



HOUSE OF LORDS

Select Committee on Economic Affairs

---

---

1st Report of Session 2009–10

# **Private Finance Projects and off- balance sheet debt**

Volume I: Report

---

Ordered to be printed 23 February 2010 and published 17 March 2010

---

Published by the Authority of the House of Lords

*London* : The Stationery Office Limited  
£price

HL Paper 63–I

### *The Economic Affairs Committee*

The Economic Affairs Committee is appointed by the House of Lords in each session with orders of reference “to consider economic affairs”

### *Current Membership*

The Members of the Economic Affairs Committee are:

Lord Best  
Lord Currie of Marylebone\*  
Lord Eatwell  
Lord Forsyth of Drumlean  
Lord Griffiths of Fforestfach  
Baroness Hamwee  
Baroness Kingsmill  
Lord Levene of Portsoken  
Lord Lipsey  
Lord MacGregor of Pulham Market  
Lord Moonie  
Lord Tugendhat  
Lord Vallance of Tummel (Chairman)

\* Lord Currie did not take part in the inquiry leading to this report.

### *Information about the Committee*

The report and evidence of the Committee are published by The Stationery Officer by Order of the House. All publications of the Committee are available on the internet at:

[http://www.parliament.uk/parliamentary\\_committees/lords\\_economic\\_affairs.cfm](http://www.parliament.uk/parliamentary_committees/lords_economic_affairs.cfm)

### *General Information*

General information about the House of Lords and its Committees, including guidance to witnesses, details of current inquiries and forthcoming meetings is on the internet at:

[http://www.parliament.uk/about\\_lords/about\\_lords.cfm](http://www.parliament.uk/about_lords/about_lords.cfm)

### *Contact Details*

All correspondence should be addressed to the Clerk of the Economic Affairs Committee, Committee Office, House of Lords, London SW1A 0PW

The telephone number for general inquiries is 020 7219 6968

The Committee’s email address is [economicaffairs@parliament.uk](mailto:economicaffairs@parliament.uk)

## CONTENTS

---

	<i>Paragraph</i>	<i>Page</i>
<b>Abstract</b>		5
<b>Chapter 1: Introduction</b>	1	7
<b>Chapter 2: Background</b>	8	8
Traditional procurement	8	8
The beginnings of the Private Finance Initiative (PFI)	15	9
Expansion of Private Finance Projects (PFPs)	19	10
Impact of the credit crunch	22	10
<b>Chapter 3: Financial Framework of Private Finance Projects</b>	25	12
Value for Money test	25	12
Cost comparisons	27	12
i) borrowing costs	27	12
ii) discount rates	31	13
iii) optimism bias	34	13
Limitations of Value for Money test and Public Sector Comparators (PSCs)	38	14
Lack of information on public sector costs	38	14
How robust are value for money tests?	41	15
A National Infrastructure Bank?	45	15
Off-balance sheet treatment of private finance	50	16
Government and national accounts	54	17
<b>Chapter 4: Private Finance in practice</b>	62	19
PFPs—on time and on budget?	62	19
Price rises	70	20
Risk transfer	76	21
What risks are transferred to the private sector?	78	21
Debt refinancing	82	21
What happens when things go wrong?	86	22
Lessons from the special case of London Underground	92	22
Bundling of construction, servicing and maintenance into whole life contracts	102	24
Better maintenance	102	24
How much does better maintenance cost?	105	24
Managing and monitoring contracts	109	25
Secondary markets	113	25
Is private finance necessary to get the benefits of bundling?	118	26
Innovation	123	26
Workforce issues	127	27
Long-term commitment	131	28
Competition	140	29
Bid costs and complexity	140	29
Credit crunch	144	30
What projects are suitable for private finance?	146	30
Long-term stable projects	146	30
Size and complexity	150	31
Extending the reach of private finance	153	31

<b>Chapter 5: Conclusions and Recommendations</b>	159	<b>33</b>
<b>Appendix 1: Economic Affairs Committee</b>		<b>37</b>
<b>Appendix 2: List of Witnesses</b>		<b>38</b>
<b>Appendix 3: Call for Evidence</b>		<b>40</b>
<b>Appendix 4: Glossary</b>		<b>41</b>

NOTE: References in the text of the report are as follows:

(Q) refers to a question in the oral evidence

(p) refers to a page of written evidence

The Report of the Committee is published in Volume I, HL Paper No 63-I

The Evidence of the Committee is published in Volume II, HL Paper No 63-II

## **ABSTRACT**

Expectations of public services have risen steadily over many years and Governments have struggled to satisfy them within the constraints of annual public spending limits. Growing public payrolls tend to pre-empt resources for maintenance and renewal of infrastructure. Governments have understandably looked for new ways to fund investment and reduce the risks of implementation. One is Private Finance Projects (PFPs), financed by privately-raised debt and equity and paid for by public authorities over many years.

The Private Finance Initiative (PFI) model was put forward in 1992 by the Conservative Government. PFI projects did not become widespread before the Conservatives left office.

After 1997, the Labour Government adopted and expanded use of Private Finance Projects as Public-Private Partnerships (PPP). The Treasury steered public authorities to PFP/PFI as the way to finance their projects. The number of deals grew fast, fuelled by readily-available finance.

In recent years PFPs have delivered a large programme of infrastructure in short order. They are probably here to stay. Although a final verdict has to await the outcome of very long-term contracts, it seems timely to take stock now that PFPs have become familiar and reached significant scale but face the challenge of scarce private finance and cuts in Government spending.

PFPs are used in a wide range of projects. There are two broad, conflicting views:

- their supporters say that private capital at risk has brought much-needed rigour and efficiency to building and maintenance of public infrastructure and delivered more than would have been possible without them.
- their opponents condemn PFPs as expensive and inflexible, a drain on non-PFP public service budgets and a way for Governments to evade public spending rules and fudge national accounts by excluding PFP liabilities. They also deny that real risk transfer takes place.

A dearth of hard data, especially on comparable projects subject to conventional procurement, encourages assertion rather than analysis. This needs to be remedied.

The next few years will show if private finance can retain its role in public procurement when money is tight and Parliament and the public expect better evidence that it is being well spent. Competitive pressures will play their part and more can be done to encourage competition in PFPs. Central Government also has a key role in ensuring and demonstrating that its approach to public procurement is efficient and economical. For PFPs, it needs to be made clearer that private finance offers good value for money despite higher borrowing costs than public finance.

At the same time, means should be explored of bringing together private rigour and public finance so that public procurement might benefit from the best features of each.

Where PFPs are efficient and value for money they should not need the support of any institutional bias in their favour. Their virtues should enable them to win

acceptance as a procurement path in the right circumstances on their own merits. Within spending limits, public authorities should be free to choose the procurement method which offers best value for money. Continued improvement in the structure of PFP contracts (particularly with respect to flexibility and innovation) and in public sector contract negotiation and management skills is also needed.

The approach to PFPs has developed organically over the years. Lessons have been learned in how to constrain the opportunities for the providers of private finance to make excessive returns and in what types of project are, or are not, suitable for PFP treatment. But there is more to learn.

On the one hand some projects are too large, complex and uncertain to be suitable candidates. On the other, now that private finance has become established in the maintenance and servicing of public infrastructure, thought should be given to the scope for expanding its use further into the provision of professional and other services currently provided directly by the public sector.

Greater transparency and clarity in the presentation of PFP liabilities in national accounts would help improve understanding of the overall economic and social impact of PFPs and confidence in the accounts themselves.

# Private Finance Projects and off-balance sheet debt

## CHAPTER 1: INTRODUCTION

---

1. We decided in June 2009 to conduct an inquiry into *Private Finance Projects and off-balance sheet debt* and appointed as Specialist Adviser Professor Paul Grout of the University of Bristol. We issued a public Call for Evidence in July 2009 and heard oral evidence from October 2009 until January 2010.
2. Private Finance Projects (PFPs) are contractual arrangements between the public and private sectors which use private finance to realise public programmes. The term is used in this Report to cover all forms of public-private partnerships (PPPs), focussing mainly on the Private Finance Initiative (PFI), a widely-used model of PFP.
3. The PFI model has two main features: use of private, mainly debt finance; and the bundling of construction, maintenance and sometimes other services into long-term “whole life” contracts under which private sector contractors are responsible for the construction and functioning of public buildings over many years, in return for annual payments by public authorities.
4. In recent years PFPs have become well-established. There are now about 800 in being in the United Kingdom, with a capital value of about £64 billion. There has been rapid growth in these projects and they affect most of us as users of public services and taxpayers. Their significance, together with the impact of the recent banking crisis upon the availability of private sector finance, the economic recession and the prospective squeeze on public expenditure, all make this a good time to assess two decades of evolution and implementation of PFPs and, in particular, their future prospects. There has been no Parliamentary inquiry into the broad topic of PFPs since 2000.
5. PFPs enjoy a generally good reputation for delivering projects on time and within budget. But they remain controversial. There have been some high profile failures. Critics say they are too costly and inflexible. Questions have been raised about their treatment in the national accounts.
6. In this report we take a broad view of the effectiveness and value for money of PFPs so far, recognising that a final verdict will be possible only when most of them have run their course over the coming decades. We make a number of recommendations as to their future.
7. We are grateful to all our witnesses for their written and oral evidence to our inquiry, and especially to the National Audit Office for their thorough and helpful contribution.

## CHAPTER 2: BACKGROUND

---

### *Traditional procurement*

8. In traditional public procurement, infrastructure projects were directly funded by the public sector and included in the definition of public sector spending. Once the completed project was handed over to the public sector client, the private contractor's involvement ceased. In the words of the Institution of Civil Engineers, "Traditional procurement models separate some or all of design, construction and maintenance of infrastructure projects" (p 312).
9. Traditional procurement did not enjoy a high reputation for efficiency. Most witnesses drew attention to cost overruns and delays. As the LIFT Council put it, "... back when projects were traditionally procured, research undertaken by the Department of Health made clear that the vast majority of such projects were built late, with significant cost overruns and a high proportion ended up in court cases with contractors" (p 183). A study by Mott MacDonald of 39 large UK infrastructure projects procured by conventional means found that completion time exceeded estimated duration by 17%, while capital expenditure exceeded estimates by 47% on average.<sup>1</sup> Not all witnesses agreed: Professor Allyson Pollock of the University of Edinburgh said that, according to a study of 1999 on cost and time overruns in NHS estates "... there is really no evidence at all ... of poor [contract] performance" (Q 272). But this was a minority view.
10. Imprecise definition by public authorities of their requirements was often at least partly to blame for poor procurement outcomes. Mr Steve Allen of Transport for London said that "one of the principal causes of cost overruns on public procurements is the procuring authority changing its specification repeatedly" (Q 378). Sir John Bourn took a similar view: "One of the major difficulties of the traditional, conventional procurement of projects—construction projects, defence projects and also, I would imagine, projects in the field of social welfare—has been the constant alteration of them and it is the constant alteration which accounted for so much of the delay and extra expense" (Q 364).
11. We heard evidence that the public sector is seldom held accountable for shortcomings in public procurement projects. Dr Tim Stone of KPMG said "There are very few people in the system who actually understand the whole life consequences of decisions" (Q 3); "... the data around public services is shockingly poor" (Q 5); "Because the data is not there ... the risks can be swept under the carpet when they go wrong" (Q 10). In the CBI's view, "Service failure is seldom quantified or penalised in traditionally procured, publicly funded services. The absence of rigorous evaluation systems limits the public sector's ability to assess the benefits of their investment in a number of areas, including how outcomes were achieved, whether benefits outweighed costs and if users were satisfied" (p 51).
12. Many witnesses also took the view that in traditional procurement there was often inadequate provision for maintenance. The PPP Forum referred to "historically chronic under-maintenance and lack of investment" which "led

---

<sup>1</sup> Grimsey, D. and Lewis, M., Public Private Partnerships and Public Procurement, Agenda, 2007, Volume 14, pp 171–188.



to the severe deterioration of assets” (p 217), a view shared by Mr Allen, who said that “... all too often in a wholly public procurement you start off with an underestimated cost and the authority tends not to budget properly for maintenance of the asset over its life” (Q 377).

13. There was a fall over many years in the share of national resources devoted to public investment. Public sector gross capital formation as a percentage of GDP fell almost continuously between 1975 (8.9%) to 2000 (1.7%). A significant part of this decline is explained by the sharp decline in local government investment between 1976 and 1982 and the impact on public corporation investment (as previously defined) in the 1980s as a result of the privatisation programme. However, central government investment also fell in the 1990s (1.4% in 1991 to 0.4% in 1999).<sup>2</sup>
14. **Against a background of shortage of funds and doubts about conventional methods of procurement, it was clearly in the public interest for Governments to look for new, efficient and cost-effective ways to meet demand for new public infrastructure.**

*The beginnings of the Private Finance Initiative (PFI)*

15. Private finance projects, such as the Dartford Crossing and Second Severn Crossing, predate the PFI. From 1981 such private investment in public projects was governed by the Ryrie Rules which laid down that any privately-financed solution must be shown to be more cost-effective than a publicly-financed alternative, and that privately-financed expenditure by the nationalised industries could not be additional to public expenditure provision, which would be reduced by the amount of any private finance borrowed.<sup>3</sup> Any role for private finance in increasing investment in public infrastructure was thus ruled out and the benefits sought were mainly efficiency gains.
16. These restrictions were largely removed by 1990. The Private Finance Initiative was formally introduced by the then Chancellor of the Exchequer, Norman Lamont MP, in the Autumn Statement of 1992. He stated that “any privately financed project which can be operated profitably will be allowed to proceed, ... Government will actively encourage joint ventures with the private sector, where these involve a sensible transfer of risk to the private sector” and “public organisations will be able to enter into operating lease agreements with only the lease payments counting as expenditure and without their capital budgets being cut”.<sup>4</sup> The scope of private finance to increase investment in public infrastructure was thus recognised. By 1994 the Government explicitly acknowledged that “the private sector’s contribution is additional to public provision”,<sup>5</sup> and the Chancellor stated that private sector finance would be the main source of growth in public investment.<sup>6</sup>

---

<sup>2</sup> ‘Trends in Public Investment’, Tom Clark, Mike Elsyby and Sarah Love, Fiscal Studies, 2002, vol 23, no 3, 305–342.

<sup>3</sup> PA Grout, The economics of the private finance initiative, Oxford Review of Economic Policy, 1997; vol 13 pp 53–66.

<sup>4</sup> HC Deb 12 November 1992 col 998.

<sup>5</sup> Financial Statement and Budget Report, November 1994, cited in John Hall, Private Opportunity, Public Benefit, Fiscal Studies, 1998, vol. 19, no. 2, pp 121–140.

<sup>6</sup> HM Treasury, Private Finance: Overview of progress, News release 118/94, 8 November 1994 which was cited in House of Commons Library Research Paper, The Private Finance Initiative (PFI), 18 December 2001.

Thereafter Treasury approval for public-sector funding for capital projects was not usually forthcoming unless private finance options had been explored and found uneconomic. This institutional bias in favour of private finance has continued in various forms under successive Governments.

17. In PFPs, building contractors, facilities managers and service providers typically form a consortium and take shares in a Special Purpose Vehicle (SPV) which signs the contract with the public authority. It usually brings together construction with maintenance and certain services (“bundling”) which the SPV undertakes to provide over a long period such as thirty years (“whole life”), in return for fixed annual payments starting when construction is complete. The SPV, which retains ownership of the building, finances its construction by borrowing (usually 85–90%) and owners’ equity (10–15%).
18. Relatively few PFPs were implemented before 1997. No long-term PFP has yet run its course.<sup>7</sup>

#### *Expansion of Private Finance Projects (PFPs)*

19. After 1997 the Labour Government accepted that private finance should continue to play a role in provision of public infrastructure and set up a Treasury task force to encourage what were now known as Public-Private Partnerships (PPP). With the Government’s support, the number of deals increased sharply, so that by 2009, as Mr Joe Grice of the Office for National Statistics told us, there were “... approximately 800 or so PFI/PPP schemes in being, and the capital value is something of the order of £64 billion” (Q 135). Despite rapid growth, PFI/PPP projects still accounted for only 10–15% of local authority capital investment over the last five years (Mr Richard Buxton, Local Partnerships, Q 79). In some sectors, however, PFI’s share of investment is clearly higher: Ian Pearson MP, Economic Secretary to the Treasury told us that “... 70% of hospital schemes have been delivered by PFI; round about 60% of new schools have been delivered through the PFI group” (Q 592).
20. The PFP model has also been used by organisations outside the public sector to finance major new building and renovation projects of housing associations. In such cases there can be no benefit in terms of the level of public sector debt since borrowing by housing associations does not count as public spending. But as well as sharing the other benefits and drawbacks—attributed to PFP—use of this model enables housing associations to finance developments off their balance sheets and thereby to extend their work without reducing the security they provide for other borrowing.
21. **The rapid growth of private finance projects over the past decade or so is striking and has played a significant role in the expansion and renewal of the nation’s infrastructure.**

#### *Impact of the credit crunch*

22. The impact of the banking crisis in 2008 was bound to affect the supply and cost of private finance. In 2009 the value of completed PFI/PPP deals is reported to have been £4.24bn, the lowest annual total for a decade.<sup>8</sup>

---

<sup>7</sup> The Skye Bridge PFP was bought out by the Scottish Government in 2004.

<sup>8</sup> “Financial Times”, PFI feels the pinch, 15 January 2010.

Mr Adrian Olsen of Bank of Ireland told us that “... the shortage of both capital and liquidity ... has had a significant effect ... on the availability of bank debt” (Q 420). At the same time, the prospective squeeze on public expenditure will also reduce the funds available for public infrastructure projects.

23. The Government set up the Treasury Infrastructure Finance Unit (TIFU) in March 2009 to lend to private finance projects struggling to raise funds from commercial banks.<sup>9</sup> By the end of 2009 TIFU had only made one loan of £120 million to the Greater Manchester Waste Disposal Authority’s PFI project. However, the PPP Forum welcomed its creation, saying confidence had been bolstered “simply by its existence”. The availability of commercial lending to some projects “has been due in some part to the backstop that TIFU provides ... allaying funding concerns that might have otherwise stalled deals” (p 221).
24. **Despite the scarcity of private finance, there are few advocates of a return to the old system of public procurement in those sectors where PFPs prevail. But PFP payments are contractual commitments and, as public spending is constrained, could have an adverse impact on the budgets available to public authorities for other, non-PFP, expenditure. They could, for example, exacerbate any budgetary pressures arising from unforeseen bunching of commitments and demands in a given financial year. The Government should monitor and control year by year the impact of PFP commitments on the budgets of Departments and public authorities with a view to ensuring that delivery of essential public services in future years is not unduly constrained or jeopardised by such commitments.**

---

<sup>9</sup> HM Treasury, The Infrastructure Finance Unit (TIFU) available at [http://www.hm-treasury.gov.uk/ppp\\_tifu\\_index.htm](http://www.hm-treasury.gov.uk/ppp_tifu_index.htm)

## CHAPTER 3: FINANCIAL FRAMEWORK OF PRIVATE FINANCE PROJECTS

---

### Value for Money test

25. The cost of financing a project by traditional procurement will inevitably be less than the cost of private finance—the Government can borrow at a lower rate than can a private sector entity. Hence the economic case for private finance projects must rest on achieving better value for money either through cost savings in the management of the project (including more efficient recognition of lifetime costs and risks), or through the delivery of a qualitatively superior project.
26. When assessing the procurement options for a given project, public authorities are required by Treasury guidance (the “Green Book”) to make estimates of the costs of undertaking the project by the private finance route and by traditional procurement, so as to help determine which is better value for money.<sup>10</sup> The estimated cost imputed to procurement of a given project by traditional means is known as the Public Sector Comparator (PSC). Three key factors in determining the cost estimates of private finance and traditional procurement are outlined below.

### Cost comparisons

#### *i) borrowing costs*

27. Financing costs are an important difference between private finance and traditional procurement routes. Private finance projects are usually financed with high levels of debt, at risk in the event of failure (Olsen Q 459), which cost more in interest than Government borrowing through gilts, which takes no account of project-specific risks.
28. The cost of debt for private finance projects pre-credit crunch was typically about one percentage point (60–150 basis points) above the nominal cost of government borrowing (NAO, p 87). Mr David Metter, PPP Forum, suggested that the overall cost of capital for PFI projects over 10 to 15 years had been about the reference gilt rate plus one and a half to two percentage points (Q 496).
29. Publicly financed procurement benefits from the lower rates of interest at which the Government can borrow. In PFI projects the private sector aims to make up for higher borrowing costs by taking on, pricing, and managing project risks more effectively.<sup>11</sup>
30. **Even though the cost of debt in private finance projects will usually be higher than under traditional procurement, this factor alone does not rule out the use of private finance. The higher cost of debt reflects risks carried by the private sector and a margin for profit. And, apart from bearing risks that would otherwise fall to the public sector, private finance can offer other advantages over traditional**

---

<sup>10</sup> HM Treasury, The Green Book—Appraisal and Evaluation in Central Government, available at [http://www.hm-treasury.gov.uk/d/green\\_book\\_complete.pdf](http://www.hm-treasury.gov.uk/d/green_book_complete.pdf)

<sup>11</sup> HM Treasury (2003), PFI: Meeting the Investment Challenge.

**procurement to offset the higher interest rates.** We return to these potential advantages in Chapter 4.

*ii) discount rates*

31. The capital costs of most projects under conventional procurement are paid in the first few years. In PFPs the costs to the public sector are deferred then spread over many years. In standard business practice, costs due to be paid in future—whether capital or revenue—are “discounted” relative to costs to be paid today. The later a cost falls due, the more it is discounted. When public authorities evaluate the relative merits of procurement routes in accordance with Treasury rules, they add up the discounted costs imputed to each year of a PFP to obtain its whole-life Net Present Value (NPV) (or notional cost), which can then be compared with the NPV imputed to the same project if undertaken by conventional means. The rate of discount applied plays a vital role in the outcome of the comparison: a higher rate makes the private finance NPV seem less.
32. HM Treasury maintain a generic single discount factor, traditionally called the test discount rate, to be used by government departments to appraise policies, programmes and projects. Historically it was mostly used to decide whether or not to undertake public projects and which technique would be best. It has increasingly become important in helping decide between private and public provision. In April 2003 the standard Treasury discount rate was reduced from 6.0% to 3.5%. This was part of a process to achieve greater recognition and transparency of risk by accounting for it in expected cash flows.<sup>12</sup>
33. Other things being equal, the reduction of the discount rate might have been expected to increase the NPV (or notional cost) of private finance options relative to conventional procurement and to tilt the balance more towards the traditional path as public authorities weighed their procurement options. But in practice the change seems not to have reduced the use of the private finance procurement route. This was in part because of a new emphasis on risks in traditional procurement, including the attribution of “optimism bias” to expected cash flows in the PSC, so that in many cases the overall appraisal has continued to favour private finance projects.

*iii) optimism bias*

34. Calculations of costs imputed to a PSC are required to include an optimism bias (NAO, pp 127–129), which assumes a tendency to unwarranted optimism in cost estimates under traditional public procurement. The estimated cost by the traditional procurement path is raised by a percentage and the resultant higher figure is the PSC compared to the private finance cost of the project. The Treasury advises public authorities to generate their own estimates of optimism bias based on their own experience, and sector-specific studies.
35. The optimism bias figures employed in PSCs are significant. For example, the NAO pointed out that the PFP for GCHQ’s new headquarters project relied solely on the highly uncertain assumption that procurement by

---

<sup>12</sup> The reasons for the change in discount rate are outlined in HM Treasury (2002), *The Green Book—Consultation Paper, Appraisal and Evaluation in Central Government*.

conventional means would have over-run its budget by 24 per cent and expressed scepticism about the uses of optimism bias (p 129). Dr Chris Edwards, University of East Anglia, said: “The average runover in 2002 was running at about 13 per cent for fairly routine projects like general hospitals, and since then it has actually been reduced” (Q 297). Mr Ed Humpherson, NAO, told us that “Optimism bias has been a crucial contributor to the PFI net present value being lower than the public sector comparator net present value in a very large number of cases we have looked at. Indeed, what we have tended to see as a general rule is two numbers clustering quite close together so if you took the optimism bias out of one of them it would make the public sector comparator lower” (Q 256).

36. **The NAO is sceptical about optimism bias uplifts in the context of Public Sector Comparators and about applying optimism bias solely to estimates of public sector costs. The projected costs of private finance projects may also be subject to optimism, although not necessarily at the same level as in conventional public sector procurement, and in practice any overruns would normally be met by the private sector.**
37. **The addition of optimism bias may in many cases have had the effect, even at reduced discount rates, of tilting the comparisons of net present value which public authorities have to make, in favour of PFP and against conventional procurement. We recommend that, in order to reach a fairer basis of comparison, where a percentage uplift for optimism bias is added to the estimated Net Present Value of Public Sector Comparators, an appropriate rate of uplift should also be added to estimates of the NPV of the cost to the client under PFP.**

### **Limitations of Value for Money test and Public Sector Comparators (PSCs)**

#### *Lack of information on public sector costs*

38. Witnesses emphasised the lack of data on traditionally procured projects necessary to make realistic value for money comparisons with private finance projects. Mr Olsen said: “I simply do not have enough reference data to compare it [private finance] with the traditional procurement method” (Q 429). The Lift Council wrote that “it is a challenge to compare the costs, performance and quality of [private finance] projects and those procured using public capital as the data for the latter group is historic and some costs, e.g. on-going maintenance and life-cycle, simply do not exist” (p 183). Similarly, Dr Stone stated that “there is very little useful data about conventional procurement” (Q 1).
39. The NAO view is that: “We have yet to come across truly robust and systematic evaluation of the use of private finance built into PPPs at either a project or programme level. The systems are not in place to collect comparable data from similar projects using different procurement routes” (p 80). They also point out that “the main reason that we have not seen such costs comparison is because departments do not collect data on whole-life costs of projects in a systematic way:
  - Central Government rarely collects data from Local Government funded projects or devolved funding.

- PPP costs are rarely collated centrally, and where they are, they are hardly ever updated for contract variations.
  - The costs of ongoing services for conventionally procured buildings are rarely monitored, making whole-life costs very difficult to compare.
  - Different procurement routes collect data on different bases” (NAO p 105).
40. **It is difficult to compare whole life costs because PFP costings include maintenance and other services over many years while costings of conventional procurement generally do not. We recommend that, in order to make possible proper comparisons between privately-financed and traditional procurement, the Government should collect on a whole-life basis cost data on some comparable traditionally-procured projects. Better data would help public authorities achieve good value for money, the main criterion of successful procurement.**

*How robust are value for money tests?*

41. In the NAO’s view PSCs “cannot be relied upon as a sole source of assurance. They are susceptible to manipulation” (p 102). Mr Humpherson added that “you should never regard the PSC as a pure pass-fail test and the only arbiter of value for money” (Q 257). The NAO also took the view that “financial modelling is error-ridden and given undue influence” in the choice of procurement route (p 102).
42. Dr Stone said value for money tests omitted potential benefits from delivering the project earlier by the PFP route: “The assumption is that however you deliver the service, the service and benefits to society will be identical, but if you deliver a new hospital or a new school earlier than would otherwise be the case I would contend that there are social benefits from that that matter and those are not measured. We assume that the results are unvaried and I think that is plain wrong” (Q 13).
43. Mr Humpherson emphasised that deciding which procurement route to take is “more than just a contract versus a model” and that the procuring authority is expected to look at a wide range of other factors, some fairly subjective, in addition to cost, such as assessing and valuing the flexibility of the different procurement options, and whether the public authority is absolutely sure that the prices quoted by the contractors are fair and reasonable (QQ 258–260).
44. **A Value for Money test based on imputed costs of a Public Sector Comparator (PSC) should be a useful tool in assessing the relative costs and merits of private finance and traditional procurement. But its value is limited by shortage of relevant data and by the selective inclusion of optimism bias. Even if these deficiencies were addressed, as we recommend above, public authorities should not rely solely on PSCs when choosing a procurement route.**

*A National Infrastructure Bank?*

45. Commercial banks are not the only source of finance for Private Finance projects. The Treasury Infrastructure Finance Unit (TIFU) was set up last year (cf. paragraph 23 above). The European Investment Bank (EIB), which lends on a not-for-profit basis, and has AAA status, is a very significant

finance provider and has lent €3–4bn. of funding for PFPs in the United Kingdom since 2005. The financial crisis has increased the EIB's attractiveness as a source of funding for PFPs and it committed over EUR 1bn in 2009 to projects in the UK (p 16).

46. The role of the EIB raises the question whether Private Finance Projects might benefit from the presence in the market of other providers also able to offer keenly competitive finance at commercial standards of rigour and due diligence. Asked if there might be a role on these lines for a National Infrastructure Bank (NIB) in the United Kingdom, Mr Simon Brooks of the EIB replied that “nobody in Europe needs to introduce a NIB because they have got us!” (Q 75). In reply to a similar question, Mr Paul Davies of PwC saw value in an NIB which complemented the market on the lines of the Treasury Industry Finance Unit (TIFU) or acted as a relatively economical lender alongside private sector banks. But an NIB designed to crowd out private sector lenders could deprive the market of well-honed skills (p 234).
47. The Economic Secretary to the Treasury said he was “very interested in the idea of a national infrastructure bank” and referred to the recent announcement of the setting up of Infrastructure UK<sup>13</sup> “looking at ways in which infrastructure can be financed” (Q 619).
48. One role for a National Infrastructure Bank might be to help channel pension fund finance into infrastructure projects, which could fit well with the funds' longer-term liabilities. The scope seems significant. A report by the OECD<sup>14</sup> estimates that \$500billion worldwide could be invested in infrastructure if 3% of total global funds held by pension funds could be accessed (Ms Kate Mingay, Department of Transport, supplementary evidence, p 249). A non-profit investment bank could attract pension funds by offering an option in addition to gilts and long-term private sector investment.
49. **There may or may not be enough lenders in the market already to finance public infrastructure, even in a period of restricted credit such as we now face. It is too early to tell whether the Treasury Infrastructure Finance Unit (TIFU) will bridge the gap. The pros and cons of establishing a National Infrastructure Bank should be kept under review.**

### Off-balance sheet treatment of private finance

50. There has long been controversy about the treatment of PFP liabilities in public accounts. Public bodies are expected to choose the best procurement route to deliver public service and good value for the taxpayer. But many witnesses said the reality was very different with the choice substantially skewed by institutional bias towards PFPs, often, in their words, the “only game in town”.
51. Sir Peter Dixon, University College London Hospitals, said of PFPs: “In health ... for the last ten years it has been the only source of finance and

---

<sup>13</sup> Announced by the Chancellor of the Exchequer on 9 December 2009 to provide a new strategic focus in government across the full range of infrastructure sectors (Pre-Budget Report, Securing the recovery: Growth and opportunity. HM Treasury. Command Paper 7747, 9 December 2009).

<sup>14</sup> G. Inderst, “Pension Fund Investment in Infrastructure”, OECD Working Paper on Insurance and Private Pensions, January 2009.



therefore one has used it.” He added: “Where local government did use PFI for housing improvement, it was typically because they had no other source of capital funding” (Q 310). The Foreign and Commonwealth Office reported: “We specifically would not have had sufficient capital funding to build the Berlin Embassy without PFI” (p 303).

52. Many witnesses believe that the Government prefers PFP because many PFPs have been off public authorities’ balance sheets on the grounds that the balance of financial risk was with the private sector (Centre for International Public Health Policy at Edinburgh University p 132, BMA p 254).
53. The National Audit Office concluded: “Public authorities often have no alternative source of funding and feel pressured to use private finance because its treatment in financial accounts and budgets make it seem more affordable from the public authority’s perspective.” The NAO found this not only affected how a project was funded but often led public bodies to “shape the project to ensure it is off-balance sheet” (NAO p 86, p 95).

#### *Government and national accounts*

54. Accounting rules consistent with UK GAAP (Generally Accepted Accounting Practice) are used by economists to determine how PFPs are treated in the National Accounts, which cover the entire economy and include Public Sector Net Debt.
55. Until April 2009 UK GAAP was used by accountants to put together public sector financial accounts. So, until April 2009, a PFP was recorded the same way in both the public authority’s financial accounts and the National Accounts.
56. UK GAAP only included the liabilities if the balance of risk and reward was with the public sector, and excluded them if the balance of risk was deemed to be with the private sector. Interpreting the balance of risk was left to individual public bodies and their auditors. This led to most PFP deals being off-balance sheet. Around 78% (£22 billion) of operational PFPs in England by capital value are not recorded on the balance sheet of public sector financial accounts and are thus excluded from the Public Sector Net Debt statistics part of the National Accounts (NAO p 95).<sup>15</sup>
57. From April 2009 departments are required to issue accounts using IFRS (International Financial Reporting Standards). Under IFRS those assets which are controlled by the public sector—which include most PFPs—will be brought on to the departments’ balance sheets. The IFRS criterion of control differs from the UK GAAP criterion of risk; thus the department accounts and National Accounts will conflict.
58. To resolve this conflict the Treasury has decided that departments should also produce a second set of accounts in line with the old UK GAAP basis which will be consistent with the National Accounts. The NAO said, therefore, that they “expect that ... the majority [of PFPs] will not be included in statistics of Public Sector Net Debt” (NAO pp 95–100).
59. **There should be greater clarity about financial liabilities arising from PFPs. The Treasury’s requirement that departments should run two**

---

<sup>15</sup> This excludes the London Underground PPPs, which before the failure of Metronet had a capital value of about £18 billion and were on-balance sheet, but are not pure PFI contracts.

sets of accounts, though an understandable response to the use of one accounting system within departments and another nationally, is far from ideal. Furthermore, national accounts solely on a UK GAAP basis give a misleading picture of overall liabilities by excluding most PFPs from figures of Public Sector Net Debt. We recommend that the Government should publish figures for total liabilities for privately-financed public sector procurement as a separate item alongside figures for Public Sector Net Debt. Brief statistical information should also be supplied as to the distribution of these liabilities across a series of separate categories that reflects differences in the extent of risk transfer away from the public sector.

60. Inclusion of PFP liabilities in Departmental balance sheets, as now required, together with publication of aggregate figures of national PFP liabilities, as we now recommend, should provide a clearer picture of their economic significance. The motive widely imputed by witnesses to the Treasury for its perceived bias in favour of PFPs—their low profile in accounts—would also fall away.
61. We recommend that, subject to the need to maintain control of public spending, the Government should take measures to remove institutional bias in favour of private financing of public procurement, so that public authorities can select it, or another procurement method, on a case-by-case basis according to value for money.

## CHAPTER 4: PRIVATE FINANCE IN PRACTICE

---

### PFPs—on time and on budget?

62. One driver behind PFPs was the cost overruns of traditionally procured projects. Data is limited but a survey in 1999 found that in 73% of construction projects costs to the public sector exceeded the price agreed at contract and 70% of projects were delivered late. The lion's share of projects surveyed were traditional procurement.<sup>16</sup>
63. Traditionally procured projects that ran over budget include the Thames Barrier, Scottish Parliament, British Library and Phase III of Guy's Hospital in London (PPP Forum p 218, John Laing p 211). The problem is international. For example, a survey of over a hundred major traditionally procured transport projects, mostly in Europe and North America, found that substantial cost escalation is the rule rather than the exception—for rail, average cost escalation is 45%, for tunnels and bridges it is 34% and for roads 20%. The projects were completed between 1927 and 1998.<sup>17</sup>
64. Although not directly comparable, NAO surveys suggest many more PFPs are completed on time and on budget. A 2003 survey by the NAO showed less than a quarter of PFPs were delivered late and a similar proportion running over budget.
65. Payments to private finance contractors do not start until the building is completed. As contractors usually have financed the project with some equity and lots of debt they apply rigour in planning and execution so that more private finance projects are on time and on budget.
66. The banks providing the debt finance add another layer of due diligence designed to help ensure projects are successful and loans repaid. Ms Mingay said: "The advantage of private finance debt is that it does do that upfront due diligence on behalf of the lenders and the contractor is suitably incentivised to work through any problems and not walk away from their obligations through the life of their contract" (Department for Transport Q 536).
67. NAO surveys also suggest the gap between the performance of traditional procurement and private finance is narrowing. A survey of projects scheduled to be completed from 2003–2008 found 31% of those procured under PFP were delivered late and 35% ran over budget which suggested a weaker performance than the 2003 survey. Under traditional procurement 37% were delivered late with 46% over budget.<sup>18</sup>
68. The NAO surveys indicate that the performance of traditional procurement has improved. Ms Margie Jaffe of Unison said: "Procurement has moved on apace since the days of the 1960s and 1970s which was the last big construction phase" (Q 571).
69. **There is strong evidence that PFPs have a better record of on time and on budget delivery than traditionally procured projects, although**

---

<sup>16</sup> National Audit Office (2003) PFI: Construction performance, Summary, Page 3.

<sup>17</sup> 'How common and how large are cost overruns in transport infrastructure projects?', Bent Flyvbjerg, Mette K. Skamris Holm and Soren L. Buhl, Transport Reviews, 2003, volume 23.

<sup>18</sup> National Audit Office (2009) Performance of PFI Construction, Pages 7–8.

**it appears this gap is narrowing. Nonetheless, too many PFPs are delivered late, albeit contractors rather than public authorities are liable to the consequent financial penalties.**

*Price rises*

70. Bidding processes for PFPs are longer because private finance contracts are more complex, including servicing and maintenance over 25–30 years, while traditional procurement contracts only cover construction. Although more PFI projects are completed on-time and on-budget, some witnesses argued this masked large cost increases which arose during the much longer bidding process. Ms Jaffe said: “Mysteriously, the price between the outline business case, which is at the start of that process, and the final business case at the end goes up fantastically, and so for the first wave of PFI hospitals, for example, it was mostly between 20 and 220 per cent. Some of that may be the public sector saying we want you to add all the twiddles and it has got to be gold-plated and so on, but a lot of it is because the consortia are protecting themselves from failing to provide to cost” (Q 571).
71. These price rises often occur during the preferred bidder stage when the public sector enters into exclusive negotiations with one consortium. The Centre for International Public Health Policy at Edinburgh University noted: “During this period, the private sector can ‘hold-up’ the public sector, pushing up prices ... meanwhile, the scope for public authorities pulling out of such negotiations is limited by the unavailability of other procurement routes” (p 133). The Centre added: “A project that is delivered to time and to budget (in post-contractual terms) may represent poor value for money if the price paid for the risk transfer that led to that outcome was too high” (p 134).
72. The National Audit Office found preferred bidder negotiations lasted on average 15 months for PFPs finalised between 2004 and 2006. In one third of these projects the value of the contract varied on average by 17% (upwards and downwards) of the total project value. The NAO conclude: “Value for money is most at risk during the final stage of negotiations, when negotiation is with a single preferred (or final bidder) and competitive tension is at its weakest” (p 107).
73. Common EU procedures—known as Competitive Dialogue—were introduced in 2006. They seek to eliminate changes late in the procurement process. But the NAO reported: “Our recent study on Building Schools for the Future found some early indications that at least some changes are still being made late in the process. Kent County Council’s project experienced seven months delay after the selection of final bidder” (p 107).
74. Preferred bidder negotiations are not exclusive to PFPs and are widely used in conventional procurement projects as well. While competition is reduced at the preferred bidder stage, it should be easier during this stage for a public body to walk away from cost increases than after construction has begun, as can happen in traditional procurement.
75. **Substantial price increases are undesirable late in the bidding process whatever procurement path is chosen. Despite the longer bidding process under PFPs—and the associated higher costs—the greater likelihood of projects being completed on time and on budget after the**

**contracts have been signed can be a benefit worth some extra expense to the public sector at the initial stage.**

### **Risk transfer**

76. A key benefit attributed to PFPs is that risk is transferred from the public sector to the private sector.
77. PFPs aim to allocate risks to the parties best able to manage them. This should lead to better management of risk overall which should be more cost efficient (NAO p 88). But not all risks can or should be transferred to the private sector. Dr Stone said: “You have to understand what risks both sides can and should manage and control” (Q 10).

### *What risks are transferred to the private sector?*

78. The private sector is usually best placed to manage construction risk—such as building on time and on-budget—and the risk of providing maintenance over the asset’s lifetime (Mr Buxton Q 91). Private contractors have a greater incentive to build a project on-time and on-budget as they only start receiving payments once construction is complete. Making the private sector responsible for maintenance aims to encourage the contractor to build a high quality asset that will require little maintenance over the course of the contract—usually 25–30 years.
79. Besides construction and maintenance, it is unclear what other risks the public sector seeks to transfer and to what extent. Ms Rachel Lomax said that when she was Permanent Secretary at the Department for Work and Pensions private finance would not be used for a core function of the Department: “There is just no way you can transfer the risk of something which is fundamental to the Department’s purpose and statute.” As a result the Department for Work and Pensions did not use private finance in benefit administration “because we felt that was what the Department was all about”. Private finance was instead used to provide medical services, which are not a core function of the Department (Q 216).
80. With private finance projects so far, the public sector usually retains risks related to demand (Mr David Belton, Sheffield City Council, p 281). So if the local population falls so much that a PFP-built school or hospital needs to close then the public sector bears the costs of closing it before the private finance contract expires.
81. **Construction and maintenance risks are usually seen as suitable for transfer to the private sector; whereas activities over which the private contractor is seen as having little or no influence have not been transferred.**

### *Debt refinancing*

82. Special Purpose Vehicles (SPVs) set up by contractors to deliver a given PFP often seek to rearrange the terms of their borrowing once building is complete. Lower interest rates may well become available because the risk of problems arising during construction has been removed.
83. At first, contractors kept the gains from refinancing PFPs. The Government then negotiated arrangements with the private sector to share the refinancing gains. For PFP contracts signed since 2002 the public sector is entitled to

50% of the gains from the refinancing. In 2008 the public sector's share of the gains rose to 70% for some new contracts. In pre-2002 contracts with no mechanism to share in the benefits of refinancing, the public sector receives 30% of the gains (NAO p 109).

84. The NAO, which criticised the Norfolk and Norwich Hospital refinancing for securing for the public sector only 29% of the refinancing gain while increasing the contract's termination costs, said of the refinancing : "New sharing arrangements appear to be working well, but there have been exceptions" (p 109).
85. **We welcome the Government's action to secure for the public sector a substantial share of refinancing gains in PFPs. We recommend that the Government should continue to learn from experience in order to ensure that the public sector enjoys a fair share of benefits from improvements in financing arrangements.**

*What happens when things go wrong?*

86. Critics, such as Unison, argued risk transfer in PFI projects is "often illusory". They added: "Failed PFI contracts, on too many occasions, have had to be rescued by the public sector meeting additional costs" (p 258).
87. However, Mr Metter argued risk has still been transferred because when the Government has to rescue a project the private sector has already been hit hard: "By the time you get to that point, the equity will have lost their money, the debt will have lost their money, the contractors will probably have lost their money, the insurers will probably have lost their money and then you get to the point where the Government stand in. For the most part business risks are transferred very, very successfully" (Q 469).
88. The PPP Forum lists the National Physical Laboratory, Cornwall Schools project, Dudley Hospital and Croydon Tramlink as projects where the private sector lost millions of pounds which shows, it argues, that risk was transferred (p 219).
89. Mr Adrian Ewer of John Laing relayed his experience of building the National Physical Laboratory. He said: "We lost £60 million on the construction and we basically lost our equity as well and the private sector in total lost over £100 million on that project" (Q 470).
90. Mr Ewer argued the private sector lost out due to risk transfer while the public sector was largely protected and ended up with high quality laboratories at a good price. He said: "We kept pouring money into this black hole. At the end of the day also the public sector has an excellent asset which delivers 98 per cent of what the scientists required and paid a lot less for it than it would have paid if we had known what we were trying to build in the first place" (Q 470).
91. But the NAO were less positive about the laboratories meeting the needs of the public sector side, overseen in this case by the former Department of Trade and Industry: "The contract protected the taxpayer effectively from the wasted costs of construction and the termination was value for money. But the project did not achieve the DTI's aims" (p 89).

*Lessons from the special case of London Underground*

92. With the National Physical Laboratory the private sector clearly had taken on some risk and lost funds when the project went awry. But the private sector

fared much better when Metronet—a consortium upgrading the London Underground—went into administration in 2007.

93. The London Underground PFP was a unique case. Unlike most other private finance projects Metronet was not building a new asset but maintaining and upgrading an existing asset. Furthermore, Transport for London guaranteed 95% of Metronet's debt obligations. Debt guarantees are not part of standard private finance contracts.
94. The NAO said: "As a consequence of this guarantee, Metronet's lenders did not protect their investment as anticipated because only five per cent of their investment was at risk" (p 88).
95. So when Metronet failed, the Department for Transport had to make a £1.7 billion payment to help Transport for London meet the guarantee of Metronet's borrowing. The NAO estimated a direct loss to the taxpayer of between £170 million and £410 million (p 88).
96. Mr Allen said: "The banks being 95 per cent guaranteed did blunt some of the incentives that you usually expect to see from private finance and some of the rigour that you look for in terms of their policing of the contracts" (Q 387).
97. The guarantees stemmed from the public sector's uncertainty over whether Metronet could borrow enough funds. Mr Allen said: "I think there was a perception at the time that this was what was required, you had three large contracts to design and a limited appetite in the bank market to provide that debt and they wanted some contractual underpinning in order to take on those risks" (Q 387). Mr Allen went on: "I am not sure that the economic arguments were very strong; I think it was more a pragmatic argument of what you needed to do in order to sign a contract" (Q 387).
98. Mr Allen added that any private finance project which needed such extensive underwriting as Metronet should serve as a wake-up call that there may be problems ahead. He said: "When somebody says that in order to get these contracts away we need to be able to offer this sort of underpinning to the banks ... that should be a very strong warning light that this is not a contract that can be let to the market on a sensible basis" (Q 387).
99. Furthermore, the companies behind the Metronet consortium put relatively little of their own money—or equity—into the project. When a company collapses the equity is usually lost. Banks usually get first claim on remaining assets to repay as much of the outstanding debts as possible. Usually nothing is left over for shareholders. So if shareholders have put lots of equity into a company they will be very reluctant to let it collapse because they will nearly always be left with nothing.
100. But when "shareholders have a very limited amount of equity in the company there comes a point when actually they would rather let the company fail than continue to support [it]," said Mr Allen. He added: "The risk you transfer effectively to the company is limited by the amount of equity that the shareholders put in, in the first place, and if the risks that the company is trying to bear are larger than that it may be that shareholders walk away from it. That is certainly what happened with Metronet" (Q 387).
101. **The failure of the London Underground Metronet PFP gave private finance projects in general a bad name. Yet this project was exceptional because huge debt guarantees together with a typically**

**narrow equity base limited risk transfer. We recommend that the state should not guarantee large amounts, and a high proportion, of debt as a means to make highly geared PFPs happen. For such exceptionally large and complex projects alternative procurement approaches should be used.**

### **Bundling of construction, servicing and maintenance into whole life contracts**

#### *Better maintenance*

102. A fundamental aspect of PFPs is that the builders will also be contracted to maintain the building over 25–30 years. This encourages the contractor to put up a more durable building, requiring less maintenance over its lifetime. With lower maintenance costs the contractor can make higher profits.
103. Most witnesses agreed PFPs led to better maintenance than had been the case under traditional procurement (for example see NAO p 90, International Project Finance Association p 316). Previously, under traditional procurement, a contractor put up a building and there was usually no further involvement. So the contractor did not have an incentive to build an asset that required little maintenance.
104. Furthermore, under PFPs, maintenance which the private contractor provides is ring-fenced for the length of the contract and funded by the public sector. The NAO reported: “PFI provides a contractual guarantee that the public client will fund the ongoing maintenance of the building” (p 90). In the past, using traditional procurement, maintenance was not ring-fenced. So maintenance was often cut when public sector budgets were squeezed: (Sir John Gieve Q 214, Ms Susan Anderson, CBI, Q 149). According to the NAO having maintenance ring-fenced under private finance projects ensures problems are not left to fester which might otherwise cause damage requiring more expensive work to be undertaken later (p 90).

#### *How much does better maintenance cost?*

105. Better maintenance is, of course, good. But some fear it has been too expensive. Dr Mark Porter, chair of the consultants committee at the BMA, said: “Anything can be bought but the price at which it is bought is too high, we would say” (Q 559).
106. The Foreign & Commonwealth Office, which used a PFP to build and service the British embassy in Berlin, reported: “Our own experience with Berlin indicates that we have a very well designed and built-to-time embassy which is operated and maintained to an extremely high standard against agreed performance measures. It is doubtful that traditional funding mechanisms would give us the same high quality of maintenance. However, this has come at a very high price” (p 302).
107. Due to data limitations the NAO could not say whether maintenance under private finance was cheaper or not. They said: “Whether it will lead to an overall reduction in whole-life costs would be very difficult to prove” (p 90).
108. **Private finance has led to a much needed focus on maintenance of public infrastructure. Public authorities should however keep a watchful eye on the price paid for what is on balance a positive**



**development. We also recommend that the Government should promote the bundling of construction and maintenance, and whole-life costing, in all public procurement, whether privately financed or not.**

*Managing and monitoring contracts*

109. For the public sector to benefit from bundling services and maintenance together the private sector providers have to be managed to ensure delivery is up to scratch at the right cost.
110. The NAO argued that public authorities need to improve management of contracts: “A culture of focus on making the deal rather than thinking about contract management is still, however, prevalent in many quarters of the public sector” (p 81).
111. Contractors disagreed on the quality of staff they negotiated with in the public sector today. Mr Ian Rylatt, Balfour Beatty Capital and CBI, said: “The competency of the people we negotiate with and we bid to is leaps and bounds from what it was before.” He attributed the improvement partly to greater experience with PFPs and the public sector recruiting staff from the private sector with procurement skills (Q 153). But Mr Dougie Sutherland, Interserve Investments and CBI, said: “I find it amazing that we are still finding people on the public sector side who are doing it for the first time. When I look across the deals that we get involved in I think that there are some really excellent teams and there are some very poor teams” (Q 153).
112. **Monitoring and managing private finance contracts has long been a weakness of the public sector, although there have been improvements in recent years. We recommend that public authorities should do more to maintain and improve commercial skills of staff dealing with private finance projects, with emphasis on long-term contract management as well as contract negotiation.**

*Secondary markets*

113. Investors in PFPs can sell their stakes. Many argue that the secondary market is very beneficial and that freedom to sell stakes makes it easier to attract funds to private finance deals in the first place (NAO p 126, Mr Philip Turville, Royal Bank of Canada Capital Markets, Q 424, Mr Olsen QQ 445–448, Mr Metter Q 462).
114. Since the construction phase of a project is the most risky for the contractor, once construction is over “a project that is into its operational stage is often considered to be a safer investment. Consequently the equity becomes worth more and is attractive to a different type of investor seeking a lower but more constant return” (NAO p 127).
115. We raised the concern that the ability of contractors to sell their stakes may dilute one of the key positive aspects attributed to private finance projects—that the bundling of maintenance into a contract encourages the contractor to build a higher quality asset. If contractors know they can sell out shortly after construction they might not be so diligent about building low maintenance into an asset.
116. In the NAO’s view this concern would normally be met by pre-purchase due diligence carried by buyers in the secondary market, so that a contractor with

an eye on eventual sale would still build a high quality asset. “Even if the secondary market were leading to the shareholders undertaking less due diligence, it is not clear what the effect on the contract would be. The sub-contractors, lenders and public authority would still need to work together to deliver the project and their due diligence would still be crucial” (p 127).

117. **There is some concern that construction companies which can sell their stakes in PFPs shortly after a project is operational may build a lower quality asset than if they remained shareholders with responsibility for maintenance. Although due diligence and checks by buyers in the secondary market amongst other parties may meet this concern, we saw no empirical evidence in this area. We recommend that the NAO should undertake studies of the effects of secondary markets on standards of quality in PFPs.**

### **Is private finance necessary to get the benefits of bundling?**

118. The PFP model has spread awareness of the possible benefits of whole-life costing more widely, without necessarily resorting to private finance. Sir John Bourn said: “It does not rest simply on PFI, but there is no doubt that PFI was the incentive to get this going” (Q 356).
119. While generally opposed to PFPs, Ms Jaffe believed they had had the benefit of introducing the concept of whole life costing into all procurement: “I think these lessons from PFI have been and are being integrated into traditional procurement, and if there is a lesson that you have to keep some money ring-fenced for maintenance then I think that is one that we can carry forward” (Q 559).
120. The NAO noted: “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” (p 90).
121. Witnesses said the skills acquired using PFPs spill over into traditional procurement. For example, with Crossrail—which is mostly traditionally procured—assessment of risk is “much more developed”, having learnt from the experience of PFPs (Ms Mingay Q 507). The Ministry of Defence sought to improve its procurement by adopting PFP methodology to evaluate all projects (Mr Jon Thompson Q 507). Mr Rylatt said skills learnt by his company in PFPs were now used in traditionally procured projects (Q 179).
122. **Traditional procurement has also benefited from the lessons learnt from private finance projects. Risk management and due diligence appear to be better in the public sector as a result of PFPs. These benefits need to be included when assessing the total benefits of private finance.**

### **Innovation**

123. Contractors cited examples where PFPs had led to innovation. These included prisons where long wide corridors enabled better use of CCTV and improved safety for inmates and staff; hospitals where better designed corridors enabled smoother transport of patients; and better road surfacing treatment which reduced disruption to motorists (CBI p 53, John Laing p 211).

124. But public sector consumers of PFPs—including from the ministries of health, transport and defence—disagreed. Jon Thompson, director-general of finance at the Ministry of Defence, said: “We do not think there has been a tremendous amount of innovation through PFI.” (Mr Thompson Q 525, Mr Peter Coates Q 525, Sir Peter Dixon Q 339). Ms Mingay said: “When we think about PFI we do not see it necessarily as a big area of innovation but more as a whole life costing, providing better focused planning and integration and that kind of thing” (Q 527).
125. There are barriers to innovation. During the bidding process little time is devoted to innovative ideas as it is only one factor in whether a consortium wins a bid. Cost and duration of construction may receive more attention. During tendering, clients often cannot spend time with all the bidders to collaborate on potential innovative ideas. When any innovative ideas are finally costed, they may be too expensive and be abandoned. Moreover, the intention of private finance is to allocate risk to the contractor. That can encourage contractors to play safe with tried and tested methods to lessen the risk of something going wrong and being penalised with reduced payments (NAO pp 90–91).
126. **PFPs have led to some innovation although few witnesses described this as a key reason for using private finance. It is for public sector clients to request more innovation from contractors when negotiating private finance contracts, if that is what they are seeking.**

#### Workforce issues

127. Private finance projects can lead to innovations in workforce practices. But this can be unpopular as it risks less favourable terms and conditions for staff who, as a result of PFPs, move from being employed by the public sector to private contractors. HM Treasury guidance states: “The value for money that PFI can deliver should not be achieved at the expense of staff terms and conditions” (NAO p 92). TUPE (Transfer of Undertakings (Protection of Employment)) regulations aim to maintain the terms and conditions of staff transferred from the public to private sector.
128. Ms Jaffe argued staff terms and conditions sometimes change with those on low wages faring “much worse under PFI/PPPs than more skilled workers” (Q 563). On the other hand, the National Audit Office, while conceding little analysis existed in this area, said a survey of 43 PFI schemes showed pay for the least skilled was “marginally worse”. Those with skilled and management roles were paid more in the private sector (p 92). The Centre for Public Service Partnerships at Birmingham University plans to study such workforce issues and their impact on services: “The industry has evidence to suggest that transferred employees have a wider range of responsibilities, better training, and better prospects for their future. However, there is also much contrary evidence” (p 290).
129. Unison also opposed the potential for the creation of what it described as a two-tier workforce, where transferred staff’s conditions are protected while new staff subsequently hired are often brought in on less favourable terms and conditions. Ms Jaffe said: “So you can have people working alongside each other on exactly the same contracts but with totally different annual leave or sick leave or pension arrangements.” She suggested that this affected staff morale and led to poorer quality of service (Q 563).

130. **Public sector employees transferred to the private sector during the course of a PFP are protected by TUPE (Transfer of Undertakings (Protection of Employment)) regulations and employees recruited directly are protected by general employment law. Pay and conditions of the two categories of employees may well differ, at least at the outset. Where average labour costs subsequently fall, in a PFP transferred from the public sector, such cost savings may simply indicate that the pay and conditions of the employees previously in the public sector exceeded the market rate.**

#### **Long-term commitment**

131. During the course of a private finance project contract, if a public body wants to close or change the use of part of a building (e.g. shut a hospital wing due to the local population size declining) under the terms of the contract it usually has to pay charges to the contractor.
132. Critics argue it is impossible to predict the type and quantity of future demand for public services. For example, the demands of a hospital will be different in 20 years given new and improved treatments and changes to the demographics of the local population. With a private finance contract requiring charges for adapting to these factors over time public authorities may be deterred from making the necessary changes.
133. Sir Peter Dixon cited the case of putting in day care facilities after the hospital had been built. These facilities had not been provided for in the original design due to a planning error before he took up his post. Rectifying this was “very expensive” because under the private finance contract the hospital was stuck with the one provider and could not get quotes from alternative contractors. “We had no ability to challenge the capital costs of our provider and of course they did it to suit them and we just had to cough up” (QQ 317–319).
134. Sir Peter Dixon believed that further big changes will be needed over the life of the hospital: “Inflexibility is an issue and there is no doubt that in 30 years time when this project comes to an end there will have been several reincarnations of the buildings” (Q 319).
135. But proponents of private finance argued that many of the costs involved in amending PFP contracts also arise under traditional procurement. Dr Stone said: “The vast majority of the costs of changes also exist in traditional procurement but are easier to hide where there is not a contract to renegotiate. The additional cost is a trade-off for transferring the risks for the long term condition of the infrastructure” (p 3). Under traditional procurement if, for example, the wing of a hospital was no longer needed, the costs of building it would have already been paid. Under PFPs not all the construction costs would have been paid for until the end of the 25–30 year contract. Partnerships UK noted that: “All sunk costs are inflexible and in that sense conventional procurement is as inflexible as PFI insofar as an asset no longer required still needs to be paid for” (p 188).
136. Others argued that the long-term nature of the contract and the associated costs helped ensure clearer specification of PFPs. Mr Allen said: “One of the principal causes of cost overruns on public procurements is the procuring authority changing its specification repeatedly. So the fact that within a PFI contract there are constraints on the public authority doing that, that has

been one of the reasons why you have seen fewer cost overruns once the contracts have been let” (Q 378).

137. The PFP route can, however, lead to inflexibility at a high level of public policy decision making. Sir Peter Dixon said that not only did PFP contracts lead to inflexibility at the level of the individual hospital but that they also restricted changes to the broader health care system. If a hospital had to close in London, it was less likely to be a PFP one because of the charges involved. So the allocation of medical care within a given budget would not be driven by health needs alone: “Whatever else happens in reorganising services in central London my hospital has to stay there because it has a £43 million a year payment to a private provider. You can shut another hospital which does not have that and sell off the land, but you cannot do it with mine” (Q 324). The Institution of Civil Engineers feared the “lack of flexibility is a factor leading to a lack of resilience and flexibility in our infrastructure networks” (p 313).
138. **Inflexibility has been a feature of private finance contracts, although it has also been a key factor in forcing the public sector to plan ahead. But flexibility is negotiable, at least to some extent. Public authorities should determine how much flexibility they want, the means of achieving it in the terms of the contract and what they are prepared to pay for it; then negotiate accordingly.**
139. One route to greater flexibility in PFPs might be by adopting some of the features, such as provision for periodic review of prices, of the model applied to regulated utilities, which in Professor Glaister’s view had “... worked spectacularly well” (Q 384). **We recommend that the Government should explore the feasibility of importing into PFP contract terms selected features of regulatory review models for utilities.**

## Competition

### *Bid costs and complexity*

140. Private finance contracts are complicated as they bundle together the provision of capital, construction and services. This means fewer companies—even coming together in consortia—may be able to bid for such contracts, thus limiting competition (Dr James Cuthbert and Ms Margaret Cuthbert, pp 295–296).
141. This complexity can also make preparing bids a costly exercise, deterring competition. Furthermore, the Centre for Public Service Partnerships reported: “There has been an insistence on very detailed drawings and specifications from all competitors, even in the earliest stages of the bidding process” (p 290). In addition, the long and drawn out nature of the process increases the transaction costs of the bid. Few firms may be able to devote enough man-hours to such tender processes. The complexity and high bid costs may be influencing the number of players in the construction sector, driving firms to merge to enable them to compete for large complicated contracts (Institution of Civil Engineers p 311).
142. Contractors may be put off by the complexity of the project rather than by bidding costs. Sir John Bourn said: “The worst projects were the ones that were so complicated to do, so in a way if you were not getting any bidders you really needed to ask yourselves whether it is a sensible thing to try to do

it this way, is this one of the projects that would be better to do conventionally?” (Q 357).

143. Competition was also limited during periods when lots of contracts were tendered and firms simply could not bid for everything. Sir John Bourn said: “In the early days ... you could not actually find anyone to compete in the short term for all the work that was available.” He added: “As time went on that was resolved to a degree” (Q 357).

#### *Credit crunch*

144. The impact of the credit crunch on competition in private finance projects has been unclear. Sir John Bourn said: “The credit crunch—through its limitation of access to funds, making them more expensive, lending money for a shorter period—has tended to reduce competition” (Q 357). But the slowdown in construction generally due to the downturn may have freed up more contractors to bid for private finance work. Mr Rylatt said: “In the current construction environment there is not a lot of conventional work around, for obvious economic reasons. The market is very, very much a buyer’s market at the moment and is not a seller’s market” (Q 185).
145. **High bidding expenses risk reducing competition for private finance projects which, in turn, could increase costs to the taxpayer. The Government should examine possible mechanisms for encouraging competition, such as returning an element of bid costs.**

#### **What projects are suitable for private finance?**

##### *Long-term stable projects*

146. A significant part of the benefit of private finance projects comes from the whole life approach to contracts that last for 25–30 years. Since amendments incur charges, projects requiring relatively few changes are better suited to this type of procurement. If the nature of the requirement cannot be well identified at the outset then it will be difficult to write successful long-term contracts. So road projects, for example, seem particularly suitable for private finance procurement. Similarly, new schools can be well specified in advance and are thought to be more successful than refurbishment where there are more unknowns outside the contractor’s control (Mr T Martin Blaiklock p 285, Mr Buxton Q 112). Sir Peter Dixon pointed out that the more unpredictable a refurbishment scheme, the more difficult it was to have a fixed price and to manage that risk appropriately (Q 316).
147. IT projects were widely viewed by witnesses as unsuitable because they are difficult to specify and define at the outset. The pace of technological change means that requirements frequently change as well (Dr Stone Q 25, Centre for Public Service Partnerships p 287, Mr Humpherson Q 232). Councillor Richard Kemp, Local Government Association, said of IT projects: “By the time you have actually gone through the process the specification will have moved on” (Q 94).
148. Nevertheless, problems with IT projects are not confined to those undertaken via private finance. Sir John Bourn believed that under certain conditions IT projects could be appropriate for private finance: “If you set about it in a sensible way, were not too ambitious, knew what you were doing, had trained people, consulted those who would actually have to

operate the projects then you could make a success of it. I think all the difficulties have led the Treasury to think for the present time—I would not quarrel with this for the time being—that you would not attempt to use PFI for IT projects but I think the time could come when you could do that again” (Q 361).

149. Private finance has been widely used in the NHS. But Mr Blaiklock argued that hospitals were not suited to the long-term, relatively stable ideal needed for PFP contracts “as the way patients are treated continuously evolves, requiring different public service assets, as technology advances” (p 285). However, Lord Crisp, formerly Permanent Secretary at the Department of Health, argued that for private finance across the NHS, “the positives outweigh the negatives” (Q 206).

### *Size and complexity*

150. Some projects are deemed too big for private finance as they would require the contractors to take on more risk than they would be prepared to. Crossrail was viewed as one such project. Mr Allen said: “You would struggle to find sufficient equity in a consortium vehicle to back that kind of risk ... I think one of the lessons might be that the London Underground PPP contracts were too large to structure efficiently” (Q 379).
151. However, private finance can be used for part of Crossrail. Ms Mingay said: “On these very large projects you often have projects within projects—that there are elements where private finance can be incorporated into the deal. Again in Crossrail it is the rolling stock and the construction of the Canary Wharf Station being done by the private sector, where the rest is being done publicly” (Q 543).
152. **The projects most suitable for private finance are those where the requirements can be clearly specified at the outset and which are of a size that consortia of private sector companies can take on their balance sheets.**

### *Extending the reach of private finance*

153. Private finance could be used in more areas than hitherto, particularly in the provision of services. Mr Metter said: “In a hospital project we have a project to build a whole huge hospital and we have a whole range of services which we provide which are what we call soft services, services like laundry, cleaning, food; many of the services which feed directly into patients are provided by PFI. A natural extension of that would be to provide nursing services.” He added: “Equally with the schools, there is no reason why some of the teaching could not go into the PFI project” (Q 482).
154. Mr Adrian Ewer, chief executive of John Laing, said: “There is no reason why the private sector could not embrace the provision of the service rather than just provide the hardware from which the service is delivered” (Q 482).
155. The CBI argued for ‘payment by results’ that would transfer at least some risk to the private sector for the quality of service provided. Susan Anderson, director of public services at the CBI, said: “If we are looking, for example, at education what we should be measuring it on is the quality of the education that is delivered in that school, not just whether you have a wonderfully designed building” (Q 186).

156. Not all demand-related risk can be transferred at a reasonable price. Mr Metter said: “In the very early days of PFI they suggested that we should take the risk for the number of prisoners they put into the prison when we had absolutely no control over how many prisoners they were going to send to the prison. They realised very quickly that to make the private sector take that risk was just going to be very expensive for them” (Metter Q 469).
157. **The private sector is clearly not best suited to bear all the risks in all forms of private finance project. Experience has shown, however, that bundling certain services with construction in PFPs has delivered benefits, including the transfer of risk from the public to the private sector. We believe there is scope to transfer more demand or output-related risks. For example, with a prison such risks could be partly transferred by rewarding contractors for lower re-offending rates. In education, more risk transfer might be possible in the provision of teaching services; independent schools already take on all such risks. There is similar scope for the transfer of demand and output-related risks in relation to medical services.**
158. **We recommend that the Government should examine what additional risks now borne by the public sector can sensibly be transferred to the private sector, acknowledge the lesson of experience that the risks of exceptionally complex, large projects are not suitable for transfer to the private sector, and produce comprehensive revised policy guidelines.**



## CHAPTER 5: CONCLUSIONS AND RECOMMENDATIONS

---

159. Against a background of shortage of funds and doubts about conventional methods of procurement, it was clearly in the public interest for Governments to look for new, efficient and cost-effective ways to meet demand for new public infrastructure (paragraph 14).
160. The rapid growth of private finance projects over the past decade or so is striking and has played a significant role in the expansion and renewal of the nation's infrastructure (paragraph 21).
161. Despite the scarcity of private finance, there are few advocates of a return to the old system of public procurement in those sectors where PFPs prevail. But PFP payments are contractual commitments and, as public spending is constrained, could have an adverse impact on the budgets available to public authorities for other, non-PFP, expenditure. They could, for example, exacerbate any budgetary pressures arising from unforeseen bunching of commitments and demands in a given financial year. The Government should monitor and control year by year the impact of PFP commitments on the budgets of Departments and public authorities with a view to ensuring that delivery of essential public services in future years is not unduly constrained or jeopardised by such commitments (paragraph 24).
162. Even though the cost of debt in private finance projects will usually be higher than under traditional procurement, this factor alone does not rule out the use of private finance. The higher cost of debt reflects risks carried by the private sector and a margin for profit. And, apart from bearing risks that would otherwise fall to the public sector, private finance can offer other advantages over traditional procurement to offset the higher interest rates (paragraph 30).
163. The NAO is sceptical about optimism bias uplifts in the context of Public Sector Comparators and about applying optimism bias solely to estimates of public sector costs. The projected costs of private finance projects may also be subject to optimism, although not necessarily at the same level as in conventional public sector procurement, and in practice any overruns would normally be met by the private sector (paragraph 36).
164. The addition of optimism bias may in many cases have had the effect, even at reduced discount rates, of tilting the comparisons of net present value which public authorities have to make, in favour of PFP and against conventional procurement. We recommend that, in order to reach a fairer basis of comparison, where a percentage uplift for optimism bias is added to the estimated Net Present Value of Public Sector Comparators, an appropriate rate of uplift should also be added to estimates of the NPV of the cost to the client under PFP (paragraph 37).
165. It is difficult to compare whole life costs because PFP costings include maintenance and other services over many years while costings of conventional procurement generally do not. We recommend that, in order to make possible proper comparisons between privately-financed and traditional procurement, the Government should collect on a whole-life basis cost data on some comparable traditionally-procured projects. Better data would help public authorities achieve good value for money, the main criterion of successful procurement (paragraph 40).

166. A Value for Money test based on imputed costs of a Public Sector Comparator (PSC) should be a useful tool in assessing the relative costs and merits of private finance and traditional procurement. But its value is limited by shortage of relevant data and by the selective inclusion of optimism bias. Even if these deficiencies were addressed, as we recommend above, public authorities should not rely solely on PSCs when choosing a procurement route (paragraph 44).
167. There may or may not be enough lenders in the market already to finance public infrastructure, even in a period of restricted credit such as we now face. It is too early to tell whether the Treasury Infrastructure Finance Unit (TIFU) will bridge the gap. The pros and cons of establishing a National Infrastructure Bank should be kept under review (paragraph 49).
168. There should be greater clarity about financial liabilities arising from PFPs. The Treasury's requirement that departments should run two sets of accounts, though an understandable response to the use of one accounting system within departments and another nationally, is far from ideal. Furthermore, national accounts solely on a UK GAAP basis give a misleading picture of overall liabilities by excluding most PFPs from figures of Public Sector Net Debt. We recommend that the Government should publish figures for total liabilities for privately-financed public sector procurement as a separate item alongside figures for Public Sector Net Debt. Brief statistical information should also be supplied as to the distribution of these liabilities across a series of separate categories that reflects differences in the extent of risk transfer away from the public sector (paragraph 59).
169. Inclusion of PFP liabilities in Departmental balance sheets, as now required, together with publication of aggregate figures of national PFP liabilities, as we now recommend, should provide a clearer picture of their economic significance. The motive widely imputed by witnesses to the Treasury for its perceived bias in favour of PFPs—their low profile in accounts—would also fall away (paragraph 60).
170. We recommend that, subject to the need to maintain control of public spending, the Government should take measures to remove institutional bias in favour of private financing of public procurement, so that public authorities can select it, or another procurement method, on a case-by-case basis according to value for money (paragraph 61).
171. There is strong evidence that PFPs have a better record of on time and on budget delivery than traditionally procured projects, although it appears this gap is narrowing. Nonetheless, too many PFPs are delivered late, albeit contractors rather than public authorities are liable to the consequent financial penalties (paragraph 69).
172. Substantial price increases are undesirable late in the bidding process whatever procurement path is chosen. Despite the longer bidding process under PFPs—and the associated higher costs—the greater likelihood of projects being completed on time and on budget after the contracts have been signed can be a benefit worth some extra expense to the public sector at the initial stage (paragraph 75).
173. Construction and maintenance risks are usually seen as suitable for transfer to the private sector; whereas activities over which the private contractor is seen as having little or no influence have not been transferred (paragraph 81).

174. We welcome the Government's action to secure for the public sector a substantial share of refinancing gains in PFPs. We recommend that the Government should continue to learn from experience in order to ensure that the public sector enjoys a fair share of benefits from improvements in financing arrangements (paragraph 85).
175. The failure of the London Underground Metronet PFP gave private finance projects in general a bad name. Yet this project was exceptional because huge debt guarantees together with a typically narrow equity base limited risk transfer. We recommend that the state should not guarantee large amounts, and a high proportion, of debt as a means to make highly geared PFPs happen. For such exceptionally large and complex projects alternative procurement approaches should be used (paragraph 101).
176. Private finance has led to a much needed focus on maintenance of public infrastructure. Public authorities should however keep a watchful eye on the price paid for what is on balance a positive development. We also recommend that the Government should promote the bundling of construction and maintenance, and whole-life costing, in all public procurement, whether privately financed or not (paragraph 108).
177. Monitoring and managing private finance contracts has long been a weakness of the public sector, although there have been improvements in recent years. We recommend that public authorities should do more to maintain and improve commercial skills of staff dealing with private finance projects, with emphasis on long-term contract management as well as contract negotiation (paragraph 112).
178. There is some concern that construction companies which can sell their stakes in PFPs shortly after a project is operational may build a lower quality asset than if they remained shareholders with responsibility for maintenance. Although due diligence and checks by buyers in the secondary market amongst other parties may meet this concern, we saw no empirical evidence in this area. We recommend that the NAO should undertake studies of the effects of secondary markets on standards of quality in PFPs (paragraph 117).
179. Traditional procurement has also benefited from the lessons learnt from private finance projects. Risk management and due diligence appear to be better in the public sector as a result of PFPs. These benefits need to be included when assessing the total benefits of private finance (paragraph 122).
180. PFPs have led to some innovation although few witnesses described this as a key reason for using private finance. It is for public sector clients to request more innovation from contractors when negotiating private finance contracts, if that is what they are seeking (paragraph 126).
181. Public sector employees transferred to the private sector during the course of a PFP are protected by TUPE (Transfer of Undertakings (Protection of Employment)) regulations and employees recruited directly are protected by general employment law. Pay and conditions of the two categories of employees may well differ, at least at the outset. Where average labour costs subsequently fall, in a PFP transferred from the public sector, such cost savings may simply indicate that the pay and conditions of the employees previously in the public sector exceeded the market rate (paragraph 130).

182. Inflexibility has been a feature of private finance contracts, although it has also been a key factor in forcing the public sector to plan ahead. But flexibility is negotiable, at least to some extent. Public authorities should determine how much flexibility they want, the means of achieving it in the terms of the contract and what they are prepared to pay for it; then negotiate accordingly (paragraph 138).
183. We recommend that the Government should explore the feasibility of importing into PFP contract terms selected features of regulatory review models for utilities (paragraph 139).
184. High bidding expenses risk reducing competition for private finance projects which, in turn, could increase costs to the taxpayer. The Government should examine possible mechanisms for encouraging competition, such as returning an element of bid costs (paragraph 145).
185. The projects most suitable for private finance are those where the requirements can be clearly specified at the outset and which are of a size that consortia of private sector companies can take on their balance sheets (paragraph 152).
186. The private sector is clearly not best suited to bear all the risks in all forms of private finance project. Experience has shown, however, that bundling certain services with construction in PFPs has delivered benefits, including the transfer of risk from the public to the private sector. We believe there is scope to transfer more demand or output-related risks. For example, with a prison such risks could be partly transferred by rewarding contractors for lower re-offending rates. In education, more risk transfer might be possible in the provision of teaching services; independent schools already take on all such risks. There is similar scope for the transfer of demand and output-related risks in relation to medical services (paragraph 157).
187. We recommend that the Government should examine what additional risks now borne by the public sector can sensibly be transferred to the private sector, acknowledge the lesson of experience that the risks of exceptionally complex, large projects are not suitable for transfer to the private sector, and produce comprehensive revised policy guidelines (paragraph 158).

## APPENDIX 1: ECONOMIC AFFAIRS COMMITTEE

---

The members of the Select Committee which conducted this inquiry were:

Lord Best  
 Lord Currie of Marylebone\*  
 Lord Eatwell  
 Lord Forsyth of Drumlean  
 Lord Griffiths of Fforestfach  
 Baroness Hamwee  
 Baroness Kingsmill  
 Lord Levene of Portsoken  
 Lord Lipsey (from November 2009)  
 Lord MacGregor of Pulham Market  
 Lord Moonie  
 Lord Paul (until November 2009)  
 Lord Tugendhat  
 Lord Vallance of Tummel

\* Lord Currie did not take part in the inquiry leading to this report.

Professor Paul Grout, Department of Economics, University of Bristol, was the Committee's Specialist Adviser.

### Declaration of Interests

Members made declarations of interests relevant to the inquiry as follows:

Lord Best  
*President, Local Government Association*

Lord Griffiths of Fforestfach  
*Chairman Trillium, then Chairman Land Securities Trillium, 1998–2008,  
 advisor to Telereal Trillium 1998  
 Advisor to International Finance Facility for Immunisation launched in 2006*

Baroness Kingsmill  
*Until 2005, Chair of the Advisory Board of Laing O'Rourke*

Lord Levene of Portsoken  
*Member, City of London Corporation*

Lord Moonie  
*Role in an IT project related to Connecting for Health*

Lord Vallance of Tummel  
*Member of the Supervisory Board of Siemens AG  
 (Siemens Business Services signed a PPP with National Savings and  
 Investments in 1999)*

Full lists of Members' interests are recorded in the Lords Register of Interests:

<http://www.publications.parliament.uk/pa/ld/ldreg.htm>

## APPENDIX 2: LIST OF WITNESSES

---

The following witnesses gave evidence. Those marked \* gave oral evidence.

- Mr David M Adamson
- \* Bank of Ireland
- Mr T Martin Blaiklock
- \* Mr Chris Bolt
- \* Sir John Bourn
- \* British Medical Association
- \* Confederation of British Industry
- Centre for Public Service Partnerships, University of Birmingham
- Coventry Friends of the Earth and Campaign for Recycling and Against Coventry Incinerator
- \* Lord Crisp
- Dr J R Cuthbert and Mrs M Cuthbert
- \* Department for Children, Schools and Families
- \* Department of Health
- \* Sir Peter Dixon
- \* Dr Chris Edwards
- \* European Investment Bank
- Foreign and Commonwealth Office
- \* Sir John Gieve
- \* Professor Stephen Glaister
- Gloucestershire Friends of the Earth Network
- Professor David Heald
- Mr Mark Hellowell, Mr David Price and Mr Moritz Liebe (with Professor Pollock)
- Institution of Civil Engineers
- The International Project Finance Association (IPFA)
- \* John Laing
- \* KPMG
- \* LIFT Council
- \* Local Government Association
- \* Local Partnerships, Local Government Association
- \* Ms Rachel Lomax
- \* Ms Kate Mingay
- \* Ministry of Defence
- \* National Audit Office

- \* Office for National Statistics
- \* Partnerships UK
- \* Mr Ian Pearson MP, Economic Secretary, HM Treasury
- People Against Incineration (PAIN) and the UK Without Incineration Network (UKWIN)
- \* Professor Allyson Pollock
- \* PPP Forum
- \* PricewaterhouseCoopers
- \* Royal Bank of Canada Capital Markets
- Scottish Government
- Sheffield City Council
- \* Sumitomo Mitsui Banking Corporation
- \* Sir Kevin Tebbit
- \* Transport for London
- \* UNISON
- \* Professor Geoffrey Whittington

## APPENDIX 3: CALL FOR EVIDENCE

---

### Private Finance Projects and off-balance sheet debt

Private Finance arrangements, whereby private firms contract with the Government to build and maintain infrastructure and other capital projects, are a controversial but significant means of funding public sector infrastructure projects. Most such arrangements are known as Private Finance Initiative (PFI) projects.

The Economic Affairs Committee has decided to conduct an inquiry on 'Private Finance Projects and off-balance sheet debt'. Evidence is invited by 25 September. The Committee will welcome written submissions on any or all of the issues set out below.

The inquiry will seek to answer questions such as:

How should the cost and benefits of Private Finance projects be assessed? What discount rate should be used in comparing Private Finance with conventional public procurement? Are current procurement procedures satisfactory? Is enough information disclosed on Private Finance projects fully to assess whether the taxpayer is getting value-for-money?

How does the performance (e.g., cost, delivery dates and service quality) of schools, hospitals, prisons, roads and other projects operated under private finance compare to those which were traditionally procured?

Is there significant risk transfer to the private sector or is it more apparent than real?

How effective and costly has it been to monitor the private sector providers' performance and quality of service in Private Finance projects in comparison with traditional procurement?

When the basis of a Private Finance contract needs to be altered post procurement because of changing client needs—for example, a bigger jail is required due to a larger than expected prison population—has this proved problematic compared to projects under traditional procurement? What has been the experience of PFI projects that have reverted to the public sector?

How should future payments by the Government under existing Private Finance contracts be recorded in public sector accounts? Is risk transfer an appropriate test? Should all such liabilities be included in the national debt? Should they be accounted for separately from government debt? How much does the public sector accounting treatment of capital and revenue aspects of projects matter?

Would public sector investment in the last decade have been lower without Private Finance? If so, by how much?

How much impact has the financial crisis had on launching new Private Finance projects? Is the crisis likely to have a permanent effect on the Private Finance market?

Are there realistic alternative roles for private finance than the current PFI-type private finance models? Should the UK be aiming for more diversity in private finance models? Would a national infrastructure bank (such as the proposed Dodd-Hagel NIB in the US) add any value in the UK? Should the public sector have a more hands-on role in financing and/or delivery?

Is there an optimal mix between conventional public procurement and Private Finance for public sector investment? What is the long run role of private finance in the delivery of infrastructure both in the UK and globally?



**APPENDIX 4: GLOSSARY**

---

NPV	Net Present Value
PFI	Private Finance Initiative
PFP	Private Finance Projects
PPP	Public-Private Partnerships
PSC	Public Sector Comparator
SPV	Special Purpose Vehicle