National Audit Office

A PAPER FOR THE LORDS ECONOMIC AFFAIRS COMMITTEE

OCTOBER 2009

Private Finance Projects

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This paper has been prepared for the Lords Economic Affairs Committee to support their inquiry on Private Finance.

Contents

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Foreword

We were pleased to take this opportunity to reflect on over twelve years' of National Audit Office work on the use of private finance in public service delivery. Our work has encompassed the impact of what is now more than 100 Private Finance Initiative (PFI) projects across the central government accounts we audit annually. We have also produced 72 value for money reports to Parliament on PFI and other uses of private finance across the public sector.

This paper shows that arriving at a simple evaluation of the overall private finance programme is not easy. Some projects are tendered and managed well; others are not. This is true regardless of the procurement route and many of our criticisms of private finance projects can also be applied to projects funded conventionally. But private finance projects are complex commercial deals. Their success or failure is particularly influenced by how well the commercial issues are handled.

Private finance has become the predominant form of investment in many sectors. With few large projects using conventional funding, it is difficult to compare the costs and benefits of using private finance to alternatives. This drive towards using private finance is in part driven by Government officials' belief in its benefits. But it has also been driven by a less commendable zeal for off-balance sheet solutions which have not appeared in statistics of Government debt.

It is also fair to note that the final judgement on value for money for each project cannot be made until their 20 to 30 year contracts have run their course.

For these reasons it is difficult to arrive at a simple summary of the value for money of using private finance as a procurement option. But to try and put all of this in a short statement: our view is that private finance can deliver benefits, but it is not suitable at any price or in every circumstance.

There are a number of points that we particularly want to stress.

Firstly, there is a pressing need for better quality evaluation of private finance and other forms of procurement across Government. The National Audit Office will continue to provide robust independent analysis. Government, especially the Treasury and spending Departments, however, need to take greater responsibility for evaluating their programmes and projects. They need particularly to ensure that they can compare the benefits and costs of different procurement routes.

Secondly, assessing the pros and cons of alternative procurement routes is especially important in the current economic climate. We know that the cost of private finance has risen since the credit crunch. This does not necessarily rule private finance out as an option for new projects, but it has implications for their value for money. Project teams embarking on new projects need to carefully consider these implications.

And thirdly, the introduction of International Financial Reporting Standards has brought the opportunity for a more consistent approach to the balance sheet treatment of PFI across the public sector. As a consequence we expect nearly all PFI schemes to be brought on-balance sheet. We believe that is the most transparent and reasonable treatment for what are, essentially, publicly controlled projects. But the decision to use different rules for the Financial Statements of Government Departments on the one hand, and their Departmental Budgets on the other, is not an ideal position.

We also hope that this paper will act as a catalyst for further debate and evaluation. There are a number of questions worth asking:

- Some private sector investors are consolidating the ownership of their side of PPPs into portfolio investment funds, through the secondary market. They hope to derive profit from the better management of the projects from the private sector's point of view. How, by extending this reasoning, should the public sector manage its 700 or so private finance projects?
- The success and failure of private finance projects are determined to a large extent by the way the commercial issues are handled. Is Government taking sufficient action to ensure Departments have suitably experienced project and contract managers?
- How will Government's need to contain public spending in the current economic climate impact both on new projects and also projects currently in operation?

We look forward to hearing feedback on these issues. Meanwhile, we will continue to use our independent analysis of Government spending to provide further reports commenting on the value for money of both private finance and other procurement methods.

National Audit Office October 2009

Summary

1 The purpose of this paper is to help the Lords Economic Affairs Committee with its inquiry into the use of private finance in the delivery of public services.

2 The paper draws on the independent analysis of the National Audit Office (NAO) in this field. The NAO has published 72 reports on the value for money (VFM) of using private finance over the past 12 years. The NAO has also considered the accounting treatment of over 100 projects[1] using private finance in our audits of the financial accounts of central Government.

3 Private finance projects are typically long term contractual arrangements between public authorities and private sector companies with funding raised by the private sector companies. The authorities manage the tendering, governance and contractual relationships for the public sector.

4 This paper uses the term private finance projects to refer to all forms of public-private partnerships (PPPs). The range of PPPs is described in Figure 1, Part 1. We have mainly concentrated on the widely used PPP model called the Private Finance Initiative (PFI). As of September 2009, there were over 500 operational PFI projects in England, with a capital value in excess of £28 billion. There are also hundreds of other types of PPPs, ranging from small joint ventures to the London Underground PPPs which have a capital value of £18 billion.

Key messages

Private finance can deliver benefits but is not suitable at any price nor in every circumstance

5 Having examined many PPPs, we have concluded that private finance can deliver benefits, but is not suitable at any price or in every circumstance. It is one of many routes of delivery, which, when used for the right reasons and managed effectively, can work well. When it is used for the wrong reasons or is managed badly, it does not deliver projects well.

1 There is limited aggregate information on non-PFI public-private partnerships, and no single list of them all. We have not counted the number of joint ventures, investments, and contractual agreements that we audit which could also be considered as PPPs.

6 We believe that external scrutiny from the NAO, Parliament and others over the past 12 years has helped the public sector to improve PPP tendering and contract management. Learning lessons from the successes and failures of initial projects has helped subsequent projects. The lessons were reflected in work done by the Treasury (HMT), Partnerships UK, Local Partnerships (formerly 4Ps) and Departments to standardise contracts, provide central support and guidance. The support has included the creation of specialist Private Finance Units within most Departments.

Private finance projects normally deliver what is asked of them

7 Most private finance projects are built close to the agreed time, price and specification: in our sample, 69 per cent of PFI construction projects between 2003 and 2008 were delivered on time and 65 per cent were delivered at the contracted price. Of those delivered late, 42 per cent were delivered within six months of the agreed time, and under half experienced price increases.

8 Public bodies using private finance are normally satisfied with the services provided by contractors. High levels of satisfaction are normally reflected in our reports, case studies and surveys. Whilst we recognise that contract managers may be biased in their response, they are likely to also be the most informed individuals for a project.

9 Despite this progress, however, our work has continued to identify important areas which continue to require attention. These are summarised below.

Departmental justifications for using private finance are often unclear

10 Private finance brings costs and risks over the use of conventional funding. Part of the cost difference is because, unlike Government borrowing, the cost of private finance reflects the risks of the project. So projects which use more expensive, risk-weighted, private finance must also bring sufficient benefits to be worthwhile. These benefits might include cost efficiencies, quality improvements, innovation or the better management of risk. It is important to establish how these will be achieved before the project is initiated.

11 Each project requires a business case that demonstrates that the project is feasible, affordable and VFM. Although business cases generally demonstrate feasibility and affordability they often do not manage to demonstrate adequately that private finance is the best VFM option. The problems we have encountered in business cases are: overall strategic reasons for using private finance are often unclear; financial modelling is error-ridden and given undue influence as the basis for decisions on VFM; and too much weight is placed upon subjective judgements of risk, which can easily be adjusted to show private finance as cheaper. Business cases also often do not explain how the desired benefits will be achieved.

Institutional incentives have encouraged the use of private finance

12 Part of the reason for the lack of clarity in business cases is that the issue of accounting treatment has distracted attention away from VFM. Most private finance projects have previously been off-balance sheet and not recorded in Government statistics of Public Sector Net Debt. Treasury guidance is clear that accounting treatment should not drive decisions to use private finance. Some departmental guidance to local projects, however, has historically emphasised the need to shape projects to make them off-balance sheet. Funding and budgeting mechanisms make on-balance sheet projects less attractive. Numerous project and programme managers have told us that keeping debt off-balance sheet was a driver behind their projects' use of private finance.

Evaluation of the use of private finance is not well developed

13 Achieving value for money from private finance projects means getting the best deal in absolute terms. It also requires demonstrating, as a relative concept, that better value for money is being achieved than through other forms of procurement. That comparison depends on identifying a counter-factual or comparator project. This is difficult to do and may require comparisons based on a hypothetical comparator if, as is often the case, similar recent conventional projects do not exist.

14 We have yet to come across truly robust and systematic evaluation of the use of private finance built into PPPs at either a project or programme level. The systems are not in place to collect comparable data from similar projects using different procurement routes. Unless such systems are established, together with robust evaluation of the overall whole-life costs of alternative forms of procurement, Government cannot satisfy itself that private finance represents the best VFM option.

Competition is vital to achieve VFM, but is not always achieved

15 Competitive pressure is vital to establish economic pricing of construction, services and funding. Competitive pressure is not, however, always as strong as it should be. Issues affecting competition in tendering are: some bidders are deterred by the high bid costs associated with many private finance projects; some projects have specifications that do not attract many bidders because they are inherently difficult to achieve or offer little chance of profit; in addition, in the early days of using PFI the large number of public authorities advertising new projects meant that bidders were selective resulting in weak competition for some projects. Although lessons have been learnt, our 2007 report on tendering found limited overall improvement.[2]

16 Achieving the benefits of competition also depends on competitive financing markets. The recent credit crisis has made finding competitive and economic funding harder. It has become difficult to achieve competition in financing because each bank is only prepared to lend a small amount, and not always for the full term of the project. Large deals may need all the lenders available to participate in the project. This is likely to have been a cause of the higher cost of finance since autumn 2008.

Delivery of real risk transfer depends on a good contract

17 Risks should be allocated to the party best able to manage them. Not all risks can or should be transferred because the cost of inappropriate risk transfer would be too high. Although ultimate responsibility for delivering the service remains with the public sector, private finance has delivered real risk transfer. Few private finance projects have failed, but when they have contractors and lenders have normally lost most, unless the public sector provided additional guarantees. The allocation of risk calls for an active public sector role throughout, particularly in the case of risks retained by the public sector.

Private finance projects require very careful management

18 Public authorities must devote sufficient attention and resources to the contract management process. Our work has long emphasised the need for better management of the contract. A culture of focus on making the deal rather than thinking about contract management is still, however, prevalent in many quarters of the public sector. Some public authorities have only relatively recently realised the resources and experience needed to manage contracts effectively.

2 *Improving the PFI tendering process*, National Audit Office (HC 149, 2006-07).

19 Many private finance projects are delivered under programmes of similar projects. There is a general shortage of the commercial and project management skills needed to manage these programmes and other complex projects across Government. This shortage has often compromised the VFM of projects. It has also led to an over-reliance on external advisors and interim staff which causes problems from a loss of knowledge when they move on. Some Departments have tackled this by developing centralised programme management to help coordinate projects and provide support to public authorities. Recent NAO reports have, however, highlighted the difficulties in building up momentum in a programme, for example for renewing the secondary school estate.[3] This may result in insufficient numbers of contracts being let quickly enough to enable the expected benefits from the programme to be delivered on time.[4]

Recent developments mean care is needed in the use of private finance

20 *Accounting and budgeting:* The introduction of International Financial Reporting Standards to the public sector offers the opportunity of developing a more consistent approach to recording assets and liabilities. We expect most PFI projects to come on to the balance sheet of the financial accounts. But the Treasury has decided that Departments' budgets will follow different guidance. This may mean that the debt and assets of most PFI projects will not be included against Departments' budgets or in statistics of Government debt. This is at odds with the Government's stated intention of aligning the accounting and budgeting systems.

21 *Financing:* Since September 2008, the credit crunch has caused the cost of new private finance to increase. This has raised questions about its suitability in the current economic climate, particularly for those embarking on new projects where there is time to consider alternatives. The National Audit Office intends to look at how well public authorities manage this process over the next year or so.

3 *Building Schools for the Future: renewing the secondary school estate*, National Audit Office (HC 135, 2008-09).
4 *Building Schools for the Future op.cit.; Department for Environment, Food and Rural Affairs: managing the waste PFI programme National Audit Office* (HC 66, 2008-09).

The scope of this paper

22 This paper is divided into five parts:

Part One: background sets out some background on private finance, including its history.

Part Two: private finance in practice sets out our summary findings on the use of private finance, showing that the potential costs and benefits of using private finance are complex, and that there is no certainty that the expected benefits will be achieved.

Part Three: the institutional incentive to use private finance sets out the way that the accounting treatment has influenced the use of private finance.

Part Four: assessing the VFM of private finance sets out the shortcomings of the ways in which public bodies have put together their business case for using private finance.

Part Five: managing private finance sets out the key risks that public bodies need to manage when they use private finance.

Part One

Introduction

This part explains:

- what private finance is and how it is used.
- the role of the NAO in the audit of private finance.
- the history of private finance and how the NAO has responded.

Private finance projects

1.1 Private finance projects are contractual arrangements between the public and private sectors, which use at least some funding raised through the private sector, to deliver public authorities' objectives. The costs, including the finance costs, are eventually paid by the public authority through annual payments, or by the users through charges. In this context, public authorities are public sector bodies that commission the project. In doing this, public authorities manage the tendering, governance and contractual relationships for the public sector.

1.2 Most projects using private finance use a specific model called the private finance initiative (PFI). PFI projects are for the serviced provision of infrastructure, such as the construction of a building and its cleaning and maintenance over the life of the contract. This paper concentrates on PFI except where we have a specific point to make about another private finance model. Other types of private finance projects are included in **Figure 1** overleaf.

1.3 The funding for PFI is project finance: all the financing for the project is tied to the project, normally in a special company set up for the purpose. There is meant to be no cross subsidy to and from other projects; the intention is that if the project fails, the finance cannot be paid back. Consequently, the cost of the private finance reflects the project's risks of failing or not having enough money to pay back its borrowings.

1.4 PFI projects typically use around 90 per cent debt finance and ten per cent equity funding. The debt finance is in the form of bank loans or, prior to the credit crunch, bond finance. The equity finance is provided by contractors or financial institutions, and comprises of a mixture of shares and loans which take second precedence to the payment of the debt finance.

1.5 As of September 2009, there are over 500 operational PFI projects in England, with a capital value in excess of £28 billion.[5] There are also hundreds of other types of PPPs, ranging from small joint ventures to the London Underground PPPs with their capital value of £18 billion.

1.6 The National Audit Office (NAO) considers the accounting treatment of over 100 PFI projects and many other PPPs in our audits of the financial accounts of central Government. The NAO has also produced some 72 reports on the Value for Money (VFM) of using private finance over the last twelve years (Appendix 1).

1.7 Discussions of private finance are necessarily complex and often require a lot of jargon. Where we cannot avoid jargon, we have defined it in the glossary at the end of this report.

Figure 1

Examples of the different models of private finance

Type of model	Some examples of when used	Key technical characteristics	Selected examples of related NAO reports
Private Finance Initiative (PFI)	Roads, bridges, hospitals, schools, prisons, police stations, government departments, social housing, waste projects, IT projects.	A private sector consortium is appointed after competition to deliver a project; The party contracting with the public sector is usually a special purpose vehicle; There is an output specification with clear requirements; There is a long term service contract (e.g. 25-30 years); Payment is by way of unitary charge for services once they are available; Standardised contracts have been developed over time.	Allocation and management of risk in MoD PFI projects (HC 343, 2007-08); Making Changes in Operational PFI Projects (HC 205, 2007-08); Benchmarking and market testing the ongoing services component of PFI projects (HC 453, 2006-07).
Joint ventures	Low carbon technologies; Defence equipment; ISIS Waterside Regeneration.	The Government, in conjunction with one or more private sector parties, makes a contribution to a commercial venture, shares aspects of control and aims to share risks and returns on an agreed basis.	Dr Foster Intelligence: A joint venture between the Information Centre and Dr Foster LLP (HC 151, 2006-07); The Radiocommunications Agency's Joint Venture with CMG (HC 21, 2000-01).
Strategic Infrastructure Partnerships	Local Education Partnerships in Schools (LEPs); Local Improvement Finance Trusts in primary care (LIFT).	Special (often exclusive) arrangement to address infrastructure-related issues over a period of time; A private partner is appointed to deliver a flow of projects over time; It could be a joint venture or be established through a contract; The private sector partner provides most of the works and services required by the contracting authority; It is suitable for procuring a stream of projects including a "bundle" of small projects which otherwise would be too small for PFI.	The Building Schools for the Future Programme: renewing the secondary school estate (HC 135, 2008-09); Innovation in the NHS: LIFT (HC 28, 2005-06).

5 The capital value of all operational PFI projects in the United Kingdom (excluding London Underground's PPPs) is £34 billion, while non-operational signed PFI projects in the United Kingdom are worth some £12 billion.

Figure 1 *continued...*
Examples of the different models of private finance

Type of model	Some examples of when used	Key technical characteristics	Selected examples of related NAO reports
Hybrid	The MoD London Estate (MoDEL); ProCure21.	Any combination of the above models in which the procurement authority adopts a very specific approach to solve unique procurement challenges; Usually associated with novel and complex projects.	Improving Public Services through better construction (HC 364-I, 2004-05).
Local Asset Backed Vehicles	Regional Development Agencies' regeneration projects; British Waterways Board's projects.	Public private joint venture; Usually the public sector puts in land and property and the private sector puts in financial and other resources; The development of the asset is expected to yield returns to cover costs and fund development; The partners share the increase/decrease in value of the land and property, usually on a 50/50 basis; The model is suitable where there is a pipeline of projects; Often the public sector shares more of the risks and rewards than in PFI; The public sector has greater influence and leverage over projects than is usual in public private housing developments; Land banking by the private sector can be prevented by provisions to transfer assets back to the public sector if pre-agreed timescales are not met.	Regeneration of the Millennium Dome and Associated Land (HC 178, 2004-05).

Figure 1 *continued...*
Examples of the different models of private finance

Type of model	Some examples of when used	Key technical characteristics	Selected examples of related NAO reports
Concession	Toll Roads	A private sector consortium is granted a private entity exclusive rights to build, operate and maintain a ring-fenced asset over a long period of time (it could be much longer than for PFIs); The private sector company recovers its investment through future charges for services once the project is in operation; High risks associated to future demands; Public sector has no or little involvement in contract management.	Skye Bridge (HC 5, 1997-98); The Re-negotiation of the PFI-type Deal for the Royal Armouries Museum in Leeds (HC 103, 2000-01)
Integrator	Ministry of Defence's projects (e.g. Military Flying Training System); Building Schools for the Future programme.	Variation of other PPPs, but the private equity is held only by a company which specialises in putting together (integrating) different suppliers rather than giving work to supply companies who are also its shareholders; The public sector authority procures a project delivery organisation (the integrator) to manage the delivery of a project through pre-procurement preparation, procurement, construction and into operation; There is scope for project risks to be better managed because the integrator only profits from the project development work, not from sub-contracts; This model also has an impact on interface risks because it reduces the integration of design, build and operations, as these are carried out by businesses with no interest in the project company.	The Building Schools for the Future Programme: renewing the secondary school estate (HC 135, 2008-09).

Source: National Audit Office and Infrastructure procurement: delivering long-term value, HMT (2008)

The history of the National Audit Office and private finance

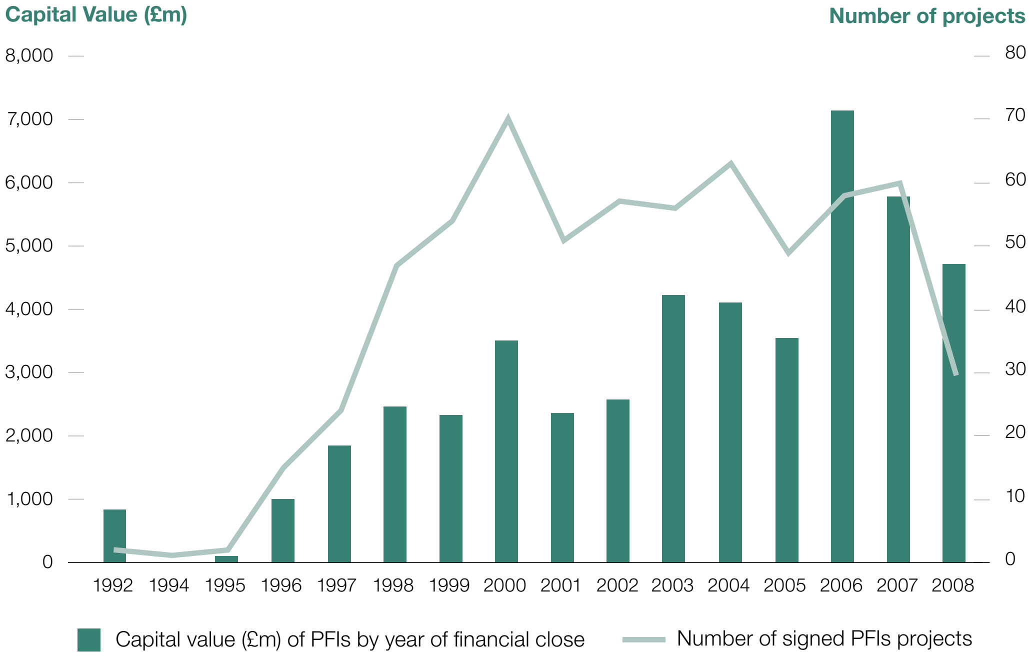
1990 to 1999: the first use of private finance

1.8 The Conservative Government started to promote the use of private finance from the beginning of the 1990s. It launched the PFI in 1992 with the aim of promoting public-private partnerships at a national and local level. Yet it took time for PFI to gain momentum, and less than a billion of capital investment had been agreed with private companies by the end of 1995 (**Figure 2**).

1.9 After the 1997 General Election, the new Labour Government endorsed PFI. Departments started putting forward a number of large projects to use private finance. For example, in 1998 the Department of Social Security transferred the ownership and management of almost all its estate to a private sector consortium, as part of a single PPP deal known as PRIME, which is worth over £1 billion.

Figure 2

The growth of PFI projects (excludes the London Underground PPPs)



Source: HMT signed PFI projects database (http://www.hm-treasury.gov.uk/ppp_pfi_stats.htm)

1.10 The National Audit Office followed the development of private finance closely throughout this period and developed a strategy of investigating as many projects as possible as soon as their contracts were signed. Drawing on our first eight reports, in 1999 we published *Examining the value for money of deals under the PFI*.[6] It sets our approach towards the audit of PFIs and PPPs, and provides a framework for how public bodies can maximise their VFM by focusing on our pillars: specifying the project; planning the procurement; running the competition; and completing the contract. Subsequently the Treasury drew upon the report heavily in developing value for money guidance for PFI projects.

2000 to 2005: the increased use of Private Finance

1.11 The period 2000 to 2005 saw a rapid expansion of PFI. Private finance became the main delivery method for new buildings in some sectors within both local and central Government. The private finance sector began to mature, with greater guidance and support from Departments. Partnerships UK was established in 2000, to help develop the Government's PPP policy, support PPP projects and advise on the approval of PFI funding. It helped the Treasury to develop standardised contracts for PFI, now in their fourth generation. Departments set up Private Finance Units, to manage their programmes of PPPs, engage with the private market and establish guidelines for each sector. Local Partnerships (formerly 4Ps) was established to provide support to local authority projects.

1.12 The NAO continued to investigate major deals such as the PPP deals signed by London Underground with Metronet and Tube Lines. We also started to look at thematic issues in the delivery of PFI projects, such as managing relationships between contract managers and contractors,[7] construction performance,[8] and refinancing.[9]

2006 to present: focusing on operational projects

1.13 While the capital value of PFI projects has remained very high, there has been a declining trend in the annual value of new deals from 2007. There is little planned new use of private finance in some sectors, such as the hospitals building programme. On the other hand other sectors are starting to emerge, such the increasing number of schools, waste treatment centres and social housing projects.[10] By 2009, some 567 PFI projects are in operation with the asset fully constructed.

6 *Examining the value for money of deals under the PFI*, National Audit Office (HC 739, 1998-99).

7 *Managing the relationship to secure a successful partnership in PFI projects*, National Audit Office (HC 375, 2001-02).

8 *PFI Construction performance*, National Audit Office (HC 371, 2002-03).

9 *The refinancing of the Fazakerley PFI prison contract*, National Audit Office (HC 584, 1999-00); *The refinancing of the Norfolk and Norwich PFI Hospital: how the deal can be viewed in the light of the refinancing*, National Audit Office (HC 78, 2005-06); *Update on PFI debt refinancing and the PFI equity market*, National Audit Office (HC 1040, 2005-06).

10 *Building Schools for the Future: renewing the secondary school estate*, National Audit Office (HC 135, 2008-09); *Department for Environment, Food and Rural Affairs: managing the waste PFI programme* National Audit Office (HC 66, 2008-09).

1.14 During the last three years we have shifted our focus to the operational stage of PFI projects. In 2006, we updated our four pillars approach with a new framework that spanned all the phases of the project and gave more attention to the operational aspects of projects.[11] We published a series of reports looking at specific operational issues, including tendering,[12] benchmarking and market testing,[13] and making changes.[14] We have also started to focus more on the way each department is managing its portfolio of private finance projects, reporting on the role of Departments in, for example, the allocation and management of risks in defence projects, the management of the waste PFI programme and the Building Schools for the Future programme.

1.15 We discuss developments in the use of private finance since the credit crunch in part two.

11 *A framework for evaluating the implementation of PFI projects*, National Audit Office (2006).
12 *Improving the PFI tendering process*, National Audit Office (HC 149, 2006-07).
13 *Benchmarking and market testing the ongoing services component of PFI projects*, National Audit Office (HC 453, 2006-07).
14 *Making changes in operational PFI projects*, National Audit Office (HC 205, 2007-08).

Part Two

Private finance in practice

This part sets out:

- a summary of the NAO's experience of auditing private finance projects;
- the costs and risks of using private finance;
- the ways in which using private finance can drive VFM and its limitations; and
- the particular difficulty of achieving VFM in the current economic conditions.

The NAO experience of auditing private finance

2.1 The National Audit Office has produced 72 reports on the uses of private finance in public service delivery. Fifty four of these reports relate to single projects, seven to programmes and 11 to strategic themes in the implementation of private finance (Appendix 1). Overall, we have looked at more than 100 of the 641 projects currently under construction or operation.

2.2 We find that using private finance brings benefits, but these cannot be counted on. Our reports assess VFM at a particular point in time. That may be after contract letting or at some stage during the contract's operation. Based on these snapshots we have found some projects which have the potential to be VFM, some where the VFM is uncertain, and some where the project has failed to achieve VFM, normally because it was tendered or managed poorly.

2.3 We select our studies based on materiality, risk, and potential impact. The studies are not therefore designed to be a representative sample. Furthermore, many of our reports look at specific aspects of projects, rather than attempting to comment on the overall VFM of a project, and particularly stress the lessons that can be learnt. Taking that into account it is not possible to say how many of the projects we examine have the potential for VFM, and how many do not. It is easier to count the failures: a fifth of the projects we have examined have clearly failed to achieve VFM, normally due to poor tendering or contract management.

2.4 In general we have found that:

a **Many projects do not have a robust justification for the use of private finance.** Public authorities often pay greater attention to the business case planning of PPPs than conventionally procured projects. Business cases, however, often do not manage to set out the strategic VFM case for using private finance convincingly. There is also considerable use of quantitative analysis to analyse estimated costs and benefits, which is helpful in assessing key decisions. But such analysis is prone to mistakes, manipulation and misuse. This point is developed in part four.

b **A lack of systematic evaluation of operational projects results in missed lessons and means that the costs and benefits commonly assumed in business cases remain largely unproved.** Furthermore, the methods of achieving potential benefits are often not built into realisable action plans. This point is also developed in part four.

c **Institutional incentives have pushed public bodies towards using private finance.** Public authorities often have no alternative source of funding and feel pressured to use private finance because its treatment in financial accounts and budgets make it seem more affordable from the public authority's perspective. This point is developed in part three.

d **Private finance normally delivers what the public authority asks for.** The delivery record of PPPs against contractual specification is good. Most projects deliver close to time and price, the construction normally meets the specification and the services receive few penalties. This point is developed in part five.

e **Private finance can deliver real risk transfer with a good contract.** Overall there have been few private finance project failures. A small number of projects, however, have failed so seriously that the public authority did not get what it wanted. This has normally led to the private sector losing some of its money and the public sector being insulated from some of the costs. Poor contracting, on the other hand, has sometimes led to public sector exposure to risks they thought were transferred. This point is developed below (paragraphs 2.12 to 2.17).

f **Competitive pressure has not always been as strong as it needs to be to achieve VFM.** In the early days of PFI, an oversupply of projects relative to the number of bidders limited competitive pressure. High bid costs also put off potential bidders. A significant number of changes are made at a late stage in the process, when only one bidder remains in the running. Since the credit crisis, there have been particular difficulties in achieving competitive financing. This point is developed in part five.

g **Public bodies must carefully manage PPPs through the project design, tendering and operational process.** It is important to protect the public interest because PPPs are commercial deals and contractors seek ways to enhance that profit, often successfully. This point is explored in more detail in part five.

h **Many private finance projects are delivered as part of nationwide programmes.** Examples are the LIFT projects for primary care, Building Schools for the Future (BSF) and waste treatment facilities. Programme management is not unique to private finance projects. It is, however, a significant aspect of the private finance landscape. Our reports have highlighted the challenges of building up momentum in a programme.

The value for money of using private finance

2.5 For private finance projects to achieve VFM depends on whether they achieve sufficient efficiency savings, quality improvements, innovation or better management of risk to justify the additional costs, risks and issues it also brings.[15] The following section of the paper covers the costs, benefits and issues which collectively need to be considered in the assessment of the VFM of using private finance.

Strategic issues

2.6 Private finance occasionally allows public bodies to do things they would find difficult to achieve using other procurement routes (**Case study 1**). Such strategic issues can outweigh considerations of pure cost efficiency, but are unconvincing if they appear as post hoc rationalisations. They need to be clearly stated at the outset and built into the procurement process. When assessing private finance projects, we expect the public authority to have considered carefully whether there are strategic advantages or disadvantages from using private finance, such as:

a the need for a development to be operational by a particular date;

b the ability to access scarce skills;

c the desire of supporting particular parts of industry;

d the need for flexibility; or

e the inability to commit to long term current spending.

Case study 1
The First Four Design, Build, Finance and Operate Roads Contracts

The first tranche of privately financed road contracts were let by the Highways Agency in 1996. Under each of the contracts, the private sector agreed to build a road meeting the Highways Agency's technical requirements and to operate and maintain it and some existing roads for a period of 30 years. The Highways Agency expected only three of the first four PFI road projects to provide better financial terms than traditionally procured and conventionally financed alternatives. It considered that the contracts were VFM because using PFI fitted with its strategy of encouraging the development of a private sector road operating industry.[1]

NOTE

1 *The First Four Design, Build and Operate Roads Contracts*, National Audit Office (HC 476, 1997-98).

15 *A framework for evaluating the implementation of PFI projects*, National Audit Office (2006).

The costs of using private finance

2.7 Using private finance brings additional costs over and above conventional funding:

a **The cost of the debt**, which before the current credit crisis was about 1 percentage point (60-150 basis points)[16] above the nominal cost of Government borrowing. Recent increases in the cost are discussed in paragraphs 2.38-2.46 below.

b **The cost of the risk capital (equity and subordinate debt)**, historically a return of about 10-15 per cent at the start of a project.

c **Upfront contingency**. In theory, the risks of a project will be the same if it is funded conventionally or with private finance. If conventionally funded, it will probably draw down funding to pay any costs associated with risks as they arise. For PPPs, investors and lenders may require the projects to raise contingency funds to cover risks. The PPP will have to pay the finance cost of this contingency funding. The cost of funding contingency depends on the way the finance is structured and drawn down into the project. Bond financed deals, for instance, will tend to draw down all the contingency funding at the start, whereas some bank finance deals will arrange funding to be drawn down as needed.

d **Transaction costs**, including the cost of arranging finance (e.g. swap fees).

e **Complex tendering**, using competitive dialogue to allow bidders to propose innovative solutions. Private finance tendering is a long and costly process, but allows more time for due diligence and understanding the true costs and risks of the project.

f **Contract administration costs**, including the costs of administering a special purpose vehicle to hold the finance and manage the sub-contracts.

2.8 Part of the difference between the cost of private finance and Government borrowing is because the cost of private finance reflects the risks of the project. The cost of Government borrowing does not. To make a proper comparison, public authorities risk adjust their estimate of the cost of a project funded through taxation or Government borrowing. This reflects the way the public purse would bear the cost of any risk that materialised in a publicly funded project. Such risk adjustments have proved controversial for reasons set out in part four, but have a sound theoretical basis. Their weakness has been in their subjective nature.

16 That is, 0.6 to 1.5 percentage points.

2.9 Some economic models show that private finance is cost neutral after taking account of risk. Using a subtle variation of this theme, the Treasury has argued *"that there is a cost to the Government's use of private finance, involving the extra cost of the private sector securing funds in the market, but a great part of the difference between the cost of public and private finance is caused by [the] different approach to evaluating risk"*.[17]

2.10 The NAO view is that achieving a price of private finance that is similar to the price of Government borrowing *after risk adjustment* should be an ambition to work towards in competitive tendering, rather than an axiomatic assumption. Achieving such competitive finance requires competitive markets. Such competition has not always been achieved (see part five), and appears particularly at risk at present (paragraphs 2.38-2.46 below). Assuming that the additional cost of private finance is accounted for solely by the risks also does not consider the need for contingency funding or the risk of contractors seeking opportunities to pass risk back to the public sector.

The potential benefits of using private finance

2.11 Using private finance brings a number of potential mechanisms and incentives that can improve the efficiency, quality, innovation, or management of risk sufficiently to drive VFM. These are not guaranteed, and may occasionally work against one other. For example, increasing innovation may put at risk the project delivery usually achieved with private finance. Different projects emphasis different drivers and some do not achieve enough to be VFM. We discuss each below.

Risk allocation and management

2.12 A key principle behind PFI is that it encourages the allocation of risks to those most able to manage them. By doing so, PFI hopes to achieve the better management of risk so as to achieve overall cost efficiencies and greater certainty of success. It is not sufficient that risks are transferred. For PFI to work, risks have to be appropriately allocated and better managed once allocated.

2.13 The optimal allocation of risk is a key determinant of the VFM of a PFI project. The standardisation of contracts has embedded a particular allocation of risk that is normally considered good practice. Standardised contracts generally provide a sound basis for the allocation of generic risk in a PFI project, although part three of this paper sets out how this has been influenced by accounting treatment. The allocation of risk is also considered as part of the due diligence work done by lenders, who may resist some elements of the risk transfer.

17 *PFI: meeting the investment challenge*, HMT (2003).

2.14 Risk allocation requires enforcement through clear reporting structures and penalties if the risk is not managed. PFI attempts to monitor and manage service risks (risks to the satisfactory delivery of the service) through payment penalties for under performance. It enforces construction risk (the risk of not delivering to time and budget) by entitling the contractors to payments only after the asset is provided. Other risks are managed through contractual entitlement and ownership, such as the control of residual risk. Sometimes risk transfer has been curtailed, such as the public guarantee of Metronet's debt (**Case study 2**).

Case study 2
Metronet

In 2007, Metronet BCV and Metronet SSL – two private infrastructure companies responsible under PPP contracts for maintaining and upgrading sections of the London Underground – went into administration. During the biding stage, the Department for Transport (DfT) gave assurance to Metronet's lenders that 95 per cent of the debt obligations were to be guaranteed by Transport for London (TfL). As a consequence of this guarantee, Metronet's lenders did not protect their investment as anticipated because only five per cent of their investment was at risk. Eventually, when Metronet failed, the DfT had to make a £1.7 billion payment to help TfL meet the guarantee of Metronet's borrowing. We estimated a direct loss to the taxpayer of between £170 million and £410 million[1].

NOTE

1 *The failure of Metronet*, National Audit Office (HC 512, 2008-09).

2.15 Ultimate responsibility for delivery always remains with the public sector. Projects that do not meet the objectives of the public authority are rarely VFM. If risks do materialise, the public authority may have to work with the contractors or lenders to find a solution that delivers the public authority's objectives (**Case study 3**). We would not regard the enforcement of contractual terms without achievement of the intended benefits of the contract as VFM (**Case study 4**).

Case study 3
National Savings and Investments' deal with Siemens Business Services

National Savings and Investments (NS&I) transferred its operations to Siemens Business Services (SBS) in 1999 under a PPP contract. SBS invested heavily in modernising NS&I's operations, which increased the value of the whole business. After signing the contract SBS discovered that NS&I in house-programme was not good enough to deliver its intended IT system; the contract was far more challenging than originally thought. Soon, key risks accepted by SBS under the contract crystallized, but the contractor and NS&I remained committed to the deal, cooperating to achieve the project's objectives. NS&I realigned contract terms to ensure the contract was clearer, less ambiguous, fairer and was a driver for a low cost operation. We reported in August 2005 that the project was delivering good results. SBS modernised the business to improve customer service by streamlining business processes. SBS also increased productivity and reduced costs. NS&I did not have sufficient resources to achieve the same results within the public sector.[1]

NOTE

1 *National Savings and Investments deal with Siemens Business Services: four years on*, National Audit Office (HC 626, 2002-03).

2.16 Joint ventures have a very different approach to risk than PFI. They pool expertise and resources in a single organisation, which it is hoped, will be better equipped to manage risks. Such PPPs work by the partners working together to manage risks, rather than assigning risks to one side or the other. They require sufficient resources to be pooled to manage the risk.

2.17 The opposite approach to PFI was also taken by the British Airports Authority in its construction of Terminal 5. It decided it was better able to insure against and hold risk than its contractors and thus organised its supply chain to drive out all contingency funding and create open book accounting throughout.[18]

Case study 4
The National Physical Laboratory

In 1998 the then Department for Trade and Industry (DTI) signed a PFI contract for the building and management of new facilities for the National Physical Laboratory. After significant delays during construction phase it was agreed to terminate the contract. This was the first instance of termination of a major PFI project for serious deficiencies in contractor performance. Our report found that the fundamental reason for the problems was that the original private sector design was deficient, and that the Department did not resolve its concerns about the design of complex units before letting the contract.[1]

The contract protected the taxpayer effectively from the wasted costs of construction and the termination was value for money. But the project did not achieve the DTI's aims. The subsequent PAC hearing found that the project was 'undermined from the start by a flawed procurement process and naivity by both the Department and the favoured private sector contractor over the technical challenges which had to be surmounted.'[2]

NOTE
1 *The termination of the PFI Contract for the National Physical Laboratory*, National Audit Office (HC 1044, 2005-06).
2 *The termination of the PFI Contract for the National Physical Laboratory*, Committee of Public Accounts (PAC) (HC 359, 2006-07).

Delivery to time and price

2.18 PFI construction contracts are fixed price contracts with heavy financial costs for the contractors if they do not deliver on time. But using PFI is not a panacea for solving construction problems. In October, we published the results of our second survey of PFI construction projects for the period 2003-2008.[19] We found that 69 per cent of construction projects in our sample were delivered within a month of the due date. Eighteen per cent were delivered over six months late, the latest being 36 months late. Of the projects experiencing delays, under half experienced price increases; in the cases where delay has only been as a result of those risks allocated to the private sector, the public sector's price of the projects has not increased as a result of the delay.

18 *Improving public services through better construction*, National Audit Office (HC 364, 2004-05).
19 *Performance of PFI construction*, National Audit Office (October 2009).

2.19 The majority of price increases were due to changes requested by the public clients during construction. But ten per cent had price increases without any changes. The public sector often has to pay for costs arising from any risks it retains such as asbestos, planning permission, the purchase of land, and the costs arising from any delay that these cause. Similarly, poor contracting can lead to claims from the private sector.

Maintenance of the asset

2.20 PFI aims to encourage the construction of assets with more efficient and transparent whole-life costs. The project company is responsible for both the construction and operation of the asset, and the cost of both is included in the single price provided to the public sector client. This can reduce the focus on upfront costs, and may involve spending more on construction if it means spending less on maintenance. Many conventionally funded projects fail to consider whole-life costs. We recently criticised the Learning and Skills Council for encouraging Colleges to focus on the affordability of upfront capital costs rather than whole-life costs.[20]

2.21 It was a common feature of publicly managed buildings that maintenance budgets were often cut in lean times, even if that meant greater costs later. This is exacerbated by a public expenditure system where capital funding is injected as additional funding, whereas maintenance is funded from revenue where it will lose out to the delivery of core services. This can lead to a significant backlog of repairs. The NHS spent £300 million in 2007-08 on its backlog of repairs.[21] In 1992, when Further Education Colleges were incorporated, they found £800 million of backlog repairs were needed.[22]

2.22 PFI provides a contractual guarantee that the public client will fund the ongoing maintenance of the building. This has generally meant higher annual maintenance costs than previously and less budgetary flexibility. But it also avoids the build up of a backlog of maintenance, which might cause damage requiring more expensive work to be undertaken. It can also make for more pleasant and better-kept environments. Whether it will lead to an overall reduction in whole-life costs would be very difficult to prove.

2.23 Private finance is not, however, the only way to ring-fence maintenance funding or consider whole-life costs. The London Borough of Lewisham, for example, has established a sinking fund to ensure its non-PFI schools are maintained to the same standard as its PFI schools.[23]

20 *Renewing the physical infrastructure of English further education colleges*, National Audit Office (HC 924, 2007-08).
21 House of Commons Commission, Written Answers, *NHS: Repairs and Maintenance* (2 March 2009).
22 *Renewing the physical infrastructure of English further education colleges*, National Audit Office (HC 924, 2007-08).
23 *Building Schools for the Future: renewing the secondary school estate*, National Audit Office (HC 135, 2008-09).

Innovation and design

2.24 PFI is meant to encourage innovation and good design through the use of output specifications. Public authorities establish a detailed output specification at the outset of the tendering process and bidders compete to provide the best costed proposal for how they would deliver it. Occasionally this brings VFM through better technical solutions than the public sector would develop on its own:

a The Contributions Agency issued an output specification in its tendering process for the Newcastle Estate Development Project that encouraged innovation. The winning bidder provided an innovative design which reduced the gross floor areas of the new construction by 25 per cent.[24]

b NHS Local Improvement Finance Trusts act entrepreneurially to build local partnerships between public bodies, such as NHS Trusts and Local Authorities, and think creatively about the needs of their local area to help bring about the co-location of services.[25]

c Siemens Business Services worked with National Saving and Investment (NS&I) to modernise the business and increase productivity so that it could compare well with the leading edge organisations in its service area. NS&I could not have achieved as much without them.[26]

2.25 Sometimes we find that the process of tendering for PFI can hinder innovation and the design process:

a There is little time devoted to design issues and it can be squeezed by the urge to finalise the tendering process. It is also but one element of the tender process, so the choice of bidder sometimes means that the bidder with the best design or technical solution is not chosen. Intellectual property rights belong to the bidders, so the ideas of rejected bidders cannot be used.

b The tendering process can create a distance between architects and those designing the services on the one hand and the end users on the other. Bids are developed in competition so end users have to engage with multiple bidders, and rarely have sufficient time to give to all, especially when the end users are also trying to deliver front-line services.[27]

24 *The Contributions Agency: the Newcastle Estate development project*, National Audit Office (HC 16, 1999-00).
25 *Innovation in the NHS: local improvement finance trusts*, National Audit Office (HC 28, 2005-06).
26 *PPP in practice: National Savings and Investments' deal with Siemens Business Services, four years on*, National Audit Office (HC 626, 2002-03).
27 *Building Schools for the Future: renewing the secondary school estate*, National Audit Office (HC 135, 2008-09); *Darent Valley hospital: the PFI contract in operation*, National Audit Office (HC 209, 2004-05).

c The bidding process often ends with a discussion on affordability and a process of value engineering. This is where bidders, sometimes reduced to a single bidder by this stage, have worked up a technical solution in negotiation with the Public authority and end users, costed it and found it to be too expensive. They then undertake a process of descoping the technical solution until it is affordable. This process often leads to abandoning many of the more innovative elements.

d PFI's emphasis on the allocation of risk can lead to the provision of tried and tested solutions. Public authorities that emphasise their desire for bids that demonstrate innovation and good design are more likely to achieve it.

2.26 Some public authorities use private finance without the intention of achieving innovation in design. The Foreign and Commonwealth Office provided a design for its Berlin Embassy's PFI building, so bidders could not provide design innovations.[28] Local Education Partnerships are designed to act strategically and entrepreneurially, but Local Authorities generally opt for a slimmed down model without the staff that could provide innovation, and some limit the partnerships to a more traditional client-contractor relationship.[29]

Performance management mechanisms and payment incentives

2.27 Private finance contracts are built around a performance regime that outlines service levels and applies penalties to providers if they fail to deliver them. This provides incentives to perform effectively and can, arguably, help build a better culture of service delivery.

2.28 Performance management regimes that tie payments to performance are not unique to private finance, and are generally a feature of major service contracts,[30] but private finance introduces performance management where it includes services that have traditionally been delivered in-house. The Building Schools for the Future programme involves the establishment of the first formal performance regimes for school IT administrators, through their transfer to the private sector. Such steps can be controversial, particularly as they often involve the transfer of staff from the public to private sectors, with significant changes to their role and job.

2.29 Such performance regimes are potentially a powerful means of controlling performance. Seventy four per cent of PFI contract managers surveyed by Partnerships UK in 2008 agreed that such mechanisms support the effective management of their project. 55 per cent said that applying financial penalties has led to performance improvements, although 46 per cent said mechanisms are difficult to use.[31] We discuss some of the problems with performance regimes in part five.

28 *The new British Embassy in Berlin*, National Audit Office (HC 585, 1999-00).
29 *Building Schools for the Future: renewing the secondary school estate*, National Audit Office (HC 135, 2008-09).
30 *Central Government's management of service contracts*, National Audit Office (HC 65, 2008-09).
31 *Investigating the performance of operational PFI contracts: a research study conducted for Partnerships UK on behalf of HM Treasury*, Ipsos MORI (2008). The National Audit Office was represented on the steering panel to verify the quality of the work, although the conclusions belong to Ipsos MORI. In total, 151 PFI contract managers were surveyed during October-November 2008.

Opportunity to improve procurement

2.30 Private finance was a new way of procuring services. The Treasury drew up new standard contractual forms and procurement procedures to draw on lessons from the early PFI contracts. Such steps were not intrinsic to the use of private finance. But standardisation enabled private finance contracts to achieve greater consistency in best practice.

2.31 The Treasury published its first guide to standardised commercial contracts In 1999,[32] revising it in 2002, 2004 and 2007. It aims to reduce the scope, time and costs of negotiations while tendering; to promote a better understanding of the risks associated to PFI projects; and to promote consistency in Government procurement. The NAO worked closely with the Treasury to ensure that the lessons from our work were reflected in the standardised contracts.

2.32 The Treasury and Partnerships UK have rigorously enforced the use of the standardised contracts, monitoring any deviations and retaining a veto on any major changes from standard form. This has ensured that previous contractual errors have been reduced. We now very rarely see the same contractual problems that we saw in the early contracts.

Additional challenges and risks presented by using private finance

Using private finance creates new and complex commercial risks.

2.33 Using private finance brings risks to the public sector:

a **Increased commercial risks:** It is reasonable that contractors seek commercial returns from their work. But the long-term nature and high monetary value of PPPs creates opportunities for contractors to increase their profits over the course of the contract, which could adversely affect the VFM for the public sector. Public sector clients face particular pressure from contractors to alter the commercial position in the private sector's favour when finalising contracts, making changes, maintaining risk transfer and ensuring services are performed to the agreed standards. Managing such commercial risks is discussed in part five.

b **Increased complexity:** private finance is inherently complicated, even before consideration of the project's specific technical complexity, increasing the risk of errors in scope and mistakes in negotiation and operation. There has been a scarcity of public sector officials with suitable skills to deal with these commercial issues. This has increased the need for public bodies to place large reliance on relatively expensive advisors.

32 *Standardisation of PFI contracts*, HMT (1999).

c **Reduced flexibility:** the specification is established in the contract at the outset and can only be changed through a set negotiation process. Although such contracts can be flexible enough (and normally are) to meet changing needs, at best the initial commercial position is preserved throughout and a contractual approach is inherently less flexible than other means of delivery.

d **Termination costs:** using PFI and some forms of PPP makes the cost of termination more apparent and increases the costs of termination for the public authority. A conventionally procured project that is no longer needed may still have wasted some tax revenues or Government borrowing, but this funding is not tied to the project and its cost can be overlooked in the decision to terminate.

The voluntary termination of PFI or PPP contracts by the public sector, on the other hand, requires the public authority to find the cash to pay for all the outstanding financing in one go. This reflects the fact that the asset has not been paid for up-front as in conventional procurement. But it also normally requires them to compensate the private sector for lost profits over the remaining term of the contract, which will mean higher termination costs than under conventionally funded procurement.

Workforce issues

2.34 Where services were previously delivered in-house, private finance can increase productivity and the quality of delivery through innovation in workforce practices. This might be because the private sector brings innovation in management practice, or because bringing in a new employer provides opportunity for change. Operators of PFI prisons encouraged more constructive prisoner-staff relationships which the Prison Service later used as best practice, and changed shift patterns to allow receptions to open later and visiting times to be more flexible.[33]

2.35 Achieving innovation in workforce practices is controversial, because there is the risk that it is at the expense of the employees. Government policy states *"PFI has allowed for considerable innovation in workforce practices, but the value for money that PFI can delivery should not be achieved at the expense of staff terms and conditions"*.[34] Employment regulations aim to protect terms and conditions of staff transferred between public and private employers. Employees' unions often argue that using private finance has been detrimental to staff without improving performance.[35]

2.36 There has been little robust analysis of this topic. The NAO surveyed 43 PFI schemes on staff terms and conditions in 2004.[36] We found that terms and conditions were not necessarily worse in the private sector, with skilled and management roles paid more in the private sector, but the pay for the least skilled was marginally worse. We also found that these differences narrowed a few years into operation.

33 *The operational performance of PFI prisons*, National Audit Office (HC 700, 2002-03).
34 *PFI: meeting the investment challenge*, HMT (2003). See also *Value for money assessment guidance*, HMT (2006).
35 For an example of UNISON's views, see *Reclaiming the initiative: putting the public back into PFI*, UNISON (2009); *Overview of public private partnerships in the UK*, UNISON (2005).
36 *Protecting staff in PPP/PFI deals*, National Audit Office (2008).

Ultimate risk remains with the public sector

2.37 Another limitation of using private finance is that although much of the risk might be transferred to the private sector, the major service delivery and reputation risks will remain with the authority responsible for the service. It is not possible to transfer risks associated with the performance of statutory duties; the risk of political fallout when key public services are adversely affected by the PFI contractor; and the residual risk from a failing contract (**Case study 5**).

Case study 5
The Passport Agency's computer systems

In late 1998 the United Kingdom Passport Agency introduced a new computerised passport processing system in two of its six offices (Liverpool and Newport). However, from early 1999, the Agency encountered increasing difficulties in meeting demand for passports. At their peak, maximum processing times in the regional offices ranged between 25 and 50 days, compared to the Agency's target of ten working days. The Agency had transferred the design and delivery risk of its new IT systems to its PFI provider, but had to face the costs of ensuring continuity of delivery and suffered a major diminution of its reputation. We estimated that the cost of the additional measures taken by the Agency to deal with the failures were around £12.6 million.[1]

NOTE
1 *The passport delays of summer 1999*, National Audit Office (HC 812, 1998-99).

Since the credit crunch, the cost of private finance has increased

2.38 Since the credit crunch, the cost of private finance has risen significantly. The cost of PFI bank borrowing is normally a fixed interest rate.[37] The rate is normally fixed at the time the contract is entered into. In addition, banks charge fees for arranging the finance.

2.39 The rate at which the cost of funding is fixed comprises:

a The long term interest swap rate (swap rate). In the years running up to September 2008, the swap rate followed the Government's cost of borrowing (the Gilt rate), at a premium (known as the swap spread) typically ranging between 20 and 60 basis points above the Gilt rate.[38]

b The margin above the swap rate, consists of a price representing the risk of conducting the swap (the swap credit margin) and a price representing the risk of lending to the specific borrower (the loan margin). The following analysis combines the two. Many published margins exclude the swap credit margin.

37 For simplicity's sake, this section ignores bond financed PFI deals, because there have been no bond financed PFI deals since the credit crunch.
38 Based on 25 year swap rates.

2.40 The margins included in the cost of debt declined from the early years of PFI up to September 2008, so that many deals were closing with a loan margin of (roughly) around 85 to 125 basis points above the swap rate.[39] The reduction in margins reflected the amount of liquidity in the financing markets, resulting in competition between lenders and keen pricing on the provision of debt finance.

2.41 By 2009, difficulties in the banking sector had reduced the willingness of banks to lend and it became difficult for projects to find competitive funding. The loan margin for new projects has risen to 180 to 350 basis points (averaging around 250 basis points for a typical building project) above the swap rate and swap credit margin. Some up-front fees charges by banks for arranging finance have also increased.

2.42 At the same time, long term swap rates have fallen, from a high of 5.4 per cent in July 2007 to a low of 3.4 per cent in December 2008,[40] although they have since increased to 4.1 per cent.[41] As always, the future direction of margins and swaps is unknowable.

2.43 This fall in the swap rate has offset some of the increased margins. The NAO does not hold data on the finance costs of projects it is not auditing. It is thus difficult for us to be precise on what the overall effect has been. However, based on our talks with stakeholders, we estimate that the absolute nominal cost of private finance is (roughly) in the region of 30 to 130 basis points higher in 2009 than it was before 2008. This has decreased the affordability of projects.

2.44 We also estimate that it has increased the cost of private finance to between around 140 to 250 basis points above the government's cost of borrowing (measured as the 25 year gilt rate) for deals closed in 2009, compared to between around 100 to 160 basis points above the government's cost of borrowing before 2008. The estimates in this paragraph and the one above must be taken with a great deal of caution. They are based on reports from market participants and not on our analysis of specific contracts.

2.45 The effect of this increased cost of private finance is complex and depends on the project. We can, however, give an indication of the cost increase public authorities face by using a simplified calculation (**Figure 3**). There are a number of factors not included in these calculations that may limit the additional costs of using private finance. For example, some departments are using other sources of funding (e.g. capital contributions) to reduce the impact of these costs.

2.46 Sharing in the gains of a future refinancing could also reduce the costs. But a refinancing cannot be guaranteed. An early refinancing, if achievable, is unlikely to recover much more than half of these additional costs, even if favourable terms can be secured. The Treasury has increased the public share of refinancing gains to 70 per cent for all PFI deals that receive final bids after 1 November 2008 or amend their investment terms after that date.

39 For simplicity's sake, this analysis assumes a constant swap credit margin of ten basis points. Since the credit crunch, swap credit margins have increased (along with loan credit margins) so assuming a constant ten basis points is likely to understate the effect of the recent increases in margins.

40 The long term swap rate briefly fell below the gilt rate, i.e. swap spreads turned negative.

41 Based on 25 year swap rates. Twenty year and 30 year swap rates have followed a similar pattern.

2.47 The current cost of private finance raises issues about the VFM case for the use of private finance. It is possible that using private finance is VFM despite increases of cost, because the benefits continue to outweigh these costs. This requires one or more of the following arguments to be true:

a **"The new margins reflect the real risks and should have been higher all along".** This argument says that risk margins were too low in the period up to the credit crunch. Thus these risks now priced into private finance, should be considered in estimates of costs of conventionally funded projects. A possible counter argument is that part of the reasons margins are higher may be because of a scarcity of funding available from lenders given the cost of finance comprises both liquidity costs (i.e. a bank's cost of funding itself) as well as compensation for taking on the specific project risks.

Figure 3

Example of the effects of the increase in margins

Length of financing:	25 years
Capital funding requirement:	£100 million
Current 25 year Gilt rate (as at 21 Sept 2009):	4.24 per cent
Current 25 year SWAP rate (as at 21 Sept 2009):	4.14 per cent
Current typical margin above SWAP rate:	260 basis points
Old 25 year Gilt rate (as at 21 Sept 2007):	4.35 per cent
Old 25 year SWAP rate (as at 21 Sept 2007):	5.08 per cent
Old typical margin above SWAP rate:	110 basis points
Increase in absolute cost	
Additional cost compared to terms available in 2007: (NPV at 6.0875 per cent)[1]	£5.4 million
Increase in unitary charge	£420,000 a year
Increase in relative cost	
Increase in the difference between the cost of private finance and government borrowing, compared to 2007 (NPV at 6.0875 per cent)	£6.3 million

NB: This example excludes refinancing, capital contributions or other mitigating factors. It also excludes stepped increases in margins and other increases in finance costs. Figures should be viewed only as indicative of the effect of changed margins, and are not actual costs of specific contracts.

Source: National Audit Office calculations

NOTE

1 Net present values discounted at 6.0875 per cent to reflect the social preference of time (estimated at 3.5 per cent) and inflation (estimated at 2.5 per cent). These are the standard discount rates suggested by HMT's Green Book Guidance and exclude consideration of risk. *The Green Book: appraisal and evaluation in central Government,* HMT (2003).

b **"Using private finance for a particular project brings sufficient benefits and efficiencies compared to conventional borrowing that it is still VFM despite the increase in the cost of funding"**. This would need to be assessed on a case-by-case basis. In the past, some Public Sector Comparators audited by the NAO have only been marginally in favour of using PFI, whilst others have shown more room for the cost to increase.

c **"It is not possible to change procurement routes without restarting tendering, and the opportunity cost of doing so outweighs the higher cost of private finance"**. The costs of starting tendering again can be considerable. But this argument, however, only applies to those projects that are significantly progressed in their procurement, potentially such as the M25 widening and the Manchester Waste schemes (both of which were signed earlier this year).

2.48 The Treasury has released guidance to departments to remind them to take into account current lending conditions in their VFM analysis.[42] The NAO will look to public authorities currently tendering, or about to tender PPPs, to pay particular attention to ensuring the VFM of their projects.

42 *Application Note. PPP Projects In Current Market Conditions*, HMT (28 August 2009).

Part Three

Institutional incentives to use private finance

This part explains the:

- way in which the assets and liabilities of many PFI projects are not recorded in the accounts;
- ways that keeping private finance off-balance sheet has shaped projects; and
- recent changes made to accounting and statistical treatment of private finance and their consequences.

Up to April 2009, Private finance was often off-balance sheet and not recorded in Government borrowing statistics

3.1 The majority of PPPs involve borrowing that is not included in the Government's statistic of public borrowing, Public Sector Net Debt. The Treasury, however, states that whether or not a project is included in the Government's statistics of public borrowing is irrelevant to deciding on the form of procurement.

3.2 Treasury guidance says that authorities should choose the procurement route based on VFM grounds alone, subject to affordability.[43] It provides guidance on how to assess VFM and requires all projects to ascertain that private finance is the best delivery mechanism before using it.

3.3 But for many projects, the public authority feels it has no choice but to use private finance and shape the project to ensure that it is off-balance sheet (i.e. ensure the asset and borrowing are not recorded in its accounts).

3.4 The rules used by statisticians to determine how PFIs are included in Government economic statistics (National Accounts) are compatible with UK Generally Accepted Accounting Practice (UK GAAP), used up to April 2009 by accountants to put together public sector financial accounts. Up to April 2009, a project was recorded the same way in both the public authority's financial accounts and the National Accounts.

43 See for example *PFI: meeting the investment challenge*, HMT (2003); *Value for money assessment guidance*, HMT (2006).

3.5 UK GAAP included the liabilities if the balance of risk and reward was with the public sector, and excluded it if the balance of risk and award was deemed to be with the private sector. Interpreting the balance of risk and award was left to individual public bodies and their auditors. The National Audit Office agrees the accounting treatment of central Government projects, while other auditors agree the treatment of local Government and local health sector projects.

3.6 Seventy eight per cent (£22 billion) of operational PFIs in England by capital value are not recorded on the balance sheet of public sector financial accounts and thus excluded from the Public Sector Net Debt statistics part of the National Accounts. Only 22 per cent (£6 billion) are on-balance sheet (**Figure 4**). This excludes the London Underground PPPs, which before the failure of Metronet had a capital value of about £18 billion and were on-balance sheet, but are not pure PFI contracts.

3.7 From September 2006, the Office for National Statistics has included the on-balance sheet finance lease liabilities in Public Sector Net Debt. This is mainly PFI and amounted to £4.92 billion when it was first incorporated, increasing the total Government debt by one per cent.[44]

3.8 About half (45 per cent) of projects by capital value audited by the National Audit Office are on-balance sheet. The NAO assesses each project on its own merits against Financial Reporting Standards. We often found that the Financial Reporting Standards require that the liabilities be reflected in the Accounts, mainly because of the balance of residual value and demand risk. Such disclosure not only meets the Financial Reporting principle of reporting substance over form, but also provides transparency over liabilities.

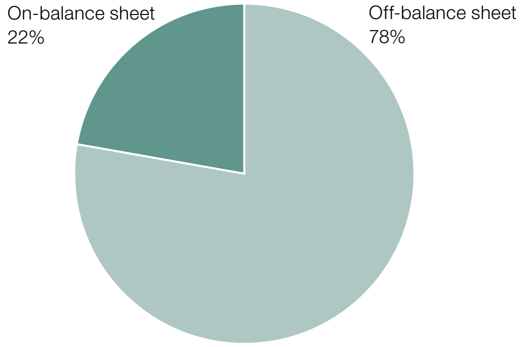
3.9 On the other hand, 95 per cent of local authority PFI projects by capital value were off-balance sheet. The Comptroller and Auditor General reported concerns about the inconsistency in accounting treatment of PFI in his annual general report on financial reporting and auditing every year since 2003 until the introduction of International Financial Reporting Standards in 2009. The National Audit Office's interpretation of both UK GAAP and IFRS would disclose PFI hospitals, schools and many other local authority projects on the balance sheet.[45]

44 Adrian Chesson and Fenella Maitland-Smith, 'Including finance lease liabilities in public sector net debt: PFI and other', *Economic Trends*, Volume 636, Office for National Statistics (November 2006).

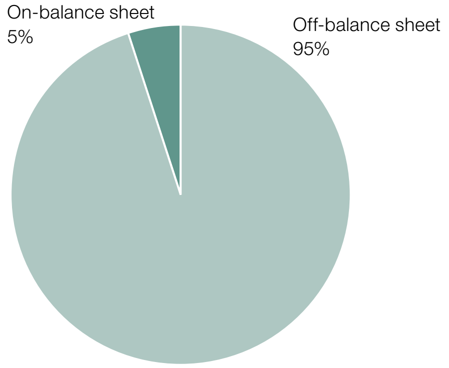
45 *Financial Auditing and Reporting: General Report of the Comptroller and Auditor General*, National Audit Office (HC 335-XIX, 2001-02; HC 517, 2002-03; HC 365, 2003-04; HC 366, 2004-05; HC 1015, 2005-06; and HC 148, 2006-07).

Figure 4
The majority of PFI projects by capital value is off-balance sheet (excludes London Underground PPPs)

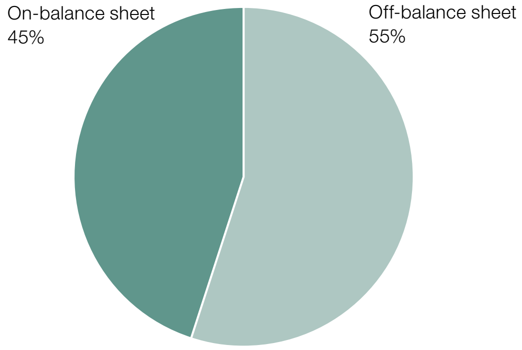
Balance sheet treatment of all operational PFI projects



Local government



Central Governmnet



Source: National Audit Office's calculations from HMT's signed PFI projects database

Budgeting mechanisms favour the use of off-balance sheet debt

3.10 Normally affordability might be defined as whether a public authority has the cash to pay for a project. But budgeting mechanisms mean that most discussions of PPP affordability relate to budgetary cover, rather than cash flows. This section sets out how the budgeting rules differ depending on whether the project is on or off-balance sheet. The budgeting rules can make a project appear more affordable if it is off-balance sheet, even though the cash flows will be the same however it is accounted for.

3.11 Treasury controls public spending through departmental budgets, including limits on capital investment – Capital Departmental Expenditure Limits (Capital DEL), and limits on resource spends – Resource Departmental Expenditure Limits (Resource DEL).[46] It allocates set amounts of Capital DEL and Resource DEL to each Department in its three year spending reviews.[47]

3.12 Most local authority PFIs are supported by PFI credits. PFI credits are a promise by Government to make available a stream of funding for local authorities that undertake PFI schemes that are *off-balance sheet*. PFI credits are outside the budgetary process. The stream of funding that they promise comes from (the Department for) Communities and Local Government and is included in its Resource DEL.

Budgeting for central government PPPs

3.13 Central government and health sector PFIs that are on-balance sheet require both up-front Capital DEL for the entire capital value in the initial operational year and annual Resource DEL to cover the annual payments.

3.14 Projects that are off-balance sheet have no effect on Capital DEL. There is no upfront charge to the departments' budgets and the annual payments to contractors score against Resource DEL. It is thus likely to be more affordable to pursue an off-balance sheet approach, because these do not require Capital DEL.

3.15 The exact amount of Resource DEL needed will not be exactly the same between an on and off-balance sheet approach, because an on-balance sheet approach includes depreciation and capital charges but not debt repayments against Resource DEL. This will roughly balance out over the life of the contract. However, timing differences on when these elements require Resource DEL can also make on-balance sheet accounting approaches seem less affordable in the early years of the contract.

46 Other budgetary controls, such as Annually Managed Expenditure, are not relevant for PPPs.

47 More detailed budgeting guidance can be found in *Consolidated budgeting guidance from 2009-10 (IFRS updated)*, HMT (June 2009).

Budgeting for local government PPPs

3.16 An off-balance sheet local government project has no impact on a Department's budgets, but will normally be funded by PFI credits. From the Local Authority's point of view, PFI credit allocations are sources of additional funding from central Government.

3.17 An on-balance sheet local government project cannot use PFI credits as a source of funding. Instead, it scores against the sponsor department's Capital DEL. This may be in the form of a grant, or a promise of a stream of funding similar to PFI credits.

3.18 Self-financed local government projects do not require any central government budget, but do not get any central government support.

3.19 Allocating each Department a set amount of PFI credits each year provides an incentive for the Department to pursue off-balance sheet projects. PFI credits are used by Departments as if they were another capital budget in addition to Capital DEL, solely for off-balance sheet projects. The Budgeting rules mean that Departments cannot switch amounts between PFI credits and Capital DEL. So if a Department intends to fund a project through PFI credits and later finds that the project will be either procured using conventional funding or is on-balance sheet, it will have to find sufficient Capital DEL and can not use the PFI credits for the project.

The effect of budgetary mechanisms on accounting treatment

3.20 Thus up to April 2009, the accounting treatment of local Government projects had a major impact on the budgets of central Government Departments. Guidance for local Government stresses that accounting treatment should be determined at an early stage. The Treasury Project Review Group assesses the suitability of PFI projects requiring PFI credits. Its reviewers check the accounting treatment and whether the balance of risks lies with the private sector (so that under UK GAAP it is off-balance sheet).

3.21 Until 2005, some departmental guidance indicated that local public authorities should ensure that PFIs were off-balance sheet:

a The Department of Health's guidance stated that *"the assessment of the accounting treatment of a scheme is a helpful guide to assessing the level of risk transfer and hence value for money in a PFI scheme. Schemes will normally be expected to be able to demonstrate that they will not be on an NHS Trust's balance sheet."*[48] It set out how to allocate risk to ensure off-balance sheet treatment.

48 *Public Private Partnerships in the National Health Service: the Private Finance Initiative*. Former section 3: technical issues, NHS Executive (1999). Section no longer extant.

b The Department for Education and Skills guidance stated that *"This guidance also includes an early warning mechanism for LEAs to apply to their schemes to identify those schemes that have a higher risk of bring considered on-balance sheet"*. And later *"DfEE provides funding to LEAs for PFI schemes through the mechanism of PFI credits. However, PFI credits can only be provided where a scheme is judged to be off-balance sheet."*[49]

3.22 Such departmental guidance was retracted by Departments in 2005 as part of a drive by Treasury to ensure compliance with its Value for Money Guidance.[50] Yet many public authority project and programme managers have continued to tell us that they feel pressure to shape projects so that they are off-balance sheet.

Seeking to keep projects off-balance sheet can have perverse effects on the shape of contracts

3.23 Contracts that pass the balance of risk and reward to the private sector may coincidently be VFM. But there are many risks which are best managed and held by the public sector and the optimal allocation of risk is a fine judgement. Incentives to use off-balance sheet private finance may present a temptation to public authorities to structure contracts so as to achieve off-balance sheet treatment rather than the best possible value for money. In particular, it provides incentives to:

a **Restrict public ownership of joint ventures to less than 50 per cent**. Joint ventures are often structured 49:51, to avoid full incorporation in the public sector's financial accounts.[51]

b **Manage or downplay demand risk (that the asset will not have the expected level of use)**. This can distort the planning for services.

c **Pass residual risk to contractors (they hold the market value of the building at the end of the contract)**. This can cost more or mean permanently transferring ownership to the private sector.

d **Increase the length of the project to reduce the residual value of the building**. Small discounted residual values reduce the risk for the public sector authority of a fluctuating residual value at the end of the contract.

e **Keep debt funding below 90 per cent**. Higher debt funding is considered more likely to resemble a financing arrangement, so more expensive risk capital is used.

f **Not include provisions for partial termination of individual services**. The ability to cancel part of the contract would indicate that the relevant service was not integral to the property and the service risk did not rest with the contractor.

49 *The accounting treatment of schools PFI projects*, Department for Education and Skills (2002). Section no longer extant.

50 *Financial Reporting Advisory Board Paper, Private Finance Initiative (PFI): Consistency of Accounting treatment adopted by the public and private sectors, progress report*, Financial Reporting Advisory Board (72) 02, HMT (March 2005).

51 *The Thames Gateway: laying the foundations*, National Audit Office (HC 526, 2006-07).

g **Not include provisions to benchmark or market test maintenance and lifecycle refurbishment costs**. The costs of maintaining the building is at the private sector's risk. This has the advantage of promoting whole-life costs, but means there is limited incentive for improvement of maintenance services.

h **Ensure payments do not relate to the level of debt or interest paid by the contractors**. This was one reason why, before the National Audit Office revealed the problem, contractors were able to profit from changed lending market conditions by refinancing.

i **Ensure contractors accept some inflation risk that Government would be better at managing**. Maintenance charges are not indexed directly to a relevant inflation index, as this would imply the public sector held the risk of inflation. Indexation is often applied to the whole of the availability portion or not at all. This creates a difference between the price contractors charge and the costs they incur, and they are likely to charge extra for holding the risk that this will not be in their favour. Government is normally considered able to handle the risk of inflation, because tax revenues increase in proportion to inflation.

3.24 The private sector has also sought to keep projects off their balance sheets, to seek tax advantages such as composite trader status. The chief advantage of composite trader status is that it allows all of the expenditure incurred in design and construction to be relieved against trading income. This encourages "off-off" accounting, where the asset is not recorded in either the public or private sectors' balance sheets. Department of Health guidance, now withdrawn, told Trusts that *"In order to take advantage of this tax treatment bidders need to structure their bids so that they qualify as composite traders. … It is expected that the full benefit of the tax saving should be passed through to Trusts in the form of reduced unitary charges. … Bidders and Trusts must clear any decision not to pursue composite trade with [the Department of Health's Private Finance Unit] … It is unlikely that an SPV accounting for a fixed asset may benefit from composite trader tax treatment."* [52]

From April 2009, International Financial Reporting Standards will change the accounting treatment of PFI, but not the statistical treatment

3.25 From April 2009, Departments and central public bodies will use International Financial Reporting Standards (IFRS) to produce their accounts. Local authorities will adopt IFRS from April 2010, but will apply an IFRS based approach to PFI accounting from 2009-10.

52 *Public Private Partnerships in the National Health Service: the Private Finance Initiative, Tax treatment for construction costs of NHS PFI schemes (composite trader)*, NHS Executive (4 February 2003).

3.26 The implementation of IFRS provides an opportunity for a more consistent approach to PFI accounting.[53] IFRS replaces UK GAAP's focus on the balance of risk with a focus on the balance of control.[54] This means that a public authority's accounts will record the asset and liability of a PFI project on a balance sheet where it:

- **i** Controls or regulates what services the contractor must provide with the PFI asset, to whom it must provide them and at what price; and
- **ii** Controls any significant residual value interest in the fixed asset at the end of the arrangements (e.g. the public authority can control the use of the asset at the end of the contract, perhaps by an option to purchase it at a set price).

In practice, we expect that nearly all PFI projects will be on the published balance sheets of the individual public bodies after the implementation of IFRS.

3.27 The Office for National Statistics uses European System of Accounts 95 guidance (ESA 95) to prepare National Accounts. ESA 95 is produced by the European Commission to standardise economic statistics between EU Member States. ESA 95 is in turn consistent with the System of National Accounts, which was prepared under the auspices of the United Nations and is used globally.

3.28 Like UK GAAP, ESA 95 determines the treatment of PFI projects on the basis of the balance of risk. The Office for National Statistics had been able to take the pragmatic approach of using accounting judgements as a source for its data when the accounting judgements were based on UK GAAP, but it decided it could not do so when they were prepared using IFRS.

3.29 The Treasury announced in April 2009 that with the move to IFRS, departmental budgets would follow the treatment in the National Accounts using ESA 95's focus on the balance of risk, and would no longer align with the accounting treatment.[55]

Effect of the changes on the incentives to use private finance

3.30 We expect that whilst nearly all PFI projects will be recorded on the balance sheets of their public client's accounts, the majority will not be included in statistics of Public Sector Net Debt. This removes the incentive to shape projects against the detailed financial reporting standards to ensure that they are off-balance sheet in the accounts.

53 *Financial Auditing and Reporting: General Report of the Comptroller and Auditor General*, National Audit Office (HC 417, 2007-08).

54 This is based on principles set out in the *International Financial Reporting Interpretations*. See Committee interpretation No.12: Service concession arrangements (IFRIC 12), 2006. IFRIC 12 is designed for the private sector, but is also used as the basis of guidance for the public sector.

55 For a fuller explanation see *Technical Guidance on the Application of the Standards used in the production of National Account to PFI and Similar Transactions*, HMT (September 2009).

3.31 There remains an incentive, however, to use private finance over other procurement options, to keep liabilities out of departmental capital budgets and excluded from Public Sector Net Debt. Furthermore, the decision as to which private finance projects require cover in capital budgets will no longer be subject to independent scrutiny by auditors.

Effect of the changes to the accounts on the Parliamentary control of expenditure

3.32 We expect that whilst nearly all PFI projects will be on the balance sheet in a Department's Accounts, the liabilities will not be recorded in its spend against budget. This creates a disjuncture between the budgeting controls over public expenditure and the way that Departmental expenditure is reported to Parliament.

3.33 There are already discrepancies between resource budgeting and resource accounting. The Prime Minister announced a commitment on 3 July 2007 to bring planning, Parliamentary approval and reporting of public spending on to a more consistent basis.[56] The National Audit Office is working closely with the Treasury on this Alignment Project.

3.34 The effects of the recent changes differ for each of the different Parliamentary controls over expenditure:

a **National Accounts** are an integrated set of economic accounts covering the whole of the economy produced by the Office for National Statistics. They are used to determine fiscal performance. They are based on ESA 95 and use the balance of risk to determine the treatment of PFIs.

b **Departmental budgets** are set by Treasury and used to control public spending. They mostly follow the treatment in the National Accounts and thus use ESA 95's approach to PFI.

c **Supply Estimates**. The House of Commons agrees the individual budgets and spending limits of each department annually (and revisions to them through supplementary estimates). At the moment estimates are closely aligned to the Financial Reporting treatment. The Alignment Project aims to align estimates with budgets to improve control over public spending. Thus from 2011-12 it is expected that estimates will be based on the ESA 95 approach to determining PFI expenditure.

d **Resource Accounts** are audited by the National Audit Office and set out how Departments have used the resources granted by Parliament. They will follow IFRS focus on control to determine the treatment of PFI.

56 *Governance of Britain* (CM 7170), Secretary of State for Justice and Lord Chancellor (July 2007).

Part Four

Business cases and evaluations

This part sets out:

- the ways in which Departments and public authorities assess the value for money of PPPs;
- the need for, but limitations of financial modelling; and
- the need for better evaluation of and comparative analysis between procurement routes.

Departmental assessments of value for money

4.1 The Treasury expects Departments to make three assessments of VFM for PPP schemes:

a At a programme level to determine whether private finance is appropriate and likely to represent good VFM across a sector;

b When scoping a project, to determine the right project specification and the right choice of procurement route, as part of the business case for the project; and

c During the tendering to ensure that the procurement approach remains the best option, especially in the light of competitive interest and market capacity.

4.2 It is also important to evaluate the VFM of PPP schemes once they are operational to ensure they are achieving the intended benefits, learn lessons and inform other procurement decisions. But there is no formal requirement for public authorities to do so.

4.3 Value for money is a relative concept. A project's VFM can only be assessed against a suitable comparator. This often involves hypothetical comparators, such as not doing the project (an absolute assessment), or other ways of achieving the project's intended outcomes (a counterfactual assessment). The VFM of a project can also be tested by comparing it to other similar projects (a relative assessment). The strongest assessments use all three comparisons.

4.4 The assessment of whether private finance will achieve VFM is only one of the questions that must be answered by a comprehensive business case. The National Audit Office has particularly argued for a reduced emphasis on cost modelling assessments of VFM because they can only contribute towards one of the questions that need to be answered (**Figure 5**).

PPP projects undertake relatively thorough initial assessments of potential VFM

4.5 Weak planning and evaluation of the costs and benefits of a project is a common finding of our work across Government. For example, impact assessments are designed to assess the needs, and likely impact, of proposed regulations. The NAO has assessed the quality of impact assessments across Government over the last decade. Although we find that the quality of impact assessments is improving, there is a wide variation in standards and there is a need to improve the sophistication of the analysis of costs and benefits of the range of options.[57]

4.6 Public authorities generally undertake greater scrutiny of the costs and benefits of PPPs than they do for other types of projects. In part, this is because there is greater guidance on what they need to do. The Treasury's Green Book provides guidance on the assessment of all projects.[58] The Treasury provides public authorities with further comprehensive guidance on the assessment of VFM for PPPs.[59] It focuses on viability, desirability and achievability, emphasising the identification of strategic and qualitative issues, and providing guidance on the quantification of costs and benefits compared to procurement through conventional funding.

Figure 5
Questions that a PPP business case must satisfy

- Is PPP a good idea for this project?
- Is the project affordable?
- Has the PPP deal been appropriately structured?
- Will the private sector deliver?
- Could the public sector deliver better?
- Will the project cope with future changes?
- Do the benefits of using a PPP outweigh its costs, risks and limitations?

Source: National Audit Office

57 *Delivering high quality impact assessments*, National Audit Office (HC 128, 2008-09).
58 *The Green Book: appraisal and evaluation in central Government*, HMT (2003).
59 *Value for money assessment guidance*, HMT (2006).

4.7 Nonetheless, while PPP business cases generally demonstrate feasibility and affordability, they often do not manage to demonstrate that private finance is the best VFM option:

- **a** The strategic reasons for using private finance are often not spelled out convincingly (see part two for a discussion on strategic issues).
- **b** Financial modelling is error-ridden and given undue influence.
- **c** There is insufficient evaluation of projects, including evaluation of whether the intended benefits are achieved.
- **d** We have yet to come across robust cost analysis between procurement routes, that tests the assumptions of cost efficiency set out in business cases.

The need for, but inherent limitations of, financial modelling

4.8 Quantification of the expected costs and benefits of a project allows for better decision-making. But it also requires public authorities to make fine judgements about the future and risk, and to consider issues which are inherently uncertain.

4.9 The main financial model prepared for PPPs is the Public Sector Comparator (PSC). The PSC compares the costs and benefits of using private finance as opposed to conventional finance. Such comparators are very useful in helping to identify the costs, benefits and risks of a project and forcing the procuring authority to consider alternative procurement approaches. But like any financial model, they cannot be relied upon as a sole source
of assurance. They are susceptible to manipulation and we often find problems with their implementation:

- **a** **PSCs are often used wrongly as a pass or fail test, with departments quoting figures saying that PFI is cheaper or more expensive than the PSC**. PSCs produce estimates of the expected (i.e. average) net present value of a large number of potential scenarios, and thus represent the most likely figure of a range. The Ministry of Defence main office building PFI had a PSC that showed PFI was as just over a 10,000th cheaper than the favoured PFI routes, although there was a 50:50 chance that it was more expensive (**Figure 6**).[60] We found that MoD considered it important for presentational purposes in its final analysis of the proposed deal that the final PFI deal price was below its estimated average cost of conventional procurement, but that in reality the costs of PFI and conventional procurement were similar.
- **b** **PSCs adjustments for risk are subject to inevitable uncertainties**. The Highways Agency relied on the subjective judgement of its advisors to risk adjust the PSC for the National Roads and Telecommunications Services contract, using their experience and judgement. This produced a result that the PSC was marginally more expensive than PFI.[61]

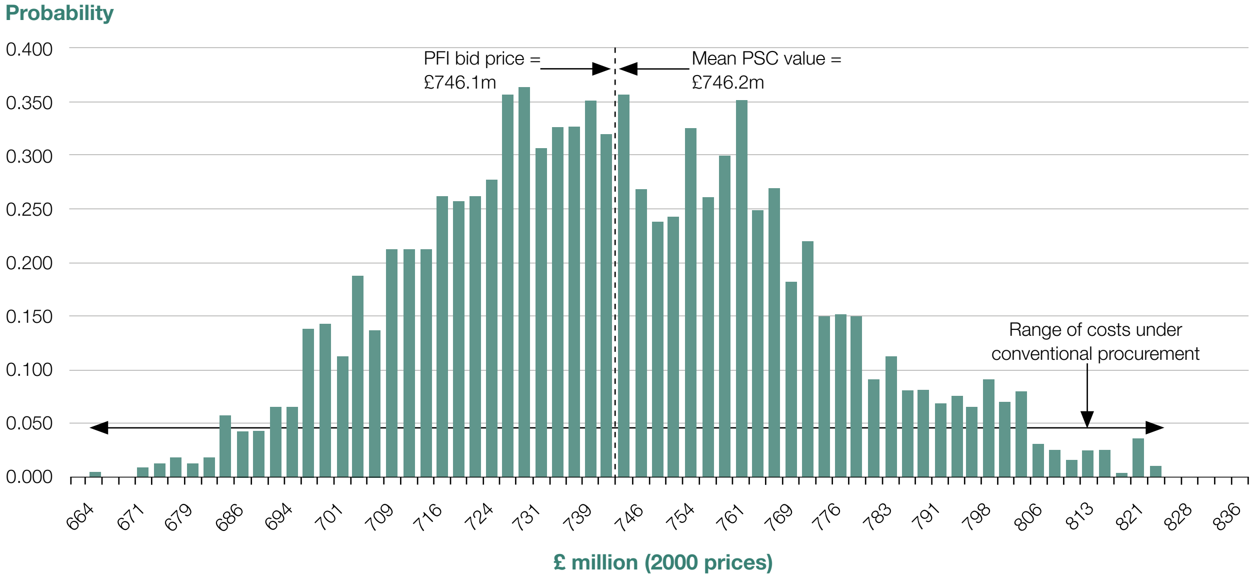
60 *Redevelopment of MoD main building*, National Audit Office (HC 748, 2001-02).
61 *The procurement of the National Roads Telecommunications Services*, National Audit Office (HC 340, 2007-08).

c **PSCs do not always represent the best counterfactual**. The National Savings and Investment's PSC for its PPP with Siemens Business Services assumed that capital funding would be restricted by annual spending limits, whilst PFI funding was additional. Lifting this restriction would have significantly narrowed the gap between the PFI and the PSC.[62]

d **Comparisons to PSCs do not assess the wider net-benefits of a procurement approach**. For example, the West Middlesex University Hospital PFI estimates were originally more expensive than the PSC, but the Trust decided that the other benefits made PFI VFM, notably the incentive on the contractor, Bywest, to complete the redevelopment quickly and with price certainty.[63]

e **PSCs, like all models, are prone to human error**. Furthermore, sense checking of models is more likely to detect errors whose correction is in favour of the desired outcome. The West Middlesex Hospital Trust's advisers strove to make slight adjustments to the PSC within the range of human error to make the PFI cost appear marginally cheaper than the PSC.[64] The Dartford and Gravesham Hospital PSC contained £12 million of errors. The Trust did not test the sensitivity of its PFI savings during procurement, and had it known they were marginal might have achieved better value for money.[65]

Figure 6
Public sector comparators do not provide clear-cut answers



Source: Redevelopment of MoD Main Building, National Audit Office (HC 748, 2001-02)

62 *National Savings: Public-Private Partnership with Siemens Business Services*, National Audit Office (HC 493, 1999-00).
63 *The PFI contract for the redevelopment of West Middlesex University Hospital*, National Audit Office (HC 49, 2002-03).
64 *Delivering better value for money from the Private Finance Initiative*, PAC (HC 764, 2002-03).
65 *The PFI contract for the new Dartford & Gravesham hospital*, National Audit Office (HC 423, 1998-99).

f **Important scenarios are often missed**. The 11th September 2001 terrorist attacks led to a significant drop in air traffic, causing the National Air Traffic Services PPP to lose significant income and require refinancing. Of the nineteen scenarios modelled, only one catered for the risk of a brief downturn in income and the Department ignored historical evidence of downturns in making its overall assessment.[66]

4.10 The Treasury responded to our criticisms of PSCs in its 2004 revision of its VFM guidance, stressing that the PSC should be only part of the assessment of VFM. The NAO agrees. PSCs are a very useful and vital part of PPP business cases. They provide some assurance that the public authority has carefully considered the costs, benefits and risks of a project and considered alternative procurement routes. They do so in a way that is better than most quantification techniques of costs and benefits that we see across Government. But they are only financial models and have inherent limitations, including being subject to manipulation and challenge. They should not be relied upon alone.

Using financial modelling to assess bids

4.11 Should-cost models are another type of financial model, which are used to assess bids. They are independent calculations of the expected costs of delivering the same technical solution as proposed by a bidder. But the preparation of should-cost models can be tricky and data hard to find. The Police Information Technology Organisation could not find reliable cost information for new technology equipment for its should-cost model of the Airwave radio communication contract.[67]

4.12 Public authorities often use should-cost models if there is only one bid. When the Department for Work and Pensions decided it would ask its incumbent contractor, Land Securities Trillium, to extend its contract to manage its property, it used a should-cost model to assess the bid, and obtained a high degree of transparency and openness from the contractor, enabling it to demonstrate VFM.[68] Treasury has generally argued that competition provides better assurance on VFM than a should-cost model, but the two are not incompatible. The Ministry of Defence used its PSC as a should-cost model to assess bids for its main building.[69]

4.13 In our view, where it is feasible to put together a should-cost model, they are a very helpful additional source of assurance and challenge to bidders' proposals. Under the Competitive Dialogue process used for most PPPs, each bidder offers a different costed solution to the output specification that are often difficult to compare to one another. Should-cost models help the public authority to assess the merits of each bid, within a competitive process.

66 *Public Private Partnerships: Airwave*, National Audit Office (HC 730, 2001-02).
67 *Ibid.*
68 *The PRIME project: the transfer of the Department of Social Security Estate to the private sector*, National Audit Office (HC 370, 1998-99).
69 *Redevelopment of MoD main building*, National Audit Office (HC 748, 2001-02).

Evaluation and real cost comparisons

4.14 Evaluation of projects is an important part of learning lessons and improving future procurement. As part of a benefits realisation process, it can also help further the aims of the project. And it is particularly important given the inherent limitations of business case assumptions and the need to rigorously test them in practice.

4.15 A systemic weakness that we have identified across Government but especially for PPPs is the poor management of benefits realisation.[70] Benefits realisation is the ongoing process of identifying a project's aims, the means of achieving them, responsibility for each, and monitoring and assessment arrangements to assess their achievement. Without such an approach there is no obvious driver to push and promote the purpose of the project, and yet many public authorities appear not to take benefits realisation seriously:

- **a** **Benefits realisation is rarely integrated into the project management**. The Highways Agency predicted the benefits of its National Roads and Telecommunications Services contract would be £2.8 billion, but relied on external Gateway reviews to identify the benefits achieved.[71]
- **b** **Projects often focus on delivery of a plan and forget the intended benefits**. The Building Schools for the Future programme aims to improve education attainment as well as renew school buildings, but national targets unduly emphasise the timeliness of delivery of new buildings, and local targets lack ownership and detail.[72]
- **c** **Authorities often include benefits in their assessment that they have no concrete plans to deliver or assess**. The Channel Tunnel Rail Link business case relied on creating £450 million of regeneration, but the Department for Transport had no mechanisms to ensure others delivered this benefit or to measure whether it was achieved.[73]

4.16 We are also yet to see robust cost analysis by any Department or public authority. Cost comparisons using real data from life projects would allow the whole-life costs of PPP projects to be compared to similar projects. This can be done across a programme to analyse variations in costs, between procurement approaches to evaluate delivery methods, or for a specific project to assess the reasonableness of its costs. Without such cost comparisons, it will not be possible to ever prove whether using private finance is more efficient or more expensive than conventional funding.

70 *The procurement of the National Roads Telecommunications Services*, National Audit Office (HC 340, 2007-08); *The Building Schools for the Future Programme: renewing the secondary school estate*, National Audit Office (HC 135, 2008-09); *Innovation in the NHS: LIFT*, National Audit Office (HC 28, 2005-06); *Home Office: the implementation of the National Probation Service Information Systems Strategy*, National Audit Office (HC 401, 2000-01).

71 *The procurement of the National Roads Telecommunications Services*, op.cit.

72 *Building Schools for the Future: renewing the secondary school estate*, op.cit.

73 *Progress on the Channel Tunnel Rail Link*, National Audit Office (HC 77, 2005-06); *The Thames Gateway: laying the foundations*, National Audit Office (HC 526, 2006-07).

4.17 No two projects are exactly the same, so cost comparisons will not say whether an individual project is VFM. But it can provide useful management information about how costs compare to a norm, or whether costs are generally reasonable. Large homogenous programmes such as hospitals, schools, housing and office buildings can provide enough data to show clear trends, and managers can assess whether variances from these trends are justifiable given the specific circumstances of each project. Cost comparisons are much harder for one-off projects, such as the London Underground PPPs or Defence projects.

4.18 The main reason that we have not seen such costs comparison is because departments do not collect data on whole-life costs of projects in a systematic way:

a Central Government rarely collects data from Local Government funded projects or devolved funding.

b PPP costs are rarely collated centrally, and where they are, they are hardly ever updated for contract variations.

c The costs of ongoing services for conventionally procured buildings are rarely monitored, making whole-life costs very difficult to compare.

d Different procurement routes collect data on different bases.

4.19 On the other hand, cost comparisons are often used during the operational phase of a PFI project to benchmark the cost of specific services and ensure that they closely resemble the market norm. They are also used to benchmark the project costs of new projects developed by Partnerships outside of competition – e.g. by Local Innovation Finance Trusts and Local Education Partnerships (**Case study 6**).[74] Such benchmarking systems are not cost comparisons between systems, but could start as the basis for collecting the data needed for such a cost comparison.

74 *The Building Schools for the Future Programme: renewing the secondary school estate*, National Audit Office (HC 135, 2008-09); *Innovation in the NHS: LIFT*, National Audit Office (HC 28, 2005-06).

Case study 6

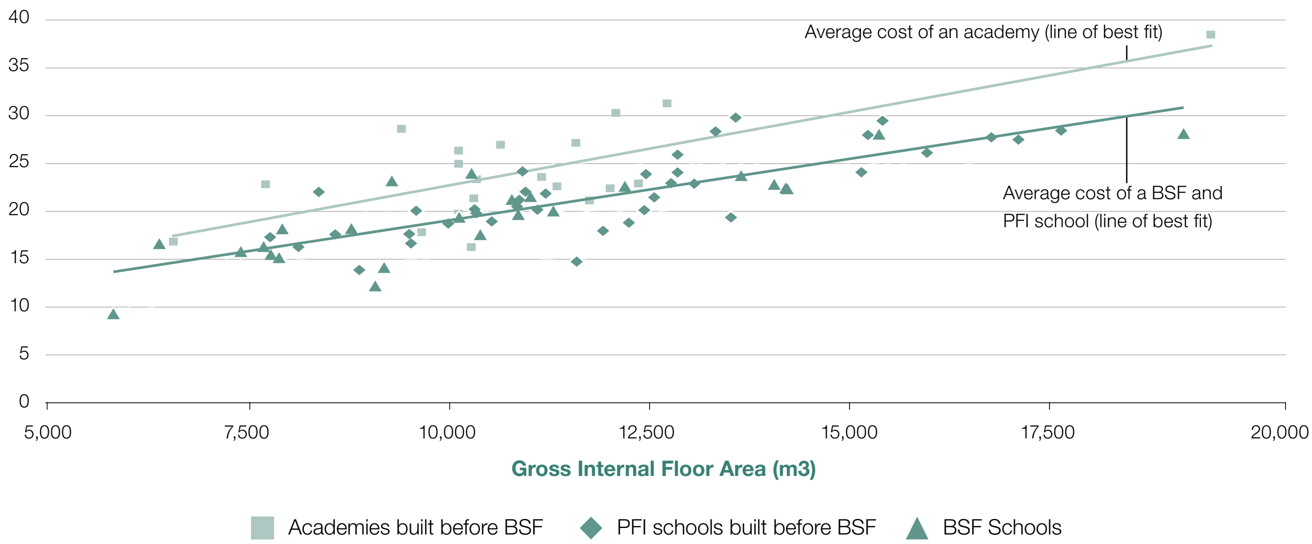
Partnerships for Schools benchmarking

Partnerships for Schools' benchmarking system promises to provide robust data across schools funded through the Building Schools for the Future programme. We were able to use this to benchmark capital costs between centrally funded programmes, but we could not assess whole-life costs or compare them to devolved funding streams (the majority of expenditure), using available data.

The price of BSF schools compared to the price of Academies and PFI schools built before the BSF programme

This figure shows that there is a great deal of variation in the individual price of each school depending on the type of site and facilities included, but that the prices of BSF schools are not significantly different from PFI schools and generally less than Academies. The price is shown as capital cost to the public sector, adjusted for annual price inflation and location to allow a better comparison. The figure excludes refurbishments, because they vary too much in the amount of work undertaken to allow a comparison.

Capital cost (£m) in 2007 prices and adjusted for location



Source: The Building Schools for the Future Programme: renewing the secondary school estate, National Audit Office (HC 135, 2008/09)

Part Five

Managing private finance

This part sets out the challenges faced by public authorities:

- in managing the tendering process;
- in managing the post contract phase of PPP contracts.

5.1 The need for better management of projects is a prevalent theme of the National Audit Office's work across Government. PPPs raise particular challenges arising from their complex commercial relationships that require specialist skills to manage. These initially affect the outcome of the tendering process. Thereafter, however good a contractual deal is, it is highly unlikely to achieve VFM if it is managed poorly. This part sets out the challenges to managing private finance projects well.

Tendering and competition

Effective tendering

5.2 Tendering is the process whereby public authorities invite tenders and select a winning bidder for the contract. Effective tendering is vital because the initial commercial terms often last throughout the life of the project. Good management requires the public authority to maintain competitive tension through to the final agreement; the development of a good solution; and establishing a fair and economic commercial basis for the contract.

5.3 The Committee of Public Accounts raised concerns in 2003 on PFI tendering, that PFI projects did not follow good practice and were not handled with sufficient skill on the part of the public sector, incurring high costs and risking VFM.[75] We undertook a cross cutting study on the tendering of PFI projects in 2007. We found that key elements of the tendering process had not improved and in some respects had worsened.[76]

5.4 Most PPPs, including all PFIs, are now tendered using the EU defined tendering process known as Competitive Dialogue. Prior to 2006, they used Negotiated Procedure, which was very similar. These processes involve the bidders developing the technical solution to the public authority's output specification in conversation with the public authority. PPP tendering thus involves both the selection of contractor and the full design of both the asset and service specification.

75 *Delivering better value for money from the Private Finance Initiative*, PAC (HC 764, 2002-03).
76 *Improving the PFI Tendering Process*, National Audit Office (HC 149, 2006-07).

5.5 Tendering can be a long process. PFI projects finalised between 2004 and 2006 took an average of 34 months to tender.[77] The comparable figure for 2000-2003 was 33 months. Large PPPs can take even longer and there is a lot of variation by sector. Defence PFI projects take a particularly long time, averaging 45 months and lasting up to 10 years.[78] Although there needs to be sufficient time for tendering in order to get things right, we found that many of the reasons for long tendering periods could be avoided or mitigated.[79]

5.6 The costs of tendering for both the public and private sectors reflect the length of tendering. Contractors often tell us that high bid costs prevent them from bidding for more projects.

5.7 There is a healthy number of contractors in the PFI and PPP market, but the number of bidders for each project is falling. Eighty five per cent of pre-2004 projects received three or more developed bids compared to 67 per cent for 2004-06 projects.[80]

5.8 VFM is most at risk during the final stage of negotiations, when negotiation is with a single preferred (or final bidder) and competitive tension is at its weakest. We found that preferred bidder negotiations lasted on average 15 months for PFI projects finalised between 2004 and 2006. One in three of these projects changed the value of the contract (both upwards and downwards) by an average of 17 per cent of the total project value.[81]

5.9 The introduction of Competitive Dialogue in 2006 was designed to eliminate changes made after the selection of the final bidder. Our recent study on Building Schools for the Future found some early indications that at least some changes are still being made late in the process. Kent County Council's project experiencing seven months delay after the selection of final bidder.[82]

5.10 Strategic infrastructure partnerships are a relatively new type of PPP designed to manage the flow of projects and handle the private sector's capacity. They are long term partnerships between public authorities and a consortium of companies that have exclusive rights to develop a stream of projects. Once the partnership has been established, each project is developed without a competitive tender. Benchmarking information is used to keep the costs economic compared to the market average. It is hoped that this will be cheaper than separately tendering for each project, because the cost of tendering is reduced and the partners have the opportunity to learn how to work with each other better. We found that it was too early to tell if it will provide VFM.[83]

77 *Improving the PFI tendering process*, National Audit Office (HC 149, 2006-07).
78 *Allocation and management of risk in Ministry of Defence PFI projects*, National Audit Office (HC 343, 2007-08).
79 *Improving the PFI tendering process*, op.cit. *The Building Schools for the Future Programme: renewing the secondary school estate*, National Audit Office (HC 135, 2008-09).
80 *Improving the PFI tendering process*, op.cit.
81 *Improving the PFI tendering process*, op.cit. *The Building Schools for the Future Programme: renewing the secondary school estate*, National Audit Office (HC 135, 2008-09).
82 *The Building Schools for the Future Programme: renewing the secondary school estate*, op.cit.
83 *Ibid*.

Competitive finance

5.11 The cost of private finance is a substantial part of the costs of PPPs and especially of PFI. Ensuring as competitive a rate as possible is essential to achieving value for money. The difference between the cost of the private finance used and Government borrowing should closely reflect the value of the risks transferred.

5.12 Most bidding consortiums have included the lead lenders as part of the bidding team. A few other projects have run a funding competition in the late part of the tendering process, to ensure the most competitive rates possible at the time. Such competitions can be complex and therefore risky. They require thorough preparation and a strong project management team to make them effective. The Treasury was the first to use a funding competition, when it tendered for its office building.[84] We have called for departments always to consider using a funding competition, although they have only occasionally been used since.

5.13 The recent credit crisis has made finding competitive and economic funding harder. It is not always possible to get much competition because each bank is only prepared to lend a small amount, and not always for the full term of the project. Large deals may need all the lenders available to contribute something. This makes it essential that project teams commissioning new projects adopt alternative strategies for considering the VFM of the financing.

5.14 The Treasury has set up a unit to offer debt funding to projects that are finding it impossible to find sufficient competitive private lenders.[85] This provides some additional competitive tension against the banks. But Departments need to consider the value for money of deals given the current high financing costs. They need to consider at what point the deals would simply not be good value for money compared to options less reliant on private finance.

Managing the contracts and operational issues

5.15 Contractors often seek to enhance their profitability over the course of a contract. Public authorities must be alert to whether this will be at the expense of value for money. There is no simple checklist of things to do to manage such commercial risks. Below is a summary of the main findings from our work on contract management.

Establishing productive relationships

5.16 PPPs are long term arrangements. Public authorities and contractors should strive to approach projects in a spirit of partnership. Poor relationships and poor performance go hand in hand, one driving the other in a vicious circle. Conversely, those that have improved performance have often focused on improving the relationship first.

84 *Innovation in PFI financing: the Treasury building project*, National Audit Office (HC 328, 2001-02).
85 Infrastructure Finance Unit (TIFU): http://www.hm-treasury.gov.uk/ppp_tifu_index.htm.

5.17 A traditional customer-supplier relationship often leads to decision-making which is not focussed on the business as a whole. That can drive behaviour which misses opportunities to achieve wider objectives or opportunities. Many contract managers and contractors tell us that they have a commercial relationship of "us and them", and that this is a fixed reality that cannot be changed. But we have seen the most successful projects build concrete partnerships that respect the commercial and contractual basis of the relationship. This includes the enforcement of contractual terms, whilst focusing on the wider picture of how to achieve mutual benefits.[86]

5.18 Partnership working requires both the right contractual framework and working culture. Contracts need to align incentives and set out the governance framework through which the relationship is established. Staff must be equipped with the appropriate contract management skills to manage the relationship. We recommend that public and private sector partners should seek to understand each others' businesses and establish a common vision.[87]

5.19 It is also important to plan how the relationship will be managed and what partnership working means during the tendering phase. Delivery has often been delayed because working practices are not thought through or planned until the project is already underway.[88]

Managing operational performance

5.20 Public authorities need to ensure that they get the quality of assets and services that they specify. They will also want to have incentives to improve performance and efficiency over time. PFI contracts include a performance management system where the contractors report their own performance against a set of performance indicators specified in the contract. These provide incentives to the contractor to perform to the specified standard by charging penalties for missed performance targets.

5.21 Such performance management systems help to define and monitor the required performance. But they are difficult to get right, needing to be both well calibrated and managed. Whether services meet an operating specification can involve subjective judgements, such as the meaning of "clean" in a hospital[89] or the acceptable level of incidents of self harm in a prison.[90] The systems do not work properly where staff may not report faults. In other situations performance indicators may be misleading or lack objectivity.[91] VFM is at risk if performance monitoring is not managed well.

86 (E.g. *National Savings and Investments deal with Siemens Business Services: four years on*, National Audit Office (HC 626, 2002-03), *Building Schools for the Future*, National Audit Office (HC 135, 2008-09).

87 *Managing the relationship to secure a successful partnership in PFI projects*, National Audit Office (HC 375, 2001-02).

88 *Building Schools for the Future*, op.cit. *Managing the relationship to secure a successful partnership in PFI projects*, op.cit. *Innovation in the NHS: LIFT*, National Audit Office (HC 28, 2005-06).

89 *Darent Valley hospital: the PFI contract in action*, National Audit Office (HC 209, 2004-05).

90 *The operational performance of PFI Prisons*, National Audit Office (HC 700, 2002-03).

91 *Allocation and management of risk in MoD PFI projects*, National Audit Office (HC 343, 2007-08); *Darent Valley hospital: the PFI contract in action,* National Audit Office (HC 209,2004-05).

5.22 We normally find very few penalties applied to payments to contractors. One reason for few penalties is that public clients do not always enforce the contract. Sometimes penalties are offset for other services rendered or suspended as part of a plan to work together to improve performance.[92] Sometimes public clients fear that applying penalties will harm their relationship with the contractors and cause further performance degradation.

5.23 The Committee of Public Accounts has made clear its view that penalties should always be applied, except under exceptional circumstances.[93] We believe that public authorities should only waive a penalty where this achieves a higher benefit than the penalty, and after consideration of any moral hazard.

5.24 The main reason for few penalties, however, is likely to be that most project managers report satisfaction with operational performance. A survey conducted on behalf of Partnerships UK in 2008 on the performance of operational PFI contracts found that 94 per cent of the 151 contract managers surveyed felt that the contract service levers were always or almost always achieved. Ninety two per cent found that user satisfaction assessments indicated that services were being delivered to a satisfactory standard.[94] High levels of satisfaction are also normally reflected in our reports and surveys of users. There may be a risk of bias in project managers self-reporting their satisfaction level. Their views, however, remain an important barometer of performance.

Making changes

5.25 It is inevitable that changes will be required during the life of a private finance contract. Making changes requires a negotiation to change the contractual specification. Contractors often use such negotiations as ways of enhancing their profitability. There is risk to VFM if changes are not competitively tendered or if the contractor charges an additional fee to process the change.

5.26 The National Audit Office report on making changes in operational projects found that PFI deals offer sufficient flexibility, but that VFM has not generally been obtained. Larger changes were not always competitively tendered; smaller changes were relatively expensive and took longer to process than in non-PFI projects. Furthermore most private sector PFI partners charged an additional management fee of 5-10 per cent for changes which was not justified by the work needed to process them.[95]

92 *The operational performance of PFI prisons*, National Audit Office (HC 700, 2002-03); *The joint services command and staff college*, National Audit Office (HC 537, 2001-02).
93 *Benchmarking and market testing the ongoing services component of PFI projects*, PAC (HC 754, 2006-07).
94 *Investigating the performance of operational PFI contracts: a research study conducted for Partnerships UK on behalf of HM Treasury*, Ipsos MORI (2008).
95 *Making changes in operational projects*, National Audit Office (HC 205, 2007-08).

Refinancing

5.27 Refinancing is where the Project Company's shareholders rearrange the terms of their debt financing. It is often done to get cheaper funding either because of more favourable market conditions or because the project has demonstrated that some risks are less likely to occur. For instance, after the building is complete, construction risk is no longer relevant. There were particular opportunities to refinance early PFI contracts because better financing terms became available once the PFI market became established.

5.28 As a result of a report by the NAO on an early refinancing,[96] and a subsequent report by the PAC,[97] the Government negotiated with the private sector arrangements to share refinancing gains. Initially the public sector was entitled to 50 per cent of the gains in new contracts. The public sector share has now been increased to 70 per cent in deals which may benefit from refinancings if the financing markets recover after the credit crisis.[98] In addition the Government agreed with the private sector that the public sector would receive 30 per cent of refinancing gains on early PFI contracts which had been entered into without any contractual mechanism to share refinancing gains.

5.29 The NAO recommended in its review of refinancing that authorities assess the impact of refinancing proposals on the future of the project. Factors to consider are particularly service delivery incentives, increased termination liabilities, and the impact of receiving the gain over time if the contract is terminated.[99]

5.30 New sharing arrangements appear to be working well, but there have been exceptions. We criticised one of the early refinancings, the Norfolk and Norwich PFI Hospital, for only securing the NHS Trust 29 per cent of the £116 million refinancing gain, whilst increasing the contract's termination costs.[100]

The development of the secondary market

5.31 A secondary market has developed which has enabled investments in the private sector project companies delivering PFI projects to be traded between parties interested in buying or selling investments in these projects.

5.32 Some of the initial investors in projects wish to realise their investment once the project is in operation. Other investors, however, are interested in acquiring investments in PFI projects in operation as an investment providing relatively stable long term returns.

96 *The Refinancing of the Fazakerley PFI Prison contract*, National Audit Office (HC 584, 1999-00).
97 *The Refinancing of the Fazakerley PFI Prison contract*, PAC (HC 372, 2000-01).
98 *Standardisation of PFI contracts*, Version 4, Addendum, Amended Refinancing Provisions, HMT (April 2009).
99 *Update on PFI debt refinancing and the PFI equity market*, National Audit Office (HC 1040, 2005-06).
100 *The refinancing of the Norfolk & Norwich hospital: how the deal can be viewed in the light of the refinancing*, National Audit Office (HC 78, 2005-06).

5.33 Specialist investment funds have developed which have acquired portfolios of various investments in PFI projects. These investment funds get their funds from other parties which may include long term investors such as pension funds. The development of the secondary market was described in a NAO's report on refinancing and the equity market.[101]

5.34 In terms of managing PFI contracts public authorities need to be aware that investors in their projects may change. The authorities should make sure they understand the business drivers of any new investors.

5.35 The specialist investment funds which have acquired investments in PFI projects are able to manage these investments as a portfolio. They may be able, therefore, to improve their returns by seeking economies of scale in the operating costs in the projects, their management of the contracts (e.g. fighting penalties) or through better financing arrangements across the portfolio. Although refinancing gains on individual projects must be shared with the public sector there is no particular requirement for other portfolio gains to be shared.

5.36 Where shares are traded in PFI project companies there is no requirement under the standard form of PFI contract for the gains to be shared with the public sector. The gains may be subject to taxation in line with the normal tax rules for chargeable gains. The NAO and PAC have noted that there is no requirement for gains on selling shares in PFI projects to be shared with the public authorities which have let PFI contracts. The NAO and PAC have said it is important, therefore, that the pricing of the use of equity in the original contract can be demonstrated to be value for money.

Resourcing the management of private finance contracts

5.37 Our work has long emphasised the need for better management of the contract and to establish systems to manage the contract during the tendering process. But a culture continues to exist across much of the public sector of exclusive focus on making the deal. This is in part because much of the VFM of a PPP is established in the planning, tendering and commercial terms embedded in the contract. It is also due to the influence of bringing in technical, legal and commercial advisors whose role it is to ensure that the contract is based on the right commercial terms, and the pressures of negotiation.

101 *Update on PFI debt refinancing and the PFI equity market*, National Audit Office (HC 1040, 2005-06).

5.38 The culture of making the deal has led to the neglect of contract management issues. The transition from tendering to operation has come as a shock to some, allowing preventable problems to cause delay and costs. A lack of staff continuity from the tendering to the contract management stages makes it harder to achieve a high standard of contract management, and causes loss of technical and commercial knowledge. A change in staff makes it harder to establish effective relationships between the public authority and the contractors.[102] Good practice, which has been adopted on some projects, is for the official leading the finalisation of the contract to stay in post for at least a year after contract letting.

5.39 Procurement authorities often underestimate the amount of resources needed for contract management, including conventionally procured projects and PPPs. Some public authorities do not employ a full-time contract manager, leaving key risks unmonitored and unmanaged.[103] There is a shortage of the commercial and project management skills needed to manage private finance and other major complex projects across Government. There is insufficient training for contract managers across Government, and limited career structures.[104]

5.40 Public authorities often over rely on interims[105] and external advisors to fill this shortage. Effective use of advisors brings many benefits, including the spread of skills between projects, and the provision of key skills at specific points. But it can lead to higher project staff costs; departmental staff not taking responsibility for commercial decisions; and commercial knowledge of projects being lost when they leave.[106]

5.41 There have been a number of Government initiatives attempting to tackle these issues. The Treasury and Partnerships UK set up an Operational Taskforce in 2006 to provide support and guidance for public authorities managing PPP contracts. Most Departments have a Private Finance Unit which provides advise and support to public authorities tendering and managing PPPs.

102 *Allocation and management of risk in Ministry of Defence PFI projects*, National Audit Office (HC 343, 2007-08); *PFI: the STEPS deal*, PAC (HC 553, 2003-04); *The Building Schools for the Future Programme: renewing the secondary school estate*, National Audit Office (HC 135, 2008-09); *Progress on the Channel Tunnel Rail Link*, National Audit Office (HC 77, 2005-06).

103 *Making changes in operational PFI contracts*, National Audit Office (HC 205, 2007-08).

104 *Managing the relationship to secure a successful partnership in PFI projects*, PAC (HC 460, 2001-02).

105 By *interims* it is meant temporary staff who are performing roles that would otherwise be carried out by civil servants.

106 *Allocation and management of risk in Ministry of Defence PFI projects*, National Audit Office (HC 343, 2007-08); *PFI: the STEPS deal*, National Audit Office (HC 530, 2003-04) and its associated PAC report (HC 553, 2003-04); *Managing the relationship to secure a successful partnership in PFI projects*, National Audit Office (HC 375, 2001-02) and its associated PAC report (HC 460, 2001-02). For all PFI projects in England that closed between April 2004 and June 2006 advisors' costs averaged £3 million a project (2.6 per cent of the capital value). *Improving the PFI tendering process*, National Audit Office (HC 149, 2006-07).

5.42 Greater support for public authorities is provided by those Departments managing their PPPs as part of a structured programme, such as the Waste Infrastructure Development Programme and the Building Schools for the Future programme. These Departments provide an overall aim of the programme, develop the private sector supply side, evaluate projects and disseminate good practice.[107] Our reports on these programmes have highlighted the benefits that such an approach can bring to a portfolio of projects.[108]

107 *Managing the waste PFI programme*, National Audit Office (HC 66, 2008-09); *The Building Schools for the Future Programme: renewing the secondary school estate*, National Audit Office (HC 135, 2008-09).

108 *Building Schools for the Future: renewing the secondary school estate*, National Audit Office (HC 135, 2008-09); *Department for Environment, Food and Rural Affairs: managing the waste PFI programme* National Audit Office (HC 66, 2008-09).

Appendix One

List of NAO's reports on private finance

A Reports on private finance

No.	Title of report	Date published	Reference	Type of deal
1	The failure of Metronet	05-Jun-09	HC 512, 2008-09	Transport
2	The Building Schools for the Future Programme: renewing the secondary school estate	12-Feb-09	HC 135, 2008-09	New forms of PPP
3	Department for Environment, Food and Rural Affairs: Managing the waste PFI programme	14-Jan-09	HC 66, 2008-09	Approach to PFI projects
4	Allocation and management of risk in MoD PFI projects	30-Oct-08	HC 343, 2007-08	Risk management
5	Letting Rail Franchises, 2005-2007	15-Oct-08	HC 1047, 2007-08	Transport
6	The Regeneration of the Greenwich Peninsula: A Progress Report	16-Jul-08	HC 338, 2007-08	Operating projects
7	The procurement of the National Roads Telecommunications Services	04-Apr-08	HC 340, 2007-08	Transport
8	Making Changes in Operational PFI Projects	17-Jan-08	HC 205, 2007-08	Operating projects
9	Benchmarking and market testing the ongoing services component of PFI projects	06-Jun-07	HC 453, 2006-07	Operating projects
10	Improving the PFI Tendering Process	08-Mar-07	HC 149, 2006-07	Approach to PFI projects
11	The Shareholder Executive and Public Sector Businesses	28-Feb-07	HC 255, 2006-07	New forms of PPP
12	ASPIRE: The re-competition of outsourced IT services	19-Jul-06	HC 938, 2005-06	IT
13	The Paddington Health Campus Scheme	19-May-06	HC 1045, 2005-06	PFI Building
14	A framework for evaluating the implementation of PFI projects	15-May-06	Good governance	Approach to PFI projects

No.	Title of report	Date published	Reference	Type of deal
15	The Termination of the PFI Contract for the National Physical Laboratory	10-May-06	HC 1044, 2005-06	PFI Building
16	Update on PFI debt refinancing and the PFI equity market	21-Apr-06	HC 1040, 2005-06	Financing
17	The Wider Markets Initiative	27-Jan-06	HC 799, 2005-06	Wider market
18	Progress on the Channel Tunnel Rail Link	21-Jul-05	HC 77, 2005-06	Operating projects
19	The refinancing of the Norfolk and Norwich PFI Hospital: how the deal can be viewed in the light of the refinancing	10-Jun-05	HC 78, 2005-06	Financing
20	Innovation in the NHS: LIFT	19-May-05	HC 28, 2005-06	New forms of PPP
21	Darent Valley Hospital: The PFI contract in operation	10-Feb-05	HC 209, 2004-05	Operating projects
22	Transfer of property to the private sector under the expansion of the PRIME Contract	26-Jan-05	HC 181, 2004-05	PFI Estates
23	London Underground PPPs – were they good deals?	17-Jun-04	HC 645, 2003-04	Transport
24	London Underground – Are the Public Private Partnerships likely to work successfully?	17-Jun-04	HC 644, 2003-04	Transport
25	Network Rail – Making a Fresh Start	14-May-04	HC 532, 2003-04	Transport
26	The STEPS Deal	07-May-04	HC 530, 2003-04	PFI Estates
27	Improving public transport in England through light rail	23-Apr-04	HC 518, 2003-04	Transport
28	Cambridge-MIT Institute (research partnership with external funding)	17-Mar-04	HC 362, 2003-04	New forms of PPP
29	Criminal Records Bureau: Delivering Safer Recruitment?	12-Feb-04	HC 266, 2003-04	IT
30	Risk Management: The Nuclear Liabilities of British Energy plc	06-Feb-04	HC 264, 2003-04	Risk management
31	Refinancing of the PPP for National Air Traffic Services	07-Jan-04	HC 157, 2003-04	Financing
32	Unlocking the past: the 1901 census online	14-Nov-03	HC 1259, 2002-03	IT
33	Government Communications Headquarters: New Accommodation Programme	16-Jul-03	HC 955, 2002-03	PFI Building
34	PFI : The New Headquarters for the Home Office	15-Jul-03	HC 954, 2002-03	PFI Building
35	The operational performance of PFI prisons	18-Jun-03	HC 700, 2002-03	Operating projects

No.	Title of report	Date published	Reference	Type of deal
36	Northern Ireland Court Service. PFI: The Laganside Courts.	04-Jun-03	HC 649, 2002-03	PFI Building
37	National Savings and Investments deal with Siemens Business Services: four years on	08-May-03	HC 626, 2002-03	Operating projects
38	PFI Construction performance	05-Feb-03	HC 371, 2002-03	Operating projects
39	New IT systems for Magistrates Courts: the LIBRA project	29-Jan-03	HC 327, 2002-03	IT
40	Innovation in the NHS: acquisition of the Heart Hospital	19-Dec-02	HC 157, 2002-03	New forms of PPP
41	The PFI Contract for the Redevelopment of West Middlesex University Hospital	21-Nov-02	HC 49, 2002-03	PFI Building
42	PFI refinancing update	07-Nov-02	HC 1288, 2001-02	Financing
43	The Public Private Partnership for National Air Traffic Services Ltd	24-Jul-02	HC 1096, 2001-02	Transport
44	Redevelopment of MoD Main Building	18-Apr-02	HC 748, 2001-02	PFI Building
45	PPPs: Airwave (Police radios)	11-Apr-02	HC 730, 2001-02	IT
46	Delivering the Commercialisation of Public Sector Science	08-Feb-02	HC 580, 2001-02	Wider market
47	Ministry of Defence: The Joint Services Command and Staff College	07-Feb-02	HC 537, 2001-02	PFI Building
48	Managing the relationship to secure a successful partnership in PFI projects	29-Nov-01	HC 375, 2001-02	Managing relations
49	National Insurance Recording System 2: Contract extension	14-Nov-01	HC 355, 2001-02	Operating projects
50	Innovation in PFI Financing: The Treasury Building project	09-Nov-01	HC 328, 2001-02	Financing
51	Channel Tunnel Rail Link	28-Mar-01	HC 302, 2000-01	Transport
52	The Re-negotiation of the PFI-type Deal for the Royal Armouries Museum in Leeds	18-Jan-01	HC 103, 2000-01	Operating projects
53	The Financial Analysis for the London Underground PPPs	15-Dec-00	HC 54, 2000-01	Approach to PFI projects
54	The Radiocommunications Agency's Joint Venture with CMG	08-Dec-00	HC 21, 2000-01	Wider market
55	The Cancellation of the Benefits Payment Card project	18-Aug-00	HC 857, 1999-00	IT
56	The New British Embassy in Berlin	30-Jun-00	HC 585, 1999-00	PFI Building
57	The Refinancing of the Fazakerley PFI Prison Contract	29-Jun-00	HC 584, 1999-00	Financing

No.	Title of report	Date published	Reference	Type of deal
58	National Savings: Public-Private Partnership with Siemens Business Services	25-May-00	HC 493, 1999-00	IT
59	PFI: The Contract for the Defence Fixed Telecommunications System	23-Mar-00	HC 328, 1999-00	IT
60	The Contributions Agency: The Newcastle Estate Development Project	25-Nov-99	HC 16, 1999-00	PFI Estates
61	UK Passport Agency: The Passport delays of Summer 1999	27-Oct-99	HC 812, 1998-99	IT
62	Examining the VFM of deals under the PFI	13-Aug-99	HC 739, 1998-99	Approach to PFI projects
63	The Procurement of Non-Combat Vehicles for the Royal Air Force	13-Aug-99	HC 738, 1998-99	Transport
64	The PFI Contract for the new Dartford & Gravesham Hospital	19-May-99	HC 423, 1998-99	PFI Building
65	The PRIME project: The Transfer of the Department of Social Security Estate to the Private Sector	23-Apr-99	HC 370, 1998-99	PFI Estates
66	PFI: The Contract to Complete and Operate the A74(M)/M74 in Scotland	09-Apr-99	HC 356, 1998-99	Transport
67	Home Office: The Immigration and Nationality Directorate's Casework Programme	24-Mar-99	HC 277, 1998-99	IT
68	The Flotation of Railtrack	16-Dec-98	HC 25, 1998-99	Transport
69	PFI: The First Four Design, Build and Operate Roads Contracts	28-Jan-98	HC 476, 1997-98	Transport
70	The PFI Contracts for Bridgend and Fazakerley Prisons	31-Oct-97	HC 253, 1997-98	PFI Building
71	Contributions Agency: The Contract to Develop and Operate the Replacement National Insurance Recording System	29-May-97	HC 12, 1997-98	IT
72	Skye Bridge	23-May-97	HC 5, 1997-98	Transport

B Reports on sales of assets

No.	Title of report	Date published	Reference	Type of deal
1	The privatisation of Qinetiq	23-Nov-07	HC 52, 2007-08	Sale of assets
2	Regeneration of the Millennium Dome and associated land	12-Jan-05	HC 178, 2004-05	Sale of assets
3	The auction of Radio Spectrum for the Third Generation of Mobile Telephones	19-Oct-01	HC 233, 2001-02	Sale of assets
4	The Sale of Part of the UK Gold Reserves	12-Jan-01	HC 86, 2000-01	Sale of assets
5	Department of Trade and Industry: Sale of CINMan by British Coal	21-Apr-99	HC 359, 1998-99	Sale of assets
6	Sale of Railfreight distribution	26-Mar-99	HC 280, 1998-99	Sale of assets
7	NHS Executive: Royal Brompton Hospital – Sale of North Block Site	10-Mar-99	HC 252, 1998-99	Sale of assets
8	Sale of the Royal Dockyards	03-Jun-98	HC 748, 1997-98	Sale of assets
9	Sale of British Energy	08-May-98	HC 694, 1997-98	Sale of assets
10	Sale of AEA Technology	20-Mar-98	HC 618, 1997-98	Sale of assets
11	Privatisation of the Rolling Stock Companies	05-Mar-98	HC 576, 1997-98	Sale of assets
12	The Sale of the Stationery Office	13-Feb-98	HC 522, 1997-98	Sale of assets

Source: National Audit Office

Appendix Two

Simplified version of the NAO framework matrix to evaluate the implementation of Private Finance projects

Phase	What is expected from the procurement authority?
When deciding the project	Ensure that the project fits with the business requirements of the Authority. Demonstrate that Private Finance is the appropriate delivery mechanism, usually through a Business Case (otherwise, use the best procurement route). Ensure that stakeholders support the project's progress, in particular that all relevant stakeholders have been consulted when deciding the best procurement route. Ensure that the desired specifications of the project are feasible and affordable. Assess all risk associated with the project before tendering, including procurement risks.
At the contract signature	Ensure that the output specifications fully address the business requirement. Design robust payment and performance regime. Encourage innovation. Demonstrate that private finance continues to be the best procurement route. Test that the stakeholders' commitment to the project remains high. Select the most advantageous bid, ensuring that it addresses all core business requirements and that key stakeholders support it. Demonstrate that the selected deal is affordable. Identify all project risks and risk-manage them, ensuring that there is a clear risk-management plan to be used once the contract goes live. Ensure that the risks best managed by the private sector have been transferred. Ensure that competitive finance has been achieved.

Phase	What is expected from the procurement authority?
During the operation	Ensure that the asset has been delivered to contractual specifications, that it is fit for purpose and being maintained at good standards. Ensure that price increases, if any, relate to changes requested by the authority, and that these are value for money. Keep all stakeholders informed about the project, and test the level of satisfaction of them. Ensure that risk mitigation procedures are in place and that risk allocation is working. If changes in the contract have implied new risks, then ensure these are consistent with the original contract. Ensure that services provisions meet contractual specifications, and that if any difference arises proper actions are taken. Demonstrate that private finance is, still, the best option, and that the deal is still affordable. Benchmark, periodically, for price and quality. Ensure that all parties are seeking to maximise quality.

The full framework matrix is available on our website: *A Framework for evaluating the implementation of Private Finance Initiative projects: Volume 1*, National Audit Office (May 2006)

Source: National Audit Office

Glossary

Committee of Public Accounts (PAC): committee appointed by the House of Commons to examine "the accounts showing the appropriation of the sums granted by Parliament to meet the public expenditure, and of such other accounts laid before Parliament as the Committee may think fit". It has 16 members and is always chaired by a member of the Opposition.

Contractors: the private sector consortiums and companies that deliver the private finance assets and services. Includes both the project company and its sub-contractors.

European System of Accounts 1995 (ESA 95): designed integrated system of economic statistics, based on the System of National Accounts 1993. National Accounts based on ESA 95 are used for international comparisons within the European Union.

Gilt: Government securities traded on the London Stock Exchange. They are called gilt edged as it is certain that the interest will be paid and they will be redeemed on the due date.

International Financial Reporting Standards (IFRS): standards used for the preparation and presentation of financial statements adopted by the International Accounting Standards Board.

Private finance: the funding raised by the private sector as part of a private finance project.

Private Finance Initiative (PFI): a particular form of PPP and private finance project, introduced by the Government in 1992 to harness private sector management and expertise in the delivery of public services, while reducing the impact of public borrowing involving.

Project Company: the financing of most PPP projects is obtained specifically for that project by a project company formed solely to fulfil the contractual obligations of the particular project. This type of company is often referred to as Special Purpose Vehicle (SPV) and is usually made up of different shareholders including a construction company and a facilities management company.

Public authority: the public body commissioning and managing the private finance project's contract.

Public-Private Partnership (PPP): a contractual partnership between bodies from the public and private sectors with dedicated governance structures to manage the relationship.

Refinancing: the process by which the terms of the funding which was put in place at the outset of a PFI contract, are later changed during the life of the contract, usually with the aim of creating refinancing benefits for the consortium company. Refinancing may be possible where the risk of a project has reduced due to, for example, the construction phase of a project being successfully completed.

Risk transfer: passing of risk from the public to the private sector party.

Senior debt: the debt that is ranked highest in terms of claims on project cash-flows and therefore carries the lowest risk that it will not be repaid.

UK GAAP: United Kingdom's Generally Accepted Accounting Practice.

Unitary charge: The payment from the public authority to the contractor in respect of the provision and operation of the asset.

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