, any implicit state guarantee (ie that it will stand behind the public body making the payments) is no different to implicit state guarantee of all contracts entered into by public bodies.

— In what circumstances are PFI deals suitable for delivery of services? This question is assumed to relate to the direct delivery of services to the end user, rather than the delivery of intermediate outputs such as availability of a building to a service provider. This applies to two of TfL's PFIs: A13 and Croydon Tramlink. Roads are generally suitable as the asset has unrestricted public access and is free to use, so the "service" is generally no more than ensuring the road is available and safe, consistent with typical PFI deliverables. With Tramlink, the service operator was sub-contracted to the SPV. This contrasts with the DLR where the service operator was contracted by TfL. The difference is that the former was a distinct integrated network whereas the DLR extensions were only part of a larger network. One advantage of the PFI not delivering the services is the ability to let operating concessions that are shorter than the PFI, thereby mitigating some of the uncertainty over future service level requirements.

5. Conclusion

5.1 TfL regards PFI as one of a number of possible procurement options for capital works, to be used where it is most efficient. The choice of PFI or not will clearly depend on the circumstances at the time. For example, PFI finance costs have increased significantly since the credit crunch and may or may not revert to previous lower (and more competitive) levels.

5.2 TfL welcomes the Committee's enquiry and expresses its hope that the combination of persistent public criticism of PFI, recent spending cuts and increase in relative costs of private finance will not lead to the end of PFI. Nonetheless, PFI is not suitable in all circumstances and is neither a panacea for lack of public sector resource or competence nor should it be imposed from "above" or adopted for the wrong reasons such as being regarded as "free money".

APPENDIX A

LIST OF TFL'S PFI PROJECTS

Project	*Date*	*Purpose*	*Capital value £m*	*Notes*
Northern Line Trains	1995	Construct and maintain 106 trains	440	Let by London Underground (LU), inherited by TfL in 2002.
Croydon Tramlink	1996	DBFO concession for new tram	205	Promoted by Croydon Council and LT, inherited by TfL in 2000. Acquired by TfL in 2008
DLR Lewisham	1996	DBFM extension of DLR	198	Procured by DLR and sponsored by DfT, inherited by TfL in 2000
LU Power	1998	Connection of LU to national power grid, maintenance of power assets	114	Let by LU, inherited by TfL in 2002, restructured in 2007
LU Prestige	1998	DBFM for new integrated smartcard ticketing system, barriers and revenue collection	161	Let by LU. Terminated by TfL in 2010
LU Connect	1999	Provide and maintain a new integrated radio communication network	351	Let by LU, inherited by TfL in 2002
British Transport Police	1999	DBFM for new BTP accommodation	30	Let by LU, inherited by TfL in 2002

Project	*Date*	*Purpose*	*Capital value £m*	*Notes*
A13	2000	DBFM covering major improvements to strategically important road	210	Let by the Highways Agency, transferred to TfL
LU PPPs (3 PPPs)	2000	Modernise and maintain the Tube infrastructure	16,000	Let by LU. Metronet bought out of administration by TfL in 2008, Tube Lines bought by TfL in 2010
DLR City Airport	2003	DBFM extension of DLR	175	First PFI to be let by TfL
DLR Woolwich	2005	DBFM extension of DLR	238	Let by TfL
Crossrail rolling stock and depot	Soon	DBFM of trains and new depot	1,000+	Being procured by Crossrail Ltd on behalf of TfL and DfT

May 2011

Written evidence submitted by Professor Dieter Helm, Oxford University

PFIs and the RAB Model

1. The UK requires a very significant increase in infrastructure spending, reflecting a combination of new policy priorities and the failure to maintain and enhance existing assets.

2. PFI is one mechanism for facilitating infrastructure investment. It combines the financing issue with the construction and its subsequent maintenance into one single contract.

3. The main reason for pursuing the PFI route has been to keep these projects off the public borrowing accounts. This reflects the fact that national accounts are in cash terms, and there is no national balance sheet that would set assets next to liabilities. As a result, we have no idea whether the infrastructure is being maintained through time.

4. A national balance sheet would enable rational decisions to be made about borrowing and investing, and hence allow the low public cost of debt to be translated into lower costs of capital for infrastructure projects. The absence of proper balance sheet accounts therefore has a real deadweight welfare cost: the higher cost of capital on highly capital-intensive projects. The private returns on PFIs reflect this deadweight loss to society.

5. It is typically objected that international (especially European) accounting standards require cash accounts. This however does not prohibit a balance sheet approach also being taken, so we can see what the true position in respect of public policy actually is.

6. PFI projects typically have long lived fairly rigid contractual forms. The reason is that the government lacks contractual credibility: investors know that there will always be the temptation to come back after the contract has been agreed and try to change the terms, especially if returns turn out to be higher than anticipated. This is the time inconsistency problem, and the current attempts to gain "rebates" are a good example of time inconsistency in practice.

7. The consequence of time inconsistency is that since investors expect ex post intervention, they will both demand rigidity in the contracts and demand a higher rate of return since the political and regulatory risk raises the cost of capital.

8. To reduce this inefficiency, the obvious strategy is to break up the contract into its three parts: the construction phase; the operation of the assets; and the finance.

9. The capital development phase is typically the higher risk part, and it is natural to have a strong element of equity finance, since it is genuine managerial risk. Project finance tends also to be short term for the construction phase. There is typically a competitive market in these construction activities.

10. The operational contract typically involves little or no assets. The cost of capital is therefore much less important—because there is no new capital required. There is a very active competitive market in facilities management.

11. At the end of the construction phase, when the asset is completed, refinancing usually takes place. This reflects the change in the risk profile: it is now all about whether the counter-party (typically the government and/or regulators) honors its side of the bargain and remunerates the completed asset. It is all about political and regulatory risk.

12. In the utilities, this refinancing problem is addressed formally through the transfer of the completed asset into the regulated asset base (RAB) at an agreed (efficient) price. The cost of capital for the RAB is correspondingly low, since the investors are protected by the duty on the regulator to ensure that the functions

are financed, and this protection is typically assumed to mean that the RAB will be honored. As a result, the RAB is typically financed by debt rather than equity, and at a rate not that far removed from the return on indexed links gilts.

13. Extending the RAB concept to the wider infrastructure covered by the PFI projects (such as waste, schools and hospitals) could potentially result in a radical reduction of the cost of capital, since it would assign the political and regulatory risk to the government rather than managers, whilst maintaining incentives on the construction and operational components through competitive tendering.

14. In effect, the RAB would replace the refinancing that currently takes place. In the utilities' case, the costs of the completed assets are remunerated through a guarantee that the functions (in this case the RAB) will be financed.

15. The difference in the PFI case is that there is no institutional structure to embed this commitment to (re) financing, and the contract form uses charges for the project's use as a way to recoup these capital costs.

16. There are a number of ways in which the PFI framework could be brought into a RAB-based model. The optimal approach would be to create an infrastructure "bank". The bank's role would be to match savings (in practice largely pension and life funds) with investments in infrastructure projects such as those currently included in the PFI contracts. The bank would "buy" completed projects, put a RAB-wrapper around them, and then sell them onto the pension and life funds. This is a formalization of the refinancing that currently goes on, and would capture the returns from the assumption of the financing requirement, and therefore limit abnormal profits to the construction phase (and any operational out-performance).

17. This bank approach is different from the current proposed Green Investment Bank. The GIB is essentially a project finance vehicle, and hence it needs capital injections and equity finance. The infrastructure bank would be a debt vehicle, and would conform to the old-fashioned idea that an investment bank is all about matching savers with investors—but only for completed projects.

18. Although the infrastructure bank would be the best solution, it is unlikely to adopted in the near future, and given that the infrastructure investment demands are high and immediate, there are a variety of ways in which the PFI approach could be pragmatically modified in the general direction of the RAB-model.

19. The obvious starting point is to separate out the PFIs into three separate contractual parts: the construction phase, the operating phase and the financing phase after project completion.

20. Construction contracts pervade the public and private sectors. A school or hospital could be tendered, with the tender price including the construction and the associated project finance for the construction period. Similarly operating contracts are familiar, and could be separately tendered. For the financing phase (strictly the refinancing phase after project completion), there could be a separate contract, with an associated cost of capital and a repayment profile. This could be subject to a guarantee that the revenues will in fact be forthcoming.

21. It might be argued that this guarantee defeats the purpose of the PFI in that it might place it back on the government's books. However a moment's reflection indicates that the guarantee is nothing more than a specific contract—and the guarantee is what the PFI contractor relies upon anyway. The PFI contact is a specific guarantee of a revenue stream. The difference is about whether the contract is credible.

22. The advantage of the separation out of the contracts is that it provides a focus and opportunity to zoom in on refinancing on project completion. If the private sector demands a high return on the completed asset, then one of two possibilities arises: either the government can clarify the commitment to remunerate the capital; or the government itself could buy-in the completed asset at a lower cost of capital (or some part of it).

23. Once separated out, the capital cost can be accounted for in the same way as the utility RABs—for that is in effect what they have become.

24. If the ONS defines the PFIs as outside the governments' borrowing but the approach suggested here as inside, then it would be treating two identical financial commitments differently, and would be at best inconsistent. It should be always borne in mind that if this were the case, and therefore the conventional PFI approach continued, the economy and society bears a considerable deadweight welfare loss through the high cost of capital. A rule based and flawed accounting methodology would be in effect imposing a tax on us all.

25. The accounting approach reflects the absence of a balance sheet. The right answer is to address the definitions of public borrowings, assets and liabilities head on, rather than avoid the problem and impose such large costs on the economy.

June 2011

Supplementary written evidence submitted by NHS Confederation

1. *Introduction*

1.1. During oral evidence on 14 June 2011 as part of the Treasury Committee's PFI inquiry, Jo Webber (Deputy Director of Policy) offered to provide further information about our proposal for an NHS banking function as described in paragraph 5.2 of our written evidence. Details are set out below.

2. *Why is a NHS banking function needed?*

2.1. The Treasury Committee has already heard from the NHS Confederation about the difficulties faced by NHS organisations in accessing capital, particularly given the lack of a capital budget set aside for the NHS.

2.2. During the current financial challenge facing the NHS, many organisations' future income will be affected by a reduction in funding, increased competition in the NHS, and a move to encourage more care and treatment into the community rather than in hospitals. Consequently, organisations will increasingly need funding not just for building projects, but to help with changing their services to adapt to changing demand, changes in healthcare, and to manage the cost of infrastructure. The high level of fixed costs and the nature of hospital buildings means that savings take time to realise. This often means that there are double running costs as new services often have to be put in place before old infrastructure can be released.

2.3. In business these situations are common and dealt with by the use of reserves or commercial borrowing. NHS providers' own balance sheets are unlikely to be of sufficient scale to support a wide-ranging investment programme in the medium-term. Access to capital through a banking function will therefore be essential if providers are to be able to adjust smoothly to changes they face.

2.4. Without some sort of a banking function which can provide long-term restructuring loans, we could be faced with a situation where some NHS organisations with falling income would not have access to finance to restructure and change their services, and they may therefore find it difficult to reduce costs to a manageable level.

2.5. We believe a special NHS banking function, whose business is focused on providing funding to bodies providing NHS care, is therefore required. All types of providers to the NHS would be allowed access but they would have to meet the criteria that they were requesting finance to help provide NHS services. Current retail banking does not meet these needs. Retail banks are unwilling to lend to the NHS for a number of reasons:

2.5.1. NHS organisations cannot borrow against their assets in the same way that commercial businesses can. Assets are locked; they normally cannot be sold for another purpose because they provide essential services and some were charitably funded or covenanted. Under the government's proposed reforms to the NHS, some organisations' assets may also be protected to ensure they are safeguarded for NHS use.

2.5.2. Hospitals built under PFI may have few unencumbered assets on which loans could be secured.

2.5.3. There is the alternative of securing loans based on future earnings. However, in the future NHS organisations will face more competition making future earnings currently harder to predict so it may take time for the market to have confidence in this option.

2.6. Earlier this year, the government indicated that they are interested in establishing a banking function[4]. However, it is currently unclear how this is developing.

2.7. More recently, the government's NHS Future Forum taskforce, setup to examine the government's NHS reforms, also recommended the creation of a NHS banking function to support access to capital and "to ensure there is a level playing field that enables people with new ideas to enter the market". The Future Forum recommended that the proposed NHS Commissioning Board should examine this idea and report on it. We endorse this recommendation.

3. *What would a NHS banking function look like?*

3.1. The precise design and detail of a NHS banking function would need to be developed with the involvement of those with expertise from banking and capital funding in the NHS. A very basic level of funding could come from the Department of Health's capital budget or from giving trusts' public dividend capital to the bank. Holding deposits for Foundation Trusts would be a less attractive option to a NHS bank as it would mean the bank was lending long and holding short term deposits.

3.2. For the reasons set out above, any banking function should provide investment and working capital not just for building programmes but for allowing organisations to invest in changes to their services. For example, this might include cash to adapt a building to make it more suitable to advances in healthcare, or in response to patient demand for a particular service.

3.3. Such a banking function would need to be sufficiently distant from the Secretary of State for Health if, as proposed under the government's NHS reforms, future NHS foundation trusts are to maintain their

[4] See answer to Q190: http://www.publications.parliament.uk/pa/cm201011/cmselect/cmpubacc/writev/764/annex2.htm

independence and freedom. It would need to have sufficient expertise from those in the banking sector. This would help to ensure appropriate experience and independence from the Department of Health.

21 June 2011

Supplementary written evidence submitted by Balfour Beatty

POINTS OF FURTHER CLARIFICATION

Question 76—Examples of Transferred Risks

The long term nature of PFI contracts require bidders to interpret and value a range of risks including construction, maintenance and asset replacement and service delivery over a set period. Experience demonstrates that the most successful PFI outcomes are derived from the risk being undertaken by the party best placed to deliver it. Balfour Beatty has an extensive range of skills and capabilities in these areas.

Examples of the potential risks associated with PFI contracts are listed below.

Risks more difficult to quantify are connected with facilities management and include the items below:

Labour quantity risk (planned and unplanned).

Small item replacement material risk (quantity).

Labour and material price risk (differential inflation).

Risks in the quality and speed of delivery which could result in the Termination of FM contract, the concession and loss of equity.

The risks associated with long term asset condition over the concession period are known as whole life costs risks, and these risks include major repairs/replacement activity which are carried by the Special Purpose Vehicle established to operate the PFI.

Question 99—Public use of Schools facilities outside normal class room hours

The historic figures in the table below were provided by Strategic Leisure during the PFI tender process as a guide to the levels of and types of activity that the PFI schools would need to accommodate.

ORIGINAL ACTIVITY PROVIDED BY BASSETLAW LEISURE CENTRES COMPARED TO CURRENT ACTIVITY (WEEKLY HOURS)

	2006–07 Activity Levels at Retford and Worksop Leisure Centres and Schools—pre PFI			*2007–08 Activity Averages*			*Average Weekly Increase/ Decrease from 2006–07 to 2007–08*	*2008–09 Average Activity*	*Average Weekly Increase/Decrease from 2007–08 to 2008–09*	*2009–10 Average Activity*	*Average Weekly Increase/ Decrease from 2008–09 to 2009–10*
	Retford LC	*Worksop LC*	*Historic Totals*	*Average Retford Schools*	*Average Worksop Schools*	*2007–08 Totals*	*Increase/ Decrease*	*Total*	*Increase/ Decrease*	*Total*	*Increase/ Decrease*
	Hours per week										
Badminton	24	18	42	24	41	65	23	77.4	12.4	95.5	18.1
Football	9	0	9	37.5	4	41.5	32.5	46.6	5.1	60.75	14.15
Hockey	0	0	0	4.5	0	4.5	4.5	2.4	-2.1	1.76	-0.64
Basketball/Volleyball	3	3	6	3	6.5	9.5	3.5	8	-1.5	9.25	1.25
Cricket	2	0	2	2.5	0	2.5	0.5	3	0.5	4	1
Tennis	0	0	0	0	0	0	0	0	0	1.5	1.5
Athletics	1.5	0	1.5	6	0	6	4.5	6.9	0.9	4.5	-2.4
Gymnastics/Trampolining	9	4	13	6	8	14	1	8.9	-5.1	10.25	1.35
Circuit training/ Keep Fit	0	3	3	1	0	1	-2	2.3	1.3	2.5	0.2
Martial Arts	0	5	5	1	7	8	3	6.4	-1.6	7.75	1.35
Dance/ Theatre	0	0	0	3.5	9.5	13	13	15.25	2.25	15.75	0.5
Meetings	0	0	0	0	0	0	0	2	2	9.2	7.2
Other	0	0	0	4	0	4	4	4	0	0	-4
Totals	**48.5**	**33**	**81.5**	**93**	**76**	**169**	**87.5**	**183.15**	**14.15**	**222.71**	**39.56**

Based on the historic/ pre-PFI activity levels, we have increased community use by 110% in the first year of the PFI schools being open from circa 81 hours of dry-side activity per week to circa 169 hours per week:

Year 2 activity levels increased by 9%.
Year 3 activity levels increased by 21%.
Year 4 activity levels are currently being compiled.

The above figures are based on an average week in summer and an average week in winter = total hours divided by 2, which is exactly how the historic figures were calculated.

Question 114- PFI Profits

We have examined the data quoted by Dexter Whitfield of the European Services Strategy Unit in his paper entitled "ESSU Research Report No. 4, *The £10bn Sale of Shares in PPP Companies*" and the raw data he has identified, in terms of sales proceeds for investment disposals and accounting book value of assets sold is accurate but open to interpretation. It is misleading to quote as a profit percentage the difference between the two values quoted as a proportion of sale proceeds, as this ignores both the time period over which investments were made and the time period over which they were subsequently sold.

A more appropriate way of looking at the value that was generated by Balfour Beatty from these investments and their subsequent sales is to look at the "Internal Rate of Return" ("IRR") generated by the investments and associated disposals, which is a standard method of appraising investment returns.

For the five assets sold, to which Mr Whitfield refers, the IRR to Balfour Beatty is 16.5% p.a. which is in line with the 15%—17% market range for this class of asset, as identified in the NAO report "*Update on PFI debt refinancing and the PFI equity market*" 21 April 2006 para 10e page 5. We therefore cannot accept the assertion that these disposals generated a "super profit" for Balfour Beatty.

Questions 119/120 Examples of contract amendments to assist clients

In the vast majority of our concessions we have had, or are currently having, some form of discussion about areas where we may be able to amend the contracts in order to assist our client's.

Healthcare Examples include:

- looking at including additional soft services, such as catering/portering/reception services, where these services can be provided more cheaply.
- discussing economies of scale for areas of the clients estates that are not within the PFI, examples are integrated helpdesks and integrated maintenance contracts.
- looking at the energy models to potentially change the risk profiles.

Examples of areas where we have, or are, already amending contracts include:

- change of security service to accommodate changes to A&E and the introduction of helipad.
- extension of laundry hours to facilitate the client's framework agreement to do laundry for other hospitals. This is an income generation scheme for the client.
- Amendments to the Managed Equipment Contract to facilitate changes to the radiology services.

Schools Examples include:

- offering to suspend a 5 year FM Benchmark (due to take effect in 2013) and instead negotiate directly to introduce savings and implement a year earlier.
- our willingness to re-zone schools in order to support changes in use.
- changes to insurance and use parameters to accommodate International Children's Games.
- changes to service and payment provisions to accommodate inclusion of BSF schools.

Examples of Where we have already, or are, already amending contracts include:

- we proposed and agreed to remove a Utilities Risk Sharing Model from a contract as it was generating a payment to Project Co.
- amending boundaries to enable authority land sales.
- changes to accommodate schools move to Academy status.
- we have agreed numerous changes to some of our BSF schools projects where the original scope has been significantly reduced in order to maintain the effective and efficient delivery of services.

Roads Examples include:

- Reducing electricity consumption by retrofitting more efficient street lighting lanterns.
- Reviewing contract mechanisms to improve service delivery.

Examples where we have, or are, already amending contracts include:

- We have modernised and harmonised standards and service levels across a number of road projects.
- Revised reporting requirements to provide additional KPI's.
- De-trunked non some strategic parts of our road projects.
- Shortened the length of route on a project to facilitate an improvement by the adjacent local authority.
- Included additional, or reduced, our responsibilities in projects to suit the Highways Agency's wider operational objectives.

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