THE VOICE OF BUSINESS

Building on success

The way forward for PFI

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Foreword

BY RICHARD LAMBERT | GENERAL DIRECTOR | CBI

The Private Finance Initiative (PFI) is a UK success story. It has been integral to the modernisation of public services over the last 15 years and will continue to be so for many years to come. The underlying principles of transparency, accountability and long-term planning mean that the PFI has achieved significant improvements in the delivery of public policy goals – in the design of learning environments for children and local community regeneration projects, for example.

The market is maturing. The PFI is overcoming challenges and tackling new ones. In addition to achieving value for money and effective transfer of risk to the private sector, the model is now increasingly being used to meet wider social and environmental goals. Innovation and evidence of user satisfaction should be recognised and celebrated.

But this success does not mean that business or the public sector can sit back and relax. Society is changing. The PFI must therefore continue to evolve. There are signs this is happening. For instance, the local improvement finance trust model is being used successfully to redesign and build GP practices and community hospitals. This model shares a similar structure to the PFI but involves greater collaboration between the public and private partners in the initial design and project planning phases. New models such as this are needed to build in more flexibility to deal with possible future uncertainties in terms of public demand and policy priorities.

This report points out that although the UK leads the world in PFI, other countries are catching up. This competition provides threats and opportunities. It is even more important now to secure the conditions necessary for the PFI industry to flourish in this country, otherwise experienced and skilled people will move abroad. The development of increasingly complex partnerships requires urgent investment in procurement capability in order for the PFI to continue to thrive and to compete successfully in the international market.

Above all, the report calls for the government to be a more active champion of the PFI and the next generation of emerging public private partnership models. The benefits of these initiatives should be set out in terms of what they have or can achieve against public policy objectives, such as the reduction in carbon emissions in new environmentally sustainable accommodation. This is crucial to give the market confidence to continue to develop innovative solutions to meet future public policy challenges.

Richard Lambert

Executive summary

Britain has a long history of public private partnerships (PPPs) and these have delivered high-quality services and infrastructure on time and to budget. The Private Finance Initiative (PFI) is the most established and successful PPP model in the UK, with more than 500 projects now operational. There is significant evidence to show that the principles of transparency and accountability underpinning the PFI have enabled radical improvements to the way services are delivered to the public.

The aim of this report is to examine the PFI, what it has delivered so far and how it might evolve and be improved. The PFI market is maturing and new models of partnership are being developed. Now is an appropriate time to reflect on what has been achieved and suggest how future benefits could be maximised.

The PFI is integral to the modernisation of our public services and is helping ensure taxpayers receive better value for money. But it is not just about infrastructure – schools, hospitals and other public buildings or equipment. Its success is due to five major innovations:

- **Bringing together design and service delivery for long-term benefits.** Unlike in the past, when buildings were constructed and their upkeep left to others, the PFI means service providers are responsible for designing and constructing buildings and then running many of the services themselves. This approach encourages innovation and rigorous planning that allows for changing user needs over the course of the contract

- **Sharing risk creates incentives to succeed.** The success of the PFI depends on effective sharing of risk between public and private sector partners. The public sector is incentivised to specify service needs at the outset of a project with greater care, while the private sector has an incentive to be innovative and efficient in how it meets specifications

- **Increasing financial transparency and accountability.** The use of private capital improves the transparency of government finances and increases accountability to the taxpayer

- **Improving service user and staff satisfaction.** The success of PFI projects depends on people – those who deliver services and those who use them. The PFI encourages stronger working relationships between private and public sector partners and focuses attention on user needs and how best to deliver services effectively

- **Prioritising environmental sustainability.** Whole-of-life asset management in PFI projects encourages contractors to be efficient, which can encourage environmentally sustainable goals, both in terms of construction, design and ongoing service delivery.

Although the success of the PFI as a model should not be in doubt, there remains a need for the private and public sectors to communicate this to the public and show how the PFI will develop and improve in the future. The CBI recommends the government should:

- **Clearly articulate the benefits of the PFI and show how it fits with its vision of modern public services.** A more rational debate is needed over the future of public services and how new funding and delivery methods are central to modernisation. Those involved in the PFI market need the confidence to search for innovative ways of delivering services

- **Encourage opportunities to develop the underlying principles of the PFI.** Much has already been achieved and much more can be achieved if PFI success stories are learned from and the lessons brought to bear on future projects

- **Improve commissioning and procurement skills to enable the success of new partnership models.** As the PFI market develops, and more complex partnerships and models evolve, there is an increasing need to improve general procurement capability. More interaction between the public and private sectors will allow the sharing of expertise

- **Ensure the growing international market in PFI is exploited for the benefit of British business and the country as a whole.** The UK invented the PFI and other countries are now catching up. The government must ensure the British PFI industry is encouraged and supported in its efforts to export its expertise. This will reap financial benefits which help improve the services delivered to the public in this country.

1 Introduction

The CBI believes the future of public services lies in a mixed economy of provision, one that harnesses the strengths of the public, private and voluntary sectors. Britain has a long history of public private partnerships (PPPs) and the use of PPP procurement models has helped the UK government secure better value for money in public spending and higher quality delivery over the long term.

PPPs have a more fundamental role than merely being used to tackle the backlog of underinvestment in public services. The underlying principles of PPPs are increasing transparency, contestability and accountability and therefore improving the way public services are designed and delivered.

The PPP landscape is constantly developing and evolving to meet the challenges of delivering complex public services. In the UK, the Private Finance Initiative (PFI) is the most established and widespread PPP model. It is different to other types of PPP as it involves a private sector partner providing an asset – for example, a school or leisure centre – and the services associated with that asset, such as building maintenance or cleaning – to the public sector over a long period of time. PFI was introduced to improve public sector procurement so that the highest quality and most cost-effective public services could be delivered with immediate effect under long-term contract with private sector partners.

For more than a decade the PFI has been the cornerstone of the government's ambition to upgrade the country's outdated infrastructure, roads, hospitals and schools. With over 500 PFI projects currently in operation, the PFI is fundamental to the modernisation of front-line public services.

Due to this success, it should remain a key plank of government policy covering asset creation and maintenance, service delivery and operation for the foreseeable future. But the PFI is maturing. It is overcoming hurdles by, for example, improving the way risk allocation is handled. It is also facing up to fresh challenges for the future – such as the need to accommodate increased flexibility in long-term contracts as service needs become increasingly complex and difficult to predict, and the growing international competition facing the UK PPP market.

Many lessons have been learnt from the initial wave of PFIs, such as the inclusion of refinancing clauses in contracts, and there are still opportunities to learn and apply further lessons. The government and the public are in a better position to reap the benefits from a more mature, efficient PFI market. PFI is evolving particularly in terms of model design, yet the underlying principles of value for money in delivering quality services over the long term and increased transparency of the financing and risks involved in government spending projects remains clear.

The CBI has published numerous reports on the benefits of the public and private sectors working together. The aim of this report is to look specifically at how the PFI has evolved over time and consider how lessons learnt can guide its future development.

2 PFI is delivering real benefits

The Treasury describes the PFI as "small but important." It makes up around 10% of gross public investment each year and is expected to continue to make up 10-15% of that investment up to 2010, with the remainder made up by conventional procurement. The PFI is used across the public sector, in hospitals, schools, roads, prisons, local community services and defence.[1]

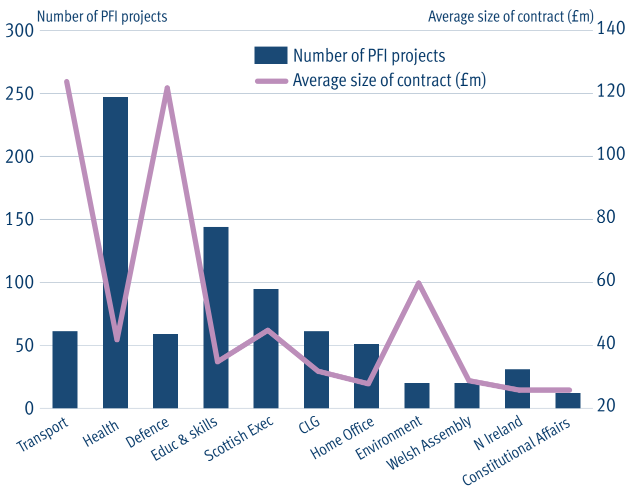
As of December 2006, 794 PFI deals had been signed, with a combined capital value of just under £55bn. At least 500 of these are now in operation.[2] As such, the PFI has made a significant impact across the public sector, including:

- Two hundred and thirty new or refurbished schools have been delivered since 2003. Total private investment in schools is now worth over £2.3bn
- Eight new PFI prisons have been built and two more are under construction
- Thirty-nine PFI hospitals have reached financial close since May 1997, with a capital value of £5.275bn. There are 18 PFI hospitals under procurement and 23 more in the pipe-line. 185 new or refurbished health facilities have also been delivered
- Fifty-eight transport projects have been signed, including roads, bridges, and the very large London Underground and Channel Tunnel projects
- Forty-one waste and water projects have been signed, with a combined capital value of over £2bn
- Almost 150 local authorities have been involved in PFI projects. The 2004 Spending Review announced a further £7bn of new funding, bringing the total funding available for investment in local services through the PFI to £19bn by 2008
- One hundred and eighty projects in other sectors including defence, leisure, culture and housing.

Exhibit 1 shows that the health and education sectors have the largest number of PFIs, but individual PFI projects in the transport and defence sectors are the largest in terms of capital value.[3]

EXHIBIT 1 PFI in key UK government departments by number and average cost

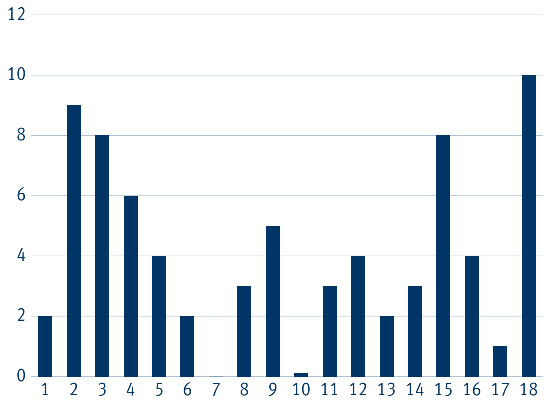
Source: Public Private Finance



The PFI was initially introduced in the 1990s with the aim of achieving closer partnerships between the public and private sectors and increasing the involvement of the private sector in public service provision. Involving the private sector in more than just the construction phase of a procurement project meant benefits could be gained from harnessing its expertise, such as improved project cost esti-mation, whole-of-life asset management, risk management

EXHIBIT 2 Expected savings as a result of PFI in 18 different school projects (%)

Source: Treasury Taskforce (1998), Audit Scotland (2002), Audit Commission (2005)



and the provision of infrastructure maintenance services. In a speech to the CBI Annual Conference in November 1994, the then Chancellor, Kenneth Clarke, reiterated the two key principles of the PFI:[4]

- To achieve a genuine transfer of risk to the private sector in public procurement projects
- To secure value for money in the use of public resources.

The PFI has developed significantly since those early days; the market has matured and lessons have been learnt. The public is now able to reap a range of benefits in addition to those gained by pursuing the original guiding principles of risk transfer and whole-of-life asset management. The PFI is delivering modernisation of front-line public services and five key lessons are:

- Integrating service and design leads to a whole-life approach
- Allocating risk creates incentives for better delivery
- Increasing transparency and accountability has wider benefits for government financing
- Improving customer and staff satisfaction is key
- Opportunities are created to prioritise environmental sustainability.

Integrating service and design leads to a whole-life approach

Under most PFIs, a single consortium or organisation is involved in both the design and construction of the asset, such as a school or leisure centre, and the running of associated 'soft services' – cleaning, catering and building maintenance. Evidence shows that soft services overall are being effectively delivered in PFIs. A recent Partnerships UK survey found that 65% of public sector managers thought operational performance good or very good, 30% thought it satisfactory.[5]

This integrated 'whole-life approach' has major advantages in terms of planning and value for money. Due to a consortium's ongoing involvement, decisions about design and construction are based on long-term service delivery considerations over the length of the contract. There is no such incentive if the soft services remain separate. Under traditional procurement, the specifications of design are often affected by short-term political and funding demands to the detriment of long-term operational efficiency. The nature of the procurement process and the way the contract is drafted means the design stage must take into account that user needs will change over the length of the contract. Although this is true of any asset procurement, the fact that maintenance and operational delivery (where soft services are included) are considered alongside the asset design and construction in a PFI project means it is more likely to successfully capture long-term needs. The problems arise when the procurement and contract are badly executed. The CBI believes that:

- Integrating service and design increases value for money
- A long-term focus can be balanced with flexibility to successfully meet service needs.

Integrating service and design increases value for money

According to the Treasury, the PFI should only be used when it represents value for money; indeed, all PFI proposals are subject to rigorous assessments. Value for money does not mean the lowest cost option, and is defined as:

"...the optimum combination of whole-of-life costs and quality (or fitness for purpose) of the good or service to meet the user's requirement." [6]

Before the earlier PFI schemes were agreed on, contracting authorities assessed value for money by comparing the proposal with a similar – but hypothetical – publicly procured proposal. This model is called the Public Sector Comparator (PSC).

Exhibit 2 (page 9) shows the expected percentage savings of 18 school PFI projects in value for money assessments using the PSC between 1999 and 2003. The average saving over conventional procurement is 4.1%, but in a number of projects there are substantial savings of 5-10%. Although school number seven had no comparative savings over a traditionally procured project, none of the projects had a negative value-for-money assessment. A Treasury taskforce report found that among a sample of 29 PFI projects for which a PSC was available, the average saving was closer to 17%.

The PFI has also saved the public sector a significant amount of money in the health sector. Exhibit 3 shows savings made in 15 PFI hospital projects using the PSC between 1999 and 2002. The average saving was £2.5m per project, but in one hospital savings were as high as £39.5m. As in the school sector, none of the projects had a negative value for money assessment.

Despite generally positive results for the PFI, the PSC does not reveal the whole story. It does not take into account factors that are more difficult to measure, such as managerial dynamism and potential for future innovation. Contracting authorities are now encouraged by the government to apply a broader assessment of value for money. The National Audit Office has set out a new framework to assess whether a PFI proposal represents value for money and whether operational PFI projects are being effectively implemented.[9] The framework covers the lifecycle of a project, from initial strategic analysis to the mature operational phase, using six business management indicators. The guidance is based on the belief that:

"Achieving value for money from PFI depends as much – if not more – on getting the required operational performance as on getting the best deal."

One of the key factors in achieving this value for money in the operational performance of a PFI is the integration of facility design, construction and service delivery. There are three key reasons for this:

- Construction is designed to maximise the efficiency of long-term maintenance and value of the facility

EXHIBIT 3 Expected saving as a result of PFI in 15 hospital projects

Source: National Audit Office (1999, 2002), Department of Health (2000, 2001), Mr Hutton, House of Commons (2001)

Hospital	PSC value (£m)	Value of signed deal (£m)	Expected saving as a result of PFI (£m)[7]
West Middlesex [8]	130	125	5
Dartford and Gravesham	181.6	176.5	5.1
South Tees	271.6	232.3	39.3
Swindon & Marlborough	1311.3	1310.6	0.7
Leeds Community	431.7	420.8	10.9
King's Healthcare	2960.1	2959.1	1
St George's Healthcare	566	565.4	0.6
Norfolk and Norwich	1681.8	1642.3	39.5
South Durham	674.8	671.8	3
Hereford Hospitals	692.6	685.1	7.5
West Middlesex	1088	1082.9	5.1
UCL Hospital	435.2	423.3	11.9
Dudley Group	1834.9	1829.4	5.5
Hull & East Yorkshire	241.6	240.6	1
West Berkshire	282.2	274.4	7.8

- Optimising operating costs and quality over the whole life of a contract has incentivised innovation
- PFIs often include a lifecycle fund to guarantee maintenance is sustained.

Construction is designed to maximise the efficiency of long-term maintenance and value of the facility

Service providers are incentivised to undertake rigorous planning in the initial design phase of a PFI project because they are responsible for service quality over the long term. If the facility is designed to maximise service delivery, savings all down the line can be reaped. For example, if the cost of door construction and maintenance is the service provider's responsibility it is more economically efficient to build stronger doors that may be more expensive in the short term, but which will save money over the length of contract. The same principle applies with the quality of the building fabric, which affects the cleaning process and therefore plays a key role in preventing the spread of hospital diseases. The overall shape of a building can have a major impact on value for money. For example, innovations in PFI prison design include long and wide corridors to enable use of CCTV. Many older public sector prisons have short narrow corridors as they were built at a time when the movement of prisoners was not deemed necessary.

Optimising operating costs and quality over the whole life of a contract has incentivised innovation

PFI contracts usually specify service delivery requirements in terms of desired outcomes. This gives service providers the flexibility to design innovative approaches to meeting service needs, as demonstrated by Grove Village social housing project and Bridgend PFI Prison (see page 12). The procurement model and risk-transfer process under the PFI allows private sector service providers to bring fresh eyes to the design process and begin with a clean slate, rather than being bound by tradition and what has gone before. In one PFI hospital project the public sector client required the separation of patients, visitors and facilities management staff. The PFI consortium developed an innovative design with separate corridors for visitors and patients, preserving the dignity of patients being moved around on trolleys.

CASE STUDY

Grove Village and Manchester City Council using innovative design to improve citizens' lives

In March 2003, Grove Village, a private sector consortium, and Manchester City Council finalised an agreement that meant, for the first time, sales of new homes to private householders would help fund a refurbishment and maintenance programme for existing local authority tenants.[10] This was the first PPP/PFI project to reach contract close in the UK social housing sector.

The scale of regeneration is unique as it includes refurbishment, significant infrastructure change, commercial and retail facilities and new homes, changing the tenure mix to 50% private ownership, 50% social rented – all while the residents stayed in their homes.

The project entailed the demolition of about 40% of existing homes in a run-down city estate in Ardwick, Manchester, to make way for new homes and a better environment. Remaining local authority homes were refurbished to bring them up to a good, modern standard – with new kitchens and bathrooms, and decent fencing and walls around private spaces.

Three years on, the housing estate has been completely remodelled. The former 'rat-run' of alleyways has disappeared as gardens are extended to reclaim space for residents. A new, tree-lined 'green-route' has been completed, with recreational areas and parks. Construction is underway on a new village centre, which will bring shops and community facilities. The existing local authority housing has undergone full internal and external refurbishment, meeting the government's Decent Homes Standard, and social housing tenants now benefit from double glazing, new kitchens and improved weatherproofing. Crime and the fear of crime have reduced and property values have increased. One tenant, who has lived in the area since the early 1970s said:

"The quality of my life has improved 100-plus percent. It's the 'feel-good factor' – the improvements to people's homes, the safety, and the sense of community there is now gives the place a fantastically better feel."

Robots are also used to move around food, linen and other goods, which allows porters to dedicate their time to moving patients and develop the 'people side' of their role.[11] PFI prisons are a good example of the way the PFI can innovate. When the first prison PFIs were let, the public sector customer had a specific agenda to deliver innovative reform, and this is reflected in what has been achieved. Also, the sustained PFI prison market – which has enabled repeat involvement by established providers – has allowed improvements to be cumulative, with each project building on the success of the last, and lessons being learned over time. One way in which innovation has been achieved is through the use of flexible staffing arrangements. Staff costs account for about 80% of the running costs of a prison. Increased operational flexibility in PFI prisons have increased flexibility in staff shift patterns, allowing changes such as receptions opening later, visiting times being more flexible and prisoners on enhanced regimes being able to eat with their families. This would be harder to achieve in public sector prisons without changing working practices.

PFIs often include a lifecycle fund to guarantee maintenance is sustained

This is a ring-fenced fund set aside by the PFI consortium to cover maintenance and refurbishment throughout the contract. This ensures maintenance funds are not raided and facilities subsequently do not become run-down and unsuitable for delivering policy objectives, as can be the case in other public sector facilities.

A long-term focus can be balanced with flexibility to successfully meet service needs

In traditional public sector procurement the economic consequences of building, operating, maintaining, changing or closing down assets and services have been generally underestimated or disregarded (often being treated as a sunk cost). By contrast, the PFI makes these costs explicit at the time of procurement. The initiative has subsequently been criticised for introducing inflexibility and additional cost - but there is a general lack of evidence that the PFI has introduced inflexibilities and costs that were not there previously. It is more likely that the PFI has made the process transparent, and these costs and risks are inherent to providing complex, long-term public services and should be factored in however a service is procured. There should not be a trade-off between transparency and flexibility. It is a positive development that the public can now see these costs set out and can have an informed debate about them. The level and mix of public services required is decided by public sector managers long before a decision is made on whether the investment will be through the PFI or not. This includes, for example, the type of wards and the number of beds in a new hospital. But the nature of service provision must be specified at the outset of a PFI contract.

This means PFI partners need to consider how service needs could change and how service provision could evolve over the life of the contract. There are some events or developments that are difficult to predict or factor in – for example, changes of policy, user needs or advances in technology. This would be the case however a project was procured. A benefit of the PFI is that due to the length of the contract, commissioners are incentivised to think about the whole life of the project, more so than under a conventional procurement, and to factor in likely future developments to the initial design and construction phase.

For example, the newly-built 27-ward, 953-bed Norfolk and Norwich University PFI Hospital is comprised of three zones (out-patients, in-patients and diagnostic/treatment services).

CASE STUDY

Bridgend PFI Prison demonstrates how innovative design creates value for money

Constructed between 1996 and 1997, Bridgend prison was one of the first PFI prisons. The contract scored favourably in the public sector comparator value for money assessment. The principle reason for this was the private sector consortium's innovative approach to the design of the prison.[12] The innovations included the use of an appointments system for visits (which reduced the space needed for visitors' rooms), replacement of kitchen facilities with a catering service, and less unused space between houseblocks. This resulted in a smaller perimeter and lower costs. The consortium had no intellectual property in these innovations and the designs have been copied subsequently in other prisons.

The design is based on a concept of creating an unbundled 'medical village', designed to grow and adapt (as it has had to already) with the communities' needs. Successful planning and design permits service flexibility through strategically placed 'soft spaces' allowing future internal and outward expansion.[13]

Throughout the life of a PFI contract there are regular reviews, or 'contract breaks', in which variations to the contract can be made. For example, the contract for the West Middlesex PFI Hospital includes a clause to allow for up to six additional wards to be provided or – alternatively – bed numbers to be reduced in order to deal with the uncertainties of providing a health service over the 35-year period of the contract. Post-contract variations are also possible – for example, the Norfolk and Norwich PFI Hospital recently added 144 beds and additional renal and cardiology facilities. The Treasury has established a PFI Operational Taskforce to support contract managers in undertaking variations and improving the flexibility of existing PFI contracts.[14]

Allocating risk creates incentives for better delivery

An underlying principle of the PFI is that risk is borne by the partner best placed to manage it. The transfer of some types of risk to the private sector, such as construction time and cost overruns, was one of the original drivers behind the introduction of the PFI. This has meant that as the PFI has evolved, the public and private sectors have both gained considerable experience in identifying risk factors, valuing them in a contract and managing them over the duration of the contract. The CBI believes:

- Project risk can be effectively managed and shared between partners
- Risk allocation creates incentives to ensure projects are delivered on time and to budget
- Clear lines of accountability increase transparency and individual responsibility.

Project risk can be effectively managed and shared between partners

Risk valuation is a complex calculation and varies from project to project. The public sector has less experience in identifying, quantifying and transferring project risk and, as a result, some traditionally procured projects have been prone to optimism bias – that is, a tendency to budget for the best possible scenario (often lowest cost and earliest completion) rather than the most likely.[15] As the public and private sectors gain more experience and expertise in this, more benefits can be gained under the PFI from successfully allocating risk.

Because of the long-term scope of the PFI, it is essential that the majority of risk is identified at the outset of the project and allocated accordingly. In most PFI projects, the risks of meeting required standards of delivery, construction costs and delays are met by the private sector, whereas the public sector is thought to be more able to deal with the risk of future changes of public service requirements and the risks associated with the actual use of the facility. The National Audit Office surveyed public and private sector partners involved in 121 PFI projects and found 95% of both partners agreed the allocation of risk was either 'wholly' or 'partially' appropriate.[16]

Factoring in possible overruns and ensuring that hidden costs, such as transferred staff pension liabilities, are accounted for in the initial procurement is essential to ensure value for money and increased transparency in the long term. Traditionally procured, publicly funded contracts are not usually subject to this kind of openness and rigorous evaluation. Increased transparency in the PFI costing stage enables an optimal transfer of risk by identifying the partners most able to manage certain types of risk.

In order to improve risk allocation, the government developed its Standardisation of PFI Contracts (SOPC) guidance. The first edition was published in 1999 and the SOPC document has since been updated several times as new lessons have been learned. The SOPC guidance sets out a standard approach to the risk allocation between the public and private sectors and includes mandatory principles and drafting for certain key contractual clauses.[17]

Risk allocation creates incentives to ensure projects are delivered on time and to budget

The public sector has a history of cost overruns and delays, both in the procurement stage and in actual delivery. Once a contract has been signed, the PFI transfers project delays and cost overruns to the consortium, which is only paid once the facility is up and running to the required standard. So with their own money at risk, consortiums are incentivised to reduce these risks. It is clear this incentive is working, as 70% of non-PFI projects surveyed were delivered late compared to only 20% of PFI projects, and 73% of non-PFI contracts ran over budget compared to 20% of PFI projects (and these were due to the public sector changing its specification).[18] In addition, all new PFI prisons have been delivered on time or earlier than scheduled compared with construction overruns under traditional procurement averaging 13%. No PFI prison has cost the government more than budgeted: the budget for seven traditionally procured prisons finished in the early 1990s overran by 18%.

Payment throughout a PFI contract is conditional on the consortium reaching the required service levels. This incentivisation to provide a good service has been shown to be working successfully by a Partnerships UK report that surveyed all 500 operational PFI projects.[19] The report found that while payment deductions have been low, reflecting the general levels of high performance, almost all projects reported satisfactory levels of service after a deduction has been applied, and 72% reported good or very good performance.

Clear lines of accountability increase transparency and individual responsibility

The provision of any public service is a very complicated operation regardless of how it is procured, involving a number of different stakeholders, and national and local priorities. A benefit of the PFI is that it involves the clear separation of purchaser and provider. This gives the provider a powerful incentive to demand high performance, good quality evidence of the true level of performance and firm action to improve poor performance. This relationship creates strong incentives for better accountability as PFI contracting cannot occur without the specification and monitoring of delivery against agreed performance outcomes. The allocation of individual responsibility also has the benefit of increasing transparency and performance management systems.

Transparency also means that should failures occur, the failure is acknowledged, accounted for and lessons are learned, as was the case with the West Middlesex University Hospital PFI project (page 15). This is a significant improvement on how such contracts are traditionally procured, when a lack of accountability, individual responsibility and risk transfer would mean that when projects failed, public money would be lost without the public being fully aware.

Given this, the potential for clarifying roles and responsibilities should be regularly reviewed for continuous improvement. Government initiatives and pioneering organisations are also working to develop simple streamlining measures. For example, Serco is working on the development of a more streamlined helpdesk system whereby all client issues – regardless of type – are logged on to a central system, and dealt with by the relevant member of the consortium.

Including soft services in the overall PFI contract can reduce the number of providers and therefore simplify lines of accountability. When soft services are included in the PFI contract they are also included under the PFI's key performance indicators. When they are not included, their

CASE STUDY

Competitive PFI market increases value for money: Bridgend and Fazakerley PFI Prisons

PFI contracts are subject to competitive tendering. The Prison Service received 60 expressions of interest in response to its required tender notice for the Bridgend and Fazakerley PFI prison projects. Of these, five were invited to submit bids, including four bidders who had overseas partners, importing knowledge of PFI from abroad. For the Bridgend contract, the eventual winning bid from the Securicor/Costain consortium of £266m was over £50m less than that of a similar publicly financed scheme, as evidenced by the public sector comparator.[20]

Quality of service is also considered in the bidding phase. In the case of the Fazakerley Prison, the contract did not go to the lowest bidder, Securicor/Costain, but to the one which came first in quality evaluations – the Group 4/Carillion consortium. In addition, the prison opened five months ahead of schedule, allowing the police and prison services to divert resources away from housing prisoners in police cells, which was wasting considerable resources.

performance is measured by a separate set of performance measures. This increases complexity and could reduce the effectiveness of performance measures, as soft service performance is integral to the whole of the service provision.

Increasing transparency and accountability has wider benefits for government financing

The PFI was introduced to improve public sector procurement so that the highest quality and most cost-effective services are delivered over a long period of time. But any type of capital investment has implications for the government's financial accounts. The introduction of private capital has increased the transparency of public finances, as the flow of money between the partners has to be recorded and accounted for. But as the financial market around the PFI develops, increasing transparency must be a continuing objective for the government in order to ensure the market functions efficiently. The CBI believes:

- The PFI increases transparency of government capital investment
- Refinancing creates incentives and improves service provision.

The PFI increases transparency of government capital investment

Government borrowing from the National Loans Fund for the purpose of conventional procurement is guaranteed by tax. A PFI consortium is financed through a range of methods, for example, through bank loans, individual backers and bonds. It is therefore difficult to compare the cost of borrowing between the government and private sector as the cost at any time is influenced by a range of factors and interest is repayable regardless of the finance route taken. But it has been estimated that the financing cost of an average PFI project is approximately 1-3 % higher than conventional procurement borrowing.[22] Financing is also an evolving area and this gap between the costs of private and public sector borrowing has been narrowing as the PFI matures and the funding market becomes more competitive.

Conventional procurement does not need to take project risk into account as the risk of the loan is underwritten by the taxpayer, and this is reflected in the lower price of borrowing.

But the PFI is more likely to achieve value for money to the taxpayer over the long term because the cost of borrowing more accurately incorporates the value of the project risk and reflects the whole-life cost of the project. Additional costs of borrowing are also offset by the private sector using its ability to innovate and make more efficient use of resources.

The rigorous borrowing regime for the PFI means that the costs and risks of a capital investment and service provision must be made explicit in the contract procurement phase.

CASE STUDY

Lessons learned at West Middlesex University Hospital

In January 2001, the West Middlesex University Hospital Trust let a PFI contract to private sector consortium Bywest. The contract is for 35 years and requires Bywest to redevelop the trust's site at Isleworth, West London, and then provide ongoing maintenance and facilities services.

The National Audit Office (NAO) examined the PFI scheme and concluded that the trust had learnt lessons from earlier hospital PFI procurements, including its own attempt at developing, but not completing, an earlier version of the same project.[21] The NAO pointed out that the trust ran an effective procurement placing particular emphasis on strong senior management involvement, input from clinicians, other stakeholders and experienced advisers. The Department of Health reviewed the first wave of PFI hospital projects and issued new guidance, including a new standard NHS PFI contract, which the trust was able to use successfully.

Prior experience also allowed the trust to run an effective bidding competition. This faster process eliminated an extra round of bidding, reducing the time and costs of the procurement process for both the trust and the bidders.

This has increased the transparency of funding public services when compared with conventional procurement methods. The way these costs are accounted for is complex, varies between different PFI projects and depends on which partner effectively 'owns' the asset and the majority of its associated risk. The accounting treatment of PFI projects follows rules set and audited by a number of independent national and international organisations. Around 50-60% of PFI projects by capital value are reported on departmental balance sheets.[23] Accounting is another evolving area, and from 2006 the future debt liability of PFI projects on departmental balances has been recorded in public sector net debt estimates. This means more of the future costs of PFIs will be accounted for in the government balance.[24]

The government has been accused of using the PFI as an accounting trick to allow spending today to be paid for in future. But the government has continually stated this is not the case. The case studies and evidence in this report support the government's claim that the use of PFI is to improve services, value for money, planning and transparency. In any case, accounting should not be the overriding factor when deciding whether to use the PFI or not, simply because what is best for accountants is not necessarily best for the public.

The disciplines of transparency and accountability integral to the PFI process are having the effect of improving financial management and planning capability within public sector organisations more broadly. PFI contracts require public sector partners to think about the whole-life costs of a project and to be less influenced by short-term budgetary constraints. Regardless of the procurement route taken, affordability can present problems for long-term financing. But it is clearly more advantageous that these issues are addressed at the onset of a contract, as is the case under the PFI, rather than running the risk of becoming unaffordable in future. Estimating the cost of a PFI contract's life span can be made more accurate by using benchmarking and market testing. The Treasury has provided guidance to assist the public sector in applying these processes more rigorously.[25]

When considering whether to invest in private finance, a public authority must consider the benefits and value to the public. The PFI can allow communities to benefit from public service facilities earlier than they would have done otherwise, and can relieve pressure due to under-capacity in other parts of the public sector. Without the injection of private finance, in some cases it is likely that communities would have had to bear the brunt of gaps in public service provision. For instance, the prison population has increased by 36% since 1996, when the Prison Service let the first PFI prison contract. The use of the PFI to build new prisons has helped the Prison Service cope with this increase speedily and cost effectively and has created the necessary conditions for competition in the management of existing public prisons.[26]

Refinancing creates incentives and improves service provision

For a consortium to enter into a PFI contract they must have backing from a bank. The risk involved with the project at the start of a PFI is very high (for example, initial capital investment and construction risk). But this risk reduces as the PFI project matures and the PFI market becomes more established. Private consortiums are able to secure improved financing terms when the construction phase of the project has been completed, when commercial interest rates drop and as the PFI market matures. This allows private providers to borrow money at a lower interest rate, so they can renegotiate their funding arrangements with the investors. Although the actual amount of finance that can be refinanced is often only a small proportion of the total funds invested, it can lead to a profit for the consortium and for public sector partners.

Some commentators claim that private companies should not be allowed to keep any of this profit. But private providers take on considerable financial risk when entering into a PFI and there must be some financial incentive to do so. If providers are put off entirely by these risks, public services will not benefit from increased competition between private sector bidders and the subsequent gains in value for money and improved service quality. The potential for refinancing is one small element of a complex package of risk transfer that the private sector provider assumes in a PFI contract.

Accepting that there should be some reward for managing PFI risks, the industry needs however to ensure proper sharing of refinancing returns. How this profit is redistributed varies with each PFI deal but is now subject to tighter government guidelines and departmental scrutiny. Prior to 2002, a voluntary code stipulated that at least 30% of any profit must be channelled back into the service. For

PFI contracts signed after 2002, the profit share of potential refinancing gains should be set out in the contract and based on a 50/50 split between the public contractor and the private provider. The public sector has since received £130m from its share of refinancing gains, enabling significant service provision improvements.[27]

As in all aspects of the PFI, the role of refinancing is evolving. The opportunity to refinance PFI contracts is now decreasing, as banks, private sector companies and public sector clients gain a greater knowledge of the PFI market and are better able to accurately reflect the long-term costs of the project in the initial contract. PFI schemes now have specific refinancing contractual clauses, or are financed largely by bonds which are long-term and therefore more difficult to refinance.

Further, the financial opportunities for PFI providers are becoming increasingly linked to the demand – largely by pension funds – for investments with very long duration and with yields better than those offered by government securities. PFI contracts create new sources of long-term investment. After the risks associated with the set-up – such as construction risks – are overcome these assets offer large and reliable returns, particularly suitable for pension funds. For instance, the London Pensions Fund Authority, which administers a fund of £3bn for over 73,000 Local Government Pension Scheme members, invests approximately £30m in PFI assets, and this is set to grow.[28]

Despite some concern about this secondary market in PFI assets, there is a limit to how much financial gain can be generated for private investors through short-term financial engineering. The focus of the secondary fund manager is the long-term performance of investments.[29] It is in their interests for the PFI project in which they have invested to be managed well, to effectively maintain assets and meet service specifications. If services are not delivered well, projects will incur revenue deductions and therefore the value of the PFI investments will be damaged. This also

CASE STUDY

Additional benefits of PFI prioritised over risk of refinancing: Norfolk and Norwich PFI Hospital

The Norfolk and Norwich University Hospital Trust currently pays £37.8m a year to the private sector consortium Octagon. This is for the construction and maintenance of a hospital and for facilities management services for a minimum period of 30 years, and is one of the early PFI hospital contracts. Octagon refinanced the deal in 2003, two years after opening the hospital, and replaced bank finance repayable by 2018 with bond finance repayable by 2035. The longer borrowing period and lower interest rates available enabled it to increase its borrowings by 53% from £200m to £306m. It then used the additional funds, a total of £116m, to accelerate the benefits its investors would receive from the project. Octagon was able to negotiate better lending terms due to successful completion of the hospital construction, the maturing PFI market and the reduction of general interest rates since 1998.

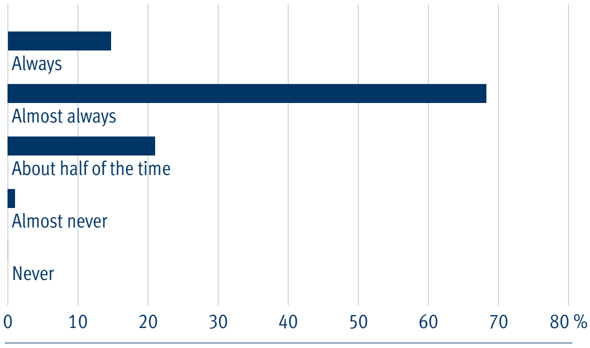
As with other early PFI deals, the contract placed no obligations on Octagon to share any refinancing gains. On refinancing in 2003, Octagon shared approximately 30% (£34m) of its total refinancing gains with the trust in accordance with the voluntary code that the Treasury had negotiated with the private sector in 2002. But the consortium has taken on more risk due to the longer borrowing returns of the refinancing. For instance, the cost to the trust to break the contract early could increase by up to £257m.

The National Audit Office, which examined this case in retrospect, concluded that the terms of the original bank finance were in line with other early PFI deals but added the trust could have avoided this by better defining its requirements.[30] Despite the refinancing gains for Octagon, the trust supports its decision to have gone ahead with the PFI deal and maintains that its priority was the additional benefits from closing a deal which had already been analysed as being value for money. The trust also stresses that other factors need to be taken into account such as the benefits of a new hospital for the community and the avoidance of high rates of recent construction cost inflation.

means that though the ownership of secondary funds may change hands, it is unlikely to fragment PFI projects, as this goes against the principle of creating stable investment portfolios and well-managed projects. An additional benefit is that the sale of the asset also allows the consortium to recycle the capital for funding other projects. There is an opportunity for government to encourage the development of a virtuous circle between pension investment needs and public service funding.[31] The benefit to the national economy of recognising and encouraging this symmetrical market could be more overall, long-term financial stability.

EXHIBIT 4 Did the last user satisfaction assessment find services were delivered to an acceptable standard?

Source: Partnerships UK report on operational PFI projects 2006



CASE STUDY Amey Business Services and Edinburgh City Council successfully improving staff relations

Amey plc is a business support services company employing some 7,500 people at more than 150 locations across the UK. In 2000, Amey secured a PFI contract to design, build, and operate services in 17 Edinburgh schools. Amey Business Services operates the facilities management side of the contract and provides a broad range of services including janitorial, cleaning, catering, building and grounds maintenance, security, waste disposal and disaster management. One hundred and fifty cleaning, catering and janitorial staff were transferred under TUPE to Amey Business Services when the contract began August 2002. New catering staff were also employed.

Of those staff who transferred in 2002, 81% continue to work on the Edinburgh Schools Project. Other key evidence has emerged:

- To date, Amey has met and exceeded all its performance targets
- Absence has fallen from 5-7% to 3-5%
- Employee turnover has fallen from 35% to 25%
- Manual employees have been provided with new development and promotion opportunities
- Employees' contribution is recognised through performance appraisals and an employee recognition scheme
- Both management and unions report that employee relations are healthy and positive
- Employee information and consultation takes place through a range of approaches, including a company newsletter and a communications forum
- Terms and conditions are unchanged for transferred employees. Sick pay and annual leave are slightly less generous for employees recruited after the transfer, but these are being reviewed by the company. A new voluntary benefits scheme is available to everyone.

Under the new performance management system introduced two years after the start of the contract, objectives were established for each team and linked to key performance indicators representing local areas as well as the individual school. Appraisals are now conducted annually. Managers feel the system had a considerable impact, in particular because employees are now more aware of what is required of them, and also see development opportunities within the company. One manager commented:

"It's made a huge difference to the company – we now know strengths and development needs of staff. Staff are our business so it's led to a stronger focus on staff development. Staff are now so keen, so enthusiastic to learn – we have four janitors now working on another contract – and we couldn't have recruited better externally."

Improving customer and staff satisfaction is key

The PFI has been crucial for the modernisation of public services. Because it affects many people's lives, the success of the programme hangs on user satisfaction – that is, the opinion of those who receive the service and those who work for PFI companies delivering the service.

The CBI believes that:

- User satisfaction supports the continued use of the PFI
- Its success is driven by improved staff performance
- The PFI encourages a long-term partnership between the private and public sectors.

User satisfaction supports the use of the PFI

Independent studies of user satisfaction with PFI projects demonstrate a consistently high proportion of positive user views of both service facilities and the way services are delivered. When considered alongside the reported performance against the contract, these results suggest PFI contracts reflect user expectations, which are in turn stimulating strong performance levels. Exhibit 4 (page 18) shows the results from a recent Partnerships UK survey which collected responses from 105 operational projects across the majority of PFI sectors.[32] User responses were generally positive, with 70% showing satisfaction with PFI projects 'almost always'.

PFI success is driven by improved staff performance

Good employment goes hand in hand with good service provision. The quality of a PFI project is driven by the staff, who in turn are motivated to do a good job. Contracting authorities are required by government to ensure that value for money of a PFI contract does not come at the expense of employee terms and conditions. The terms and conditions of transferred staff are protected through TUPE regulations and a code of practice to prevent two-tier workforces.[33]

The evidence on PFI contracts points to good working practices and effective use of performance measurement.

CASE STUDY

Surrey Care Homes building a relationship beyond the contract

The first PFI contract for the provision of long-term residential care homes was signed by Surrey County Council in March 1998. Under this 20-year partnership arrangement the Council transferred 17 homes – providing care to almost 800 older people – to its new service provider, Anchor Homes. A PFI route was chosen because the council had a number of residential homes in need of significant capital investment but did not have the level of capital required.

Eight of the homes were refurbished and nine were rebuilt over a five-year programme. The buildings were delivered on budget and ahead of schedule despite encountering some unusual problems – including the discovery of a badger set which meant fences had to be re-routed.

The assistant executive director of Surrey County Council Adults and Community Care explains:

"The relationship is more than the contract: it's the partnership approach which ensures the issues are addressed well before they become difficult to resolve. Both organisations maintain a very straightforward approach to managing the contract and the partnership. This has been key to the success of the project. I think you have to work that way to get the best from this kind of partnership.

"We approached the project on the basis of very strong partnership working and it was helpful that PFI encourages that. I can remember sitting with lawyers for many hours trying to thrash out some of the finer details. Ultimately we recognised it was about striving for a contract that was mutually negotiated, mutually acceptable and pragmatic and workable."

Key to success was..."Sharing as much information as possible with partners ... Extensive early meetings were held, even before Anchor was chosen as our preferred bidder, full presentations were made to bidders to say this is what our project is about, this is what we're trying to achieve, and this is what we would be looking for from potential partners."

For example, the National Audit Office reports considerable innovation in the way staff are recruited and deployed in prisons.[34] In 2005, the CBI commissioned a team of independent researchers to interview the clients, managers and staff of 12 organisations delivering public services under a public private partnership contract, including Amey Business Services and Edinburgh City Council partnership.[35] The study found that good employee relations were closely linked to improved service. Also crucial are the following lessons from PPPs:

- Involving employees during the procurement process reduces uncertainty for staff
- Training and development opportunities have been improved and are greatly valued by employees
- Performance management has been made more meaningful
- Employers communicate with employees and their representatives and involve them in the way the service is run
- Most employees are happy with their employers, even where concerns were present at the time of transfer.

Most of the companies studied could be broadly characterised as operating with a hands-on, open style of management. Employees were typically offered more autonomy within a performance framework. Some employees expressed surprise at being listened to, and remarked on their new freedom to get on with the job. The study also found that in general, employees and managers perceived there to be more opportunities for promotion in supplier organisations than in the public sector, supported by internal development progression and a culture of 'stepping up'. For example, one employee commented:

"I went to meetings [in the past] and was told 'don't say this' and 'don't mention that'. You would not say what you felt. Then all of a sudden it was different, [they] encouraged you to talk in management meetings."

In a housing maintenance contract, private sector provider Accord introduced a performance management system for its skilled manual workers. The arrangement included annual appraisals, six-monthly reviews and regular one-to-ones. The focus of the system was on the training needs of a multi-skilled workforce. It was also used to communicate changes in the organisation and to highlight ongoing issues, such as health and safety concerns. The meetings were a channel for individual employees to make their suggestions for improvement. As one manager reported:

"A plumber came up with the idea that if he also became a lock-smith he would not have to damage the door to get into properties. Another idea was doing drain-jetting in-house instead of contracting it out. The staff are encouraged

CASE STUDY

Defence Estates and CITEX group encouraging sustainability

Defence Estates, the unit within the Ministry of Defence responsible for the department's facilities, and a private sector partner consortium, the CITEX group, are involved in a £40m PFI project to rebuild offices for the Defence Logistics Organisation.[36]

A specialist sustainability consultant was employed to advise and audit the designs and works, not only in terms of functionality and efficiency but also the whole-life costs of the materials selected. The project secured an 'excellent' rating in the Building Research Establishment Environmental Assessment Measure.

Measures adopted include:

- Recycling the demolition material and incorporating them in the new building works
- Using natural materials from proven sustainable sources in construction
- Installing low-energy intelligent light fittings
- Establishing on-site cycle and pedestrian routes linked to the local transport infrastructure.

By having the prime contractor responsible for maintaining the building fabric and engineering services for six and a half years after the completion of the building, there was a smooth transfer from the construction phase to the offices' occupancy and use. There was also an opportunity for the partners to assess together how effectively the design of the building was working and, where there were technical problems, there was a single point of responsibility to identify potential solutions.

to suggest better ways of doing things. The council was not interested in new or different ideas."

The PFI encourages a long-term partnership between the private and public sectors

For a PFI contract to be successful and to deliver better public services, the partners need to share objectives. This has seen a move by public and private partners towards concentrating on wider aims than merely fulfilling a contract, such as how to be better partners.[37] Ninety-seven percent of public sector contract managers surveyed rated their relationship with the private service provider as either 'very good', 'good' or 'satisfactory' and none rated their relationship as 'very poor'.[38] The PFI has encouraged the development of a new form of management behaviour with partners trying to solve problems rather than reach for a contractual resolution.[39] Most authorities and PFI contractors have made efforts to understand each other's organisations and establish a shared vision for the future.[40] The Surrey Care Homes PFI project demonstrates how success can be driven by working together to achieve mutual goals (see page 19).

Opportunities are created to prioritise environmental sustainability

The success that PFI projects have demonstrated in developing environmentally sustainable facilities shows how whole-life project costing and service delivery has benefits above and beyond the achievement of improved asset management and value for money. One such benefit is that the PFI can assist the public sector in its efforts to deliver services in a more environmentally sustainable way.

The PFI is driving innovations in environmental sustainability because bidders are encouraged to submit bids to public sector clients which demonstrate innovative ways of meeting environmental challenges – both those of today and the future. The ability to tackle environmental challenges is made possible by the operational flexibility and capacity to innovate under the PFI model. This is the case in tackling the need to reduce carbon emissions and increase recycling. Defence Estates and its private sector partners, for example, demonstrate best practice in the design and construction of new offices which are not only delivered on time and to budget but which included environmental sustainability as a design priority.

The PFI model also encourages contractors and public authorities to build strong partnerships. This encourages both partners to invest time and resources in search of developing solutions which go beyond increasing efficiency and value for money. Some local authorities are harnessing the PFI procurement model to help them to pursue environmental and social goals[41] – for example, the Brighton Jubilee Library PFI demonstrates how environmental considerations can help to achieve social goals such as transforming a run down inner city area (see page 22).

The PFI involves more than the construction or refurbishment of an asset. Equally, sustainability does not stop with the tendering of a procurement project. The PFI has the advantage of encouraging both contractors and clients to think seriously about service delivery over the long-term and to how to ensure that the facilities and services continue to represent the best environmental outcome. Most PFI schemes involve service providers from the outset which encourages partners to think seriously about how the services will be delivered and the impact they will have on the environment. In addition, services which take account of their environmental impact are more likely to deliver efficiencies and value for money, for example, energy-efficient technology, fixtures and fittings can be cheaper to maintain over the long run.

CASE STUDY

Brighton Jubilee Library, Brighton and Hove City Council and Land Securities Trillium prioritising environmental sustainability

The central Brighton Jubilee Library is a £14m project which is part of a £50m redevelopment of a run-down area of Brighton city centre. The library was built on time and to budget, receives very positive feedback from users and has won awards for architecture, construction, PFI, regeneration and sustainability.[42]

The library is one of the most eco-friendly public buildings in the UK. Drawing most of its heat, light and ventilation from sunshine and sea breezes. The library also features low energy consumption (using an estimated 50% reduction in carbon), low embodied energy and recycled rainwater.

A Brighton and Hove Council spokesperson explains:

"Sustainability goes hand in hand with cost effectiveness and providing the perfect environment for a library. For instance, we rely on sunshine to provide heat and light and what's better for reading than natural light? The open-plan nature of the building that is essential for natural ventilation also provides flexible accommodation that is essential to a modern public library".

Since the library opened in March 2005 membership has soared. A record 3,000 new people signed up in the first two weeks alone. The library now has three times the number of visitors each day than it originally did. The project has won eight awards, including the Prime Minister's Better Public Building Award.

Another unique feature of this PFI project is that the consortium has included the supply of library materials and the full bibliographic services for all the 16 libraries in Brighton and Hove. Money is ring-fenced for new books irrespective of whether council policy priorities change.

The main success factors include clear service specifications, a good and trusting working relationship between the partners, open communications with all stakeholders in the community and clear lines of accountability.

3 Next steps: The way forward for PFI

The evidence shows that the PFI is achieving real benefits in terms of delivering quality public services, on time and to budget. The PFI market has been evolving over the last 15 years, risks are more effectively shared, private finance is more efficient, procurement expertise is developing and lessons are being learned. This is supported by evidence of positive and consistent user satisfaction with the facilities and services procured under the PFI. The government, private sector partners and the public are therefore in a better position to reap a range of benefits from PFI projects – including a whole-of-life approach to service delivery and improvement, increasing focus on long-term priorities such as environmental sustainability, flexibility and transparency. For this reason, the PFI must continue to evolve and improve.

But the public and private sectors both need to be clear on how they want the PFI market to develop. The CBI recommends the government should:

- Clearly articulate the benefits of the PFI in terms of its vision for future public services
- Encourage opportunities to develop the underpinning principles of PFI
- Improve commissioning and procurement skills to enable the success of new partnership models
- Ensure the growing market in PFI projects is exploited for the benefit of British business and the country as a whole.

Clearly articulate the benefits of the PFI in terms of its vision for future public services

The government has collected significant evidence about the benefits that the PFI delivers, and this evidence must be more actively – and effectively – promoted. This should be set out in terms of the benefits to communities rather than concentrating on financial aspects of PFI projects – for example, the number of patients treated in a PFI hospital or the benefits of a redeveloped housing estate. Continuous development and improvement in the PFI market should be acknowledged and encouraged. Public and private sector partners have been working to develop understanding and improve delivery in areas where the PFI can be strengthened, which has shown some positive results.

Government support will give both private sector bidders and contracting authorities greater confidence in seeking innovations and solutions in PFI policy. In general, departmental policy input into the PFI is low and could be improved. For policy initiatives and developments to be successful, a thorough appreciation of the PFI in practice, at every stage from conception to operation, is needed.

The same is true of the implementation of PFI policy and guidance. For example, cost is an important element but there are numerous other factors to be considered – such as long-term value for money or operational service considerations. Therefore, there is room for commissioners to be more proactive and less risk averse when considering PFI contracts and new PPP models in line with the wider value for money National Audit Office and HM Treasury guidance.

Moreover, there is a danger that if the government does not more actively champion the benefits of the PFI, it will increasingly be seen as a means for a private sector partner to provide assets rather than assets and accompanying services. This constrains innovation and flexibility in the development of future PFI projects and wider public service reform.

Encourage opportunities to develop the underpinning principles of PFI

Although the operational processes of PFI are evolving and continually improving, there are more fundamental developments now underway that will see the underpinning principles of PFI being harnessed in different ways. This means that when the PFI route is not appropriate for a particular service, an alternative PPP model can be considered in order to achieve the benefits available from such partnerships. This is especially the case for sectors that look set to expand rapidly in the next five years, including waste management and leisure.

In a number of cases, the principles that underpin PFI procurement have already evolved in innovative ways. Strategic partnership models have recently been developed which provide umbrella organisations to procure smaller PFI or PFI-type projects alongside other projects requiring a different method of procurement – such as investment in information technology systems (an area unsuited to PFI procurement).

The two main examples of this model are Local Improvement Finance Trusts (LIFTs) in the health sector and the Building Schools for the Future (BSF) programme. Both programmes provide a long-term strategic framework for planning and delivering investment. The individual projects undertaken by LIFT and BSF are structured in similar ways to PFI projects, and some of the companies entering into LIFT agreements are also involved in the PFI. The key differences between these two models and a typical PFI model is that they are joint ventures, taking strategic planning and procurement decisions that were previously the sole responsibility of the public sector. This allows private sector partners to contribute project planning and design expertise at an earlier stage. The LIFT and BSF programmes are also supported by a national programme management organisation, and by central co-ordinating bodies, Partnerships for Health and Partnerships for Schools, which assist with procurement and knowledge transfer across projects.

EXHIBIT 5

Building Schools for the Future

Six out of seven schools in England were built more than 25 years ago. At the end of the 20th century, many thousands of children were being taught in unsuitable schools or in temporary classrooms that had been used for years. Some schools were unsafe in terms of their structure or their security. Overheads were excessive because of old heating systems and inefficient lighting. Government net total investment was completely inadequate to meet the needs of a fast-declining school estate.

Building Schools for the Future (BSF) is a 15-year investment programme, providing £2.2bn capital investment a year, representing two fifths of total school capital spending. The programme includes conventional and PFI funding. Of the £2.2bn for BSF, £1.2bn (55.5%) will be covered by the PFI. Together with other school investment, BSF has raised capital spending from £90 per pupil to £680 per pupil a year.[43] The aim is to bring all secondary schools in the country up to 21st century standards and to inspire new ways of learning. Schools will be rebuilt, redesigned or refurbished, depending on need, with high quality facilities and integrated information technology to provide an environment conducive to learning.

Local Education Partnerships (LEPs) are formed by the appointed private sector partner, the Local Authority and Partnerships for Schools, the delivery body of the BSF programme, to develop a strategy for upgrading the secondary education infrastructure in a particular area. The LEP then contracts a mix of conventionally procured projects and PFI to deliver the investment. The private sector partner contributes expertise to allow innovation in school design and the capacity to integrate various services so that, for instance, information technology and building infrastructure are integrated. The partnership model also improves supply chain management, creates economies of scale and enables faster delivery.[44]

One of the key benefits of such models is that they can offer improved flexibility. Financiers are able to spread risk between a number of projects, allowing more scope for flexible development and innovations. With risks spread across a number of projects, it is also easier for these financiers to recycle capital into funding new projects. In the case of LIFT, flexibility means that projects can be used for a range of facilities not normally considered for PFI and for contracts of five years rather than the more typical 25-30 years. Further benefits include a more streamlined procurement process and the ability to derive value from working with a consistent supply chain for sequential projects, therefore building expertise and a better understanding between project partners over time.

The opportunities for public service modernisation offered by LIFT and BSF have encouraged officials in other government departments to consider whether similar innovative projects can be devised to address other policy challenges. For instance, work is underway within the Communities and Local Government department to assess whether a partnership model similar to LIFT or BSF would be appropriate for the social housing sector.

A variation on the LIFT/BSF models is the competitive partnership model, in which several LIFT companies/LEPs are appointed in competition with each other, allowing public sector clients to reallocate projects on the basis of performance. This increases the competitive pressure on the companies.[48] The performance data can also be used to benchmark one competing company against the others. This model is currently being explored in the schools sector and in housing and regeneration (Oldham and Rochdale) and has been used successfully in the private sector by the Bank of America.[49]

In a recent report, the Treasury acknowledged that the PFI market is evolving and that new procurement methods which capture the benefits of PFI should be developed.[50] One potential model the Treasury has put forward is the project delivery organisation (PDO). The PDO model aims to manage the delivery of a project through the procurement, construction and operational phases. On completion of the procurement phases the PDO becomes responsible for delivering the service to the public sector client. This model aims to more effectively manage the procurement through early contractor involvement. Unlike an individual project,

EXHIBIT 6

Local Improvement Finance Trusts in health

Local Improvement Finance Trusts (LIFTs) are an innovative approach to meet the challenges of investing in small health schemes. This development is in response to the years of under-investment suffered in primary care health facilities. Most GP surgeries were in adapted buildings that needed redevelopment or replacement. About 80% were too small, most could not deliver modern healthcare and many breached the Disability Discrimination Act in terms of limited access for disabled users. There was no structure for private investment in GP surgeries, with 84% owned by the GPs.

To overcome this and create the capacity to meet the investment challenge, individual contracts were grouped together or ‘batched’, and standardised terms were used. Contract batching benefits from a coherent strategy, economies of scale and repeat contracts. Batching also attracts larger construction companies into the market. Private sector partners bring expertise in terms of project delivery and property development.

Forty-two LIFT companies have been set up as joint ventures between local health bodies, Partnerships for Health and private sector partners (who hold the majority of shares). These companies establish investment priorities in each local area.[45] By October 2005, 50 LIFT schemes had been developed covering almost half of Primary Care Trusts and about 70% of the population.[46] LIFT has so far attracted £671m additional investment into primary care facilities, and by the end of 2004, 1,510 one-stop primary care centres were under construction.

A National Audit Office report on the LIFT programme found that they were effective and offer value for money, but that local management frameworks need to be strengthened. The NAO also found that LIFT offers a faster delivery route than PFI, with shorter procurement timeframes and lower transaction costs, and that it is a suitable route for smaller projects which would be unsuitable for PFI.[47]

a PDO will manage the procurement of the underlying assets and integrate these with necessary component services to provide an overall service to the procuring authority. This could be beneficial in projects where there is a long construction period, where the service requires significant investment in new capital assets or where there is a high likelihood of material change in service requirements throughout the life of the contract. This type of model also offers reduced procurement times, as the private sector partner will be incentivised to deliver on time, improved procurement capability and early private sector involvement in projects.[51]

A PDO is currently being developed for the Military Flight Training Services project. This Ministry of Defence contract requires the service provider to deliver trained flight-deck crews (pilots, navigators and flight engineers), but where the precise nature of the training required will inevitably change over time.

Another alternative, although older, model is 'alliancing', which has been used in a number of sectors, such as the oil industry. Alliancing can be more workable than the PFI when there is a high level of uncertainty in the project. The model is based on collaboration through aligned project objectives. It is usually based on key project outcomes (rather than inputs) and involves an integrated project team with shared profit and loss arrangements. Alliancing requires strong partners to work. An example of an alliancing arrangement is the Aircraft Carrier Alliance project, in which a single integrated team has formed between Babcock, BAE Systems, Kellogg, Brown and Root UK, Thales UK, VT Group and the Ministry of Defence (MoD), which acts as both partner and client. The team is aiming to deliver two new aircraft carriers.

The potential benefits of the new models discussed above are great and there is need for more experimentation. A proactive and innovative project can change the landscape of possible service delivery opportunities, as demonstrated in the housing sector by the Croydon Care Homes project.

Improve commissioning and procurement skills to enable the success of new partnership models

As the PFI market develops, and more complex partnerships and models evolve, there is an increasing need to improve general procurement capability. In November 2006, the CBI published a report, *Realising best practice in procurement and contract management*, which sets out key steps the public and private sectors need to take to ensure commissioning and delivery of complex projects achieves a variety of service outcomes.

The recommendations draw on discussions with key figures in the public and private sectors and propose steps to ensure:

Competitive supply markets are managed by skilled professional staff

The first step to improving public services is to ensure contracting authorities have the capabilities to harness the benefits of the supply market. A comprehensive understanding of markets requires a constant process of market engagement, including ongoing dialogue with suppliers

CASE STUDY

Croydon Care Homes PPP developing innovative new models

This project between Caring for Croydon Ltd consortium and registered social landlord, the Eldon Housing Association, involves the provision of three registered care homes and one extra care sheltered housing facility, together with day and community centres for older people in the borough. The new centres are designed to be bright and airy, with internet connections and fitness suites.

The project was financed partly through a standard PFI structure and partly through borrowing by the registered landlord. This involved considerable negotiations to develop a financing structure which made the project affordable and contractually viable. Innovation in the deal structure ensured value for money for the public sector. Partnerships UK has approved the scheme and this model may be used as a precedent for future care and housing projects.

outside the tendering process. This is essential for building trust and certainty in public service markets and encouraging innovation in service design. More interaction between the public and private sectors will allow the sharing of expertise and lessons learnt

Transparency and rigour in the tendering process

Procurements need to be driven by outcomes not processes. Strategic commissioning must ensure rigorous needs assessment and clear project specifications. This is the only way to ensure those carrying through procurements have adequate understanding of how the specified service will realise the public authority's policy outcomes

Governance arrangements that are fit for purpose

Partnerships are evolving into complex models for flexible contracts which deliver complicated outcomes. Senior-level leadership is vital for partnerships to succeed, along with robust governance mechanisms and excellence in relationship management.

The CBI recommends:

- The private sector should build links with public sector commissioners in central and local government and share best practice, through existing programmes and more informally

- All central government departments and large strategic-level public bodies should have commercial directorates, or their equivalent

- Public bodies should improve the detail of project specifications

- Central government should establish a mechanism by which bidders can raise concerns about the way procurements are progressing

- Quantitative and qualitative evaluation criteria should be published at the start of all procurements. Authorities must show evidence that they have used rigorous methods for evaluating bids and be prepared to publish the results to bidders and auditors

- Above a certain threshold, all projects must go through gateway reviews. These reviews must trigger external interventions by central or regional procurement teams as appropriate and should be widely available

- All projects should have a named sponsor at the highest level to provide strategic vision and a point of accountability

- All projects should develop an end-to-end project plan at the outset, setting out the obligations and dependencies on both sides and stipulating how resourcing challenges will be met.

The government has since recognised many of these recommendations and has announced changes to the Office of Government Commerce (OGC) to create a government procurement function that is adaptable, flexible and knowledgeable about the commercial world.[52] A slimmed-down OGC will now focus on putting procurement and innovation at the heart of delivering public service outcomes and raising the level of procurement skills across government. These improvements in procurement are seen as increasingly necessary if the Gershon efficiency targets are to be achieved and the momentum of public service reform is to be maintained. Among the government's recommendations are plans for:

- Rigorous external scrutiny for complex projects
- An outcome-based and whole-life value approach to procurement
- Raising procurement capacity within departments
- Introducing a clear procurement framework setting cross-departmental standards for procurement
- An informal complaints procedure for suppliers to report concerns about the failure of departments to follow standard procedures.

In terms of procurement delays, this is an area that still needs improvement. Traditionally procured project costs have increased on average by 47% from the original design phase to completion.[53] In addition, the bidding process for a PFI contract is typically two years, and is expensive both for bidders and public sector contracting authorities: for instance, the extra costs caused by procurement delays are adding an average bill of £2.4m, or more than one percent of capital value, to major hospital projects. Based on this estimate, almost £100m has been lost to overruns on 40 major PFI hospital projects alone since the first wave of schemes began in 1994, money which could have been spent on front-line healthcare.[54] While this is a considerable figure, it is also a conservative estimate.[55]

Such tendering delays are putting off private sector companies from bidding for some PFI contracts and many of the reasons for such delays could have been mitigated by the public sector, without risking overall value for money.[56] Resolving this is crucial, as healthy competition in the PFI market ensures the best contractor is selected and therefore value for money and quality service provision is achieved. For instance, competition at present in prison management is saving the taxpayer £40m-£60m a year, equivalent to the annual cost of operating two or three 800-place local prisons.[57] Simplifying the bidding process and reducing the bidding period, together with the development of standardised contracts and payment mechanisms, the standardisation of submission document requirements and the omission and/or paralleling of procurement stages is realising some efficiencies and improvements to the process, but further progress is needed.

Ensure the growing market in PFI projects is exploited for the benefit of British business and the country as a whole

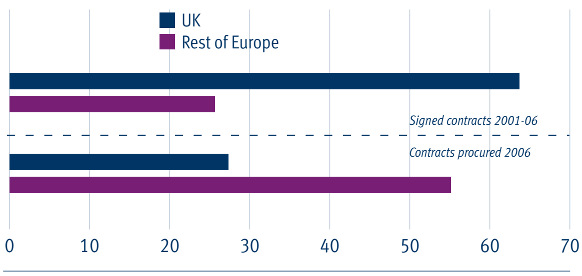
The UK leads the world in terms of PFI investment and many countries are designing public services and developing PPP projects based on UK models. But other countries are catching up and the international PFI market is growing. For instance, the Italian Ministry for Finance has set up a PPP unit based on the UK Treasury's PFI taskforce – the Unità Tecnica Finanza di Progetto (UFP). The aim of the UFP is to help meet the challenges of public sector investment, to help identify projects suitable for private sector involvement, and to provide assistance for central, regional and local administrations on PPPs. In addition, PFI markets are developing in various sectors across Europe – for instance, PFI transport markets in Portugal, Spain, Ireland and Greece, healthcare in Italy, schools in Germany and custodial projects in France. Exhibit 7 shows how public private partnerships in Europe (a majority of which are PFI projects) are growing in comparison with the PFI market in the UK.

The UK government must ensure the conditions necessary for the national PFI market to flourish. If it fails to do so, the UK market will suffer from a skills and investment drain as businesses seek other opportunities abroad. Countries thinking about PPPs are seeking skilled people with UK PPP experience to help advise and develop their models. If the right conditions are in place, this new market presents an opportunity for UK public service companies to provide services in other countries and to lead the market in terms of new developments and innovations.

Ensuring the environment for UK companies to flourish in an international PFI market should be a key priority for government, but this can only be achieved when there is a clear understanding of the benefits of PFI and how the PFI market can be developed and strengthened in future.

EXHIBIT 7 Trends in PFI in the UK and PPP in Europe (€bn)

Source: Public Private Finance (2007)



This report has set out the benefits of PFI in terms of its success in achieving public policy goals – for example, improved learning environments for children and community regeneration through improved housing and shared facilities such as libraries. In addition to better facility design and maintenance through whole-life asset management, transferring construction risk to the private sector and increased transparency of government finances, the PFI has also achieved success in increasing user and staff satisfaction and in meeting environmental goals. With the government's political commitment and an investment in procurement skills, the developing PFI market can continue to achieve results in this country and enable the UK to compete in a thriving international market.

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Annexe: More about the PSSB

CBI Public Services Strategy Board – transforming public services

Formed in 2002, the Public Services Strategy Board (PSSB) leads the CBI's campaigning work on public service reform. As a funder, user and provider of public services, business is keen to influence the ongoing debate of public service reform and shape policy development in this area. Our campaign seeks to increase awareness and understanding of the contribution business is making to one of the most pressing public policy issues facing the UK today.

The PSSB is made up of CBI member companies which are involved in the design and delivery of a wide range of public services and support functions.

The CBI Public Services Strategy Board promotes quality and value in public services through competition and choice.

For more information about its work, visit www.cbi.org.uk/publicservices