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AUDITOR GENERAL

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Lessons from PFI and other projects

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Lessons from PFI and other projects

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Amyas Morse
Comptroller and
Auditor General

National Audit Office

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This report draws out lessons from recent project experience that the public sector needs to address to achieve the best commercial outcomes in the current economic environment of spending constraints.

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Summary

Procuring public projects

1 Government uses a range of procurement methods for its projects and programmes. This report draws out lessons from recent experience that the public sector needs to address to achieve the best commercial outcomes in the current economic environment of spending constraints.

2 The Private Finance Initiative (PFI) is a particular form of procurement where there is a large body of experience. Lessons from the use of PFI have wider application to other forms of Government project. Key enablers of the PFI model have included the range of valuable guidance, support and project assurance developed by the Treasury and departments. This has included a standard contract model and specialist private finance units to support projects. In return, good practice and experience from non-PFI projects can help improve PFI procurement and management.

3 In October 2009, we summarised key messages from the 72 PFI reports which we had then published in a paper to the Lords Economic Affairs Committee. The paper concluded that private finance can deliver benefits but is not suitable at any price or in every circumstance. Our paper also highlighted that, not withstanding the available guidance, we had been unable to identify a truly robust and systematic evaluation of the actual performance of the use of private finance at either a project or programme level.[1]

4 Changes in market conditions have, however, created new challenges. Uncertainty in the financing markets, since the onset of the credit crisis in 2008, has made the use of private finance more expensive. This factor, together with public spending constraints, has increased pressure on the public sector to obtain better outcomes for less. This includes the need to consider a range of possible financing models and to seek greater efficiencies in existing contracts.

5 The type of project that Government aims to procure is changing. With large programmes to develop social infrastructure such as hospitals and schools having been delivered in recent years, the future focus of spending will be on economic infrastructure[2] such as energy and transport projects. According to the Government, around £200 billion will need to be spent on economic infrastructure over the next five years,[3] with the majority of the £200 billion expected to come from the private sector. At the same time, the Government is seeking to be more efficient in its spending to deliver annual infrastructure savings of £2-3 billion.[4]

1 See http://www.nao.org.uk/publications/0809/private_finance_projects.aspx
2 The network and systems in energy, transport, digital communications, flood protection, water and waste management.
3 Infrastructure UK, *National Infrastructure Plan 2010*, October 2010.
4 See http://www.hm-treasury.gov.uk/iuk_cost_review_index.htm

6 Recent National Audit Office PFI reports have examined projects and programmes being undertaken in these new market conditions. The high level lessons learned from recent PFI experience will be relevant to both PFI and other areas of Government expenditure.

Scope of this report

7 This report mainly draws on findings from our five recent PFI reports examined by the Committee of Public Accounts in 2010, which between them considered 162 projects with a capital value of £18 billion. The five PFI reports (see Appendix Two) are:

- *Procurement of the M25 private finance contract*
- *Financing PFI projects in the credit crisis and the Treasury's response*
- *PFI in Housing*
- *The performance and management of hospital PFI contracts*[5]
- *Delivering multi-role tanker aircraft capability*[6]

We also also refer to other National Audit Office reports on non-PFI projects (see Appendix One on scope and methodology) to further illustrate issues relevant to all projects.

8 In order to secure the best value for money, public sector bodies need to act as intelligent customers across the three phases to a capital project: specifying the requirements; negotiating the contract and arranging finance; and managing the asset and service delivery. In a PFI project these phases are dealt with in a single contract. As well as taking care over the contracts that are entered into, public officials need, in the current economic environment, to give greater emphasis than previously to effective service contract management to obtain best value.

9 This report is in four parts which focus on the issues which need to be considered as a capital project passes through its three phases. Part One highlights the characteristics of PFI projects and the aspects that are relevant to other forms of procurement. The remaining parts consider the key enablers of successful projects in the context of:

- Making informed decisions where there are alternative courses of action (Part Two);
- Ensuring the intended outcomes from projects and programmes are delivered (Part Three); and
- Pushing the boundaries of existing commercial arrangements to get better outcomes from projects and programmes for less (Part Four).

5 Referred to as PFI in hospitals.
6 Referred to as Future Strategic Tanker Aircraft.

Key findings

10 We identified from our reports, the key enablers that allow the public sector to act as intelligent customers across all phases of a project. They are:

- **accurate data** to make informed choices; provide accurate estimates of time and cost, get better outcomes for less, and secure value for money;
- **skills, capacity and experience** to assess whether complex major projects represent a good deal over the life of the contract;
- **effective accountability and project assurance with appropriate empowerment** to ensure that projects and programmes only go ahead where they will deliver value for money; and
- **challenge** to the method of procurement, the scope of the deal and the business case assumptions **to identify opportunities to obtain better deals.**

Accurate data

11 There is no clear data to conclude whether the use of PFI has led to demonstrably better or worse value for money than other forms of procurement. Although most PFI projects are delivering the services expected, we have previously highlighted the lack of systematic ongoing value for money evaluation by departments of operational PFI projects.[7] This was raised as a concern by the Committee of Public Accounts in their recent report on PFI in housing and hospitals.[8] Consequently, the departments had not had appropriate data available to assess the merits of using PFI for future projects. The Department for Communities and Local Government told us it has now addressed the need for better data for its PFI housing programme.

12 Procuring authorities fail to specify the essential cost and operational data they require. Projects have incurred delays, extra costs and have failed to explore potentially beneficial alternative solutions as a result of not gathering the best data to inform decisions. This was an issue in our reports on the PFI deals to procure the Future Strategic Tanker Aircraft and the M25 widening. There is also scope for better use of benchmarking data including 'should cost' modelling to provide assurance that bidders' costs are reasonable.

13 There is insufficient data on the returns made by equity investors for the risks they are bearing. The original basis of PFI contracts let in a competitive environment did not generally require disclosure or regulation of investors' returns after the contracts had been let. Transparency on investors' returns is required where refinancings take place and, in current standard contract terms,[9] authorities may request updated financial models for the project which will provide details of financial performance. Nevertheless, there is still limited data on investors' returns. In particular, when investors sell their shares in project companies to other investors, there is little transparency of the price

7 See http://www.nao.org.uk/publications/0809/private_finance_projects.aspx
8 Committee of Public Accounts, *PFI in Housing and Hospitals*, Fourteenth Report of Session 2010-11, HC 631, January 2011.
9 Standardisation of PFI contract (SOPC4 (2007)).

at which these shareholdings are bought or sold or the impact of these transactions on investors' returns. In our 2010 report on the effects of the credit crisis, we recommended that the Treasury should consider whether the returns to equity investors are aligned to the risks they are bearing. This is an issue we expect to return to in our future work.

Skills, capacity and experience

14 The lack of commercial skills to match those of the private sector can put the public sector at a disadvantage in the negotiation and management of contracts. Since our 2009 report on commercial skills for complex projects,[10] the Government has taken steps to improve commercial skills across the public sector. Despite this, the public sector's skills are generally not as well developed as their private sector counterparts, which puts value for money at risk. The risk arises in particular during the life of the contract. Major contractors and investors can improve their returns through cost efficiencies not shared with the public sector, or, high margins on the changes in asset usage which are likely to occur over a long contract.[11]

15 Because of the length and complexity of PFI procurements, there is a risk of important knowledge not being passed on when advisers or key individuals move on to other work. Skill shortages leave departments over-reliant on advisers who may be expensive and are not always incentivised to deliver more quickly. For example on the procurement of the M25,[12] we noted that the Highways Agency was over-reliant on advisers, in part due to insufficient commercial and technical skills.

Effective accountability and project assurance with appropriate empowerment

16 Despite a range of valuable project assurance and governance processes, many specifically related to PFI, it has been rare for large projects to be halted. The development of department private finance units, together with central government review processes, has helped the oversight of PFI projects. Existing project assurance processes, such as the Project Review Group for local authority projects, have been valuable. There have, however, been notable examples of large projects not being cancelled[13] or significantly changed where value for money has been in doubt. We welcome the Government's actions to strengthen project assurance through the recent formation of the Major Projects Authority and revised Treasury approval processes for all major projects as part of a wider programme of strengthened spending control. There is a particular need for greater project assurance from the senior management of departments and local authorities, and other independent parties, who have not been closely involved with the projects.

10 Comptroller and Auditor General, *Commercial skills for complex government projects*, Session 2008-09, HC 962, National Audit Office, November 2009.

11 Comptroller and Auditor General, *Making Changes in Operational PFI Projects*, Session 2007-08, HC 205, National Audit Office, January 2008.

12 Comptroller and Auditor General, *Procurement of the M25 private finance contract*, Session 2010-11, HC 566, National Audit Office, November 2010.

13 *Assurance for high risk projects*, National Audit Office, June 2010; Comptroller and Auditor General, *Procurement of the M25 private finance contract*.

17 Local bodies procure contracts as part of programmes managed and funded by central government. The shortcomings in post-contract programme evaluations have meant that good practice and lessons learned have not been sufficiently identified and disseminated. The regular forums of NHS Trusts to share experiences of PFI contract management is an example of how this can be done. A lack of good quality information has also restricted departments' ability to identify and intervene in projects. The use of standard contract models has, however, helped local bodies who may not have had previous experience of privately financed projects.

Challenging the business case assumptions and taking opportunities to obtain better deals

18 There is a need for greater challenge of both the decision to use private finance and the scope of the deal. The decision to procure assets and services creates long-term commitments. It is therefore essential that there is a robust, impartial scrutiny of the business case decisions on the form of procurement and project scope. The value for money case before the credit crisis was sometimes marginal. The case for the use of private finance therefore needs to be challenged, given our analysis which showed that the costs of debt finance increased by 20-33 per cent since the credit crisis. Also, although there is well developed Treasury guidance on assessing the value for money of PFI projects, the method of calculating public sector net debt may, even though the financial accounting treatment has changed, continue to act as an incentive to use PFI as it often leaves liabilities off the national balance sheet. This makes robust project assurance especially important. Finally, projects have not always considered how better negotiation on conventional procurement could lead to more challenging comparators to PFI procurement.

19 With an average contract period of 25 to 30 years, PFI contracts can be relatively inflexible. Long contract periods are needed to enable the private sector to repay the bank loans out of affordable public sector payments. There is a risk that any asset may become obsolete but in PFI, the termination costs would include breaking long-term service contracts.

20 There has also previously been little opportunity for public authorities to obtain further efficiencies during these long contract periods. Our PFI in hospitals report highlighted that there are limited PFI contractual mechanisms to share efficiencies although existing value testing[14] of facilities services can generate savings. There has, however, generally been little evidence of a collaborative approach to identifying efficiencies with little use of open book accounting of private sector costs. The Treasury and Cabinet Office have recently launched a series of initiatives to seek cost savings on existing and new contracts.

14 Value testing takes two forms: Benchmarking, where subcontractors' prices are compared to the market price for equivalent services and adjusted accordingly; and market testing, where services are re-tendered to test the cost of the contract in the market.

21 Unlike its private sector contractors, the Government has not used its market position to obtain economies of scale. There are around 700 PFI contracts in the United Kingdom (500 in England), most of which are procured and managed locally. Whilst this encourages local decision-making, local bodies are not well placed to use the Government's buying power on common services such as catering, cleaning and building maintenance. Investors have, however, built portfolios of PFI projects from which economies of scale should be possible. There is no formal mechanism for the Government, which created these large markets, to share these gains.

Conclusion on value for money

22 The use of private finance has brought useful disciplines and a framework of support which are applicable to other forms of procurement. Our recent reports on PFI and other major projects have, however, highlighted that Government needs to act as a more intelligent customer in the procurement and management of projects. Value for money will be improved through officials being proactive in: collecting data to inform decision-making; ensuring they have the right skills; establishing effective arrangements to test, challenge and, if necessary, stop projects; and using commercial awareness to obtain better deals. In the current climate, PFI may not be suitable for as many projects as it has been in the past. The lessons from PFI can, however, be applied to improve other forms of procurement to help Government achieve its aim of annual infrastructure savings of £2-3 billion.[15]

Recommendations

23 Our recommendations below focus on important improvements which need to be prioritised to ensure value for money is secured on all future projects, whatever the form of procurement.

a **Too often, Government has failed to identify, collect and use the data it needs to help support decision-making and secure the best value for money.** Greater focus should be given to the types of data that should be gathered to improve decision-making, who should collect them and the cost of collection. In particular:

- The Major Projects Authority, the Treasury and departments should work collaboratively to agree the data that is required to support the preparation, assurance and scrutiny of major projects in Government. Data should be collected where it adds demonstrable value, and supports decisions but only where the benefits clearly outweigh the costs and burden of collecting the data.
- Those setting the data requirements should consider whether good quality up-to-date data is available to challenge whether the best solution to a defined requirement is being pursued and the best commercial terms are being obtained.

15 See http://www.hm-treasury.gov.uk/iuk_cost_review_index.htm

- Departments should undertake periodic value for money reviews of their programmes highlighting any areas where value for money has diminished. These should be high level reviews, with sufficient project data to inform the reviews, but should not include burdensome revisiting of all aspects of project business cases. Gateway 5 Reviews of operational projects will be useful evidence to draw on. The programme reviews should be used to improve performance and to assess how well the procurement method is working.
- As there has not been a Government assessment of the value which PFI equity investors contribute, the Treasury should consider how data can be collected to better understand the relationship between investors' returns and the risks they have borne.

b **Although PFI has delivered benefits, the payments for facilities services do not harness Government's buying power and may involve liabilities for longer than needed if assets become obsolete.** The Treasury should work with departments in identifying a range of alternative methods for delivering infrastructure and related facilities services, building on the lessons learnt from PFI, to maximise value for money for Government. Contracts should allow for flexible usage of the asset over time with clear arrangements to ensure that charges levied for additional services are both reasonable and equitable.

c **There is a shortage of the public sector skills needed to manage and oversee complex major projects.**

- The Cabinet Office and departments should urgently report on progress in implementing our previous recommendations to improve commercial skills and expertise in central government. The Major Projects Authority should keep under review the standard of commercial skills in projects which it oversees. It should provide feedback to the Cabinet Office and departments on any further skills issues which need to be addressed.
- Procuring authorities should ensure that there are suitably experienced contract managers prepared to robustly challenge contractors. The managers should be incentivised and held to account for maximising value for money.

d **Procuring authorities do not always set expectations for the service they expect to receive from their advisers, and do not incentivise them to provide a more effective service.** Procuring authorities should define at the outset the outcomes and benefits they expect to receive from the use of advisers; the measures to be put in place to ensure full transfer of knowledge; and the framework that will be used to assess performance. More use should be made of incentive-based and fixed price contracts.

e **Although there are project assurance processes in place, they have rarely resulted in robust interventions.** The Major Projects Authority should prioritise independent project scrutiny within Government by experienced senior individuals who are independent of the project. They should be empowered to intervene and, if necessary, recommend to the Accounting Officer that the project is stopped. To facilitate this, departments could use peer review from either within their department or elsewhere in Government, supported by a team with experience and the relevant technical skills.

f **Government is seeking to devolve responsibility for local public services.** Where departments sponsor and fund significant programmes of investment which are delivered at the local level they should set out, at the earliest stage, the roles and responsibilities of all parties and the criteria for central intervention. Departments should facilitate local bodies to work collaboratively and share best practice, including experience of securing cost efficiencies in existing contracts.

g **All parts of the public sector need to seek better deals in the current economic environment.** To ensure that the best deals are achieved:

- Project managers should challenge their existing commercial arrangements, being alert to changes in operational need, market conditions, or technological innovation to maximise benefits and cost reduction;
- Project and programme managers should develop an efficiency plan for each project and programme, setting out a strategy for getting better value over the life of the contracts. This should include identifying the scope for sharing benefits from economies of scale; and
- The Treasury and Cabinet Office should consider what changes should be made to procurement methods to harness the Government's buying power. There is a risk of conflict between Government exercising its buying power and local purchasing.

Part One

Introduction

1.1 Over the last fifteen years, private finance has become the predominant method by which public authorities procure infrastructure in many sectors. It has been used particularly where there is the need for a significant capital outlay followed by ongoing services, for example for hospitals, schools and roads.

1.2 In our experience, departments identify a range of potential benefits for PFI in their business cases but there are also potential disadvantages in using private finance (see **Figure 1**).

Characteristics of current PFI deals

1.3 Under a typical PFI deal, the public sector enters into a long-term contractual arrangement with private sector companies, which undertake to design, build, operate (and often maintain) an asset. There are around 700 PFI contracts in the United Kingdom. Over 500 of these are in England with a combined capital value of almost £50 billion. The forecast PFI payment for these projects for 2010-11 is estimated at £8 billion. They are usually long-term arrangements typically spanning 25 to 30 years. HM Treasury (the Treasury) estimates that the total commitments on current PFI contracts for the next 25 years for the United Kingdom are approximately £200 billion.[16, 17]

1.4 Since the mid-1990s, the majority of assets procured using PFI were commissioned by local authorities or arm's length bodies within nationwide programmes of similar assets. Procurement often involves more than one public sector body.

16 See http://www.hm-treasury.gov.uk/d/pfi_signed_projects_list.xls
17 The Treasury estimates that the present value of the total commitments on signed PFI contracts is £121.4 billion.

Figure 1

PFI contracts can deliver benefits but are inherently complex

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

Source: National Audit Office

Since the credit crisis, newly negotiated PFI deals face higher charges

1.5 The cost of PFI bank borrowing is normally a fixed interest rate, set at the time the contract is entered into. In 2010, we reported that loan margins on recent PFI deals had increased from 1 per cent to 2.5 per cent. As a result, the cost of borrowing under PFI has risen substantially, typically increasing the financing costs by 20 to 33 per cent. These increased costs are reflected in higher monthly charges for PFI deals than those negotiated before the credit crisis. The effect has been to increase the price of a typical building project by between 6 and 7 per cent.[18] The price of other projects has increased more. For example, the cost of the project to widen the M25 increased by 24 per cent following the credit crisis. Higher borrowing rates erode the value for money advantage that departments have previously attributed to PFI deals.

Privately financed solutions are still likely to be considered

1.6 The Government estimates that it requires a further £200 billion of new economic infrastructure investment over the next five years[19] mainly to facilitate transport and energy services. Much of this spend, for example, new power stations, will be financed and delivered directly by private sector companies. The cost of such private sector investment will ultimately be paid for by consumers through utility bills. In addition, as public sector finances are currently constrained, it is likely that privately financed solutions will still be considered for other infrastructure projects paid for by taxpayers.

1.7 A positive development has been the publication in autumn 2010 by Infrastructure UK[20] of the results of a study to identify ways of reducing the costs of delivering infrastructure projects. The study included comparisons with overseas experience. The Treasury is now targeting savings of £2-3 billion a year.[21]

18 Comptroller and Auditor General, *Financing PFI projects in the credit crisis and the Treasury's response*, Session 2010-11, HC 287, National Audit Office, July 2010.
19 Infrastructure UK, *National Infrastructure Plan 2010*, October 2010.
20 The Treasury set up Infrastructure UK in 2010 to oversee the planning of infrastructure across Government.
21 See http://www.hm-treasury.gov.uk/iuk_cost_review_index.htm

Many lessons learned on PFI apply to other forms of procurement

1.8 Many aspects of PFI are relevant to other forms of procurement, as they are not related to any particular financing method. These include:

- **identifying long-term service needs.** This will often require careful modelling and allowing some flexibility for those needs changing;
- **considering alternative solutions and alternative forms of procurement.** This requires rigorous evaluation of alternatives both at the outset and as the project develops;
- **handling complexity.** This is not just in the intricacy of the contract terms but also in the complex set of outcomes sought by the various users of the asset;
- **managing the interface between central government and local bodies;**
- **establishing good contract management procedures.** This is critical to avoiding the erosion of value for money during the service period; and
- **pursuing efficiencies.** There are opportunities both in individual projects and through economies of scale arising from Government's purchasing power.

1.9 The remaining parts of the report consider the key enablers for acting as an intelligent customer in the context of:

- making informed decisions where there are alternative courses of action (Part Two);
- ensuring the intended outcomes from projects and programmes are delivered (Part Three); and
- pushing the boundaries of existing commercial arrangements to get better outcomes from projects and programmes for less (Part Four).

Part Two

Making informed decisions

2.1 Decisions need to be made at critical stages in the development of a project and the management of the contract after it has been let. These decisions relate to important issues where there are alternative possible actions. For example, choices include whether to:

- use private finance or conventional procurement;
- adopt a solution to a service need which has been used previously or try an innovative solution which may have risks;
- go ahead with, or discontinue, a project that has been developed; and
- change the scope of a contract which is in operation or perhaps consider terminating the contract.

To act as an intelligent customer the public sector needs to make informed decisions where there are alternatives. Making the wrong choice can adversely affect value for money for many years into the future.

Data

2.2 Decisions on whether to use PFI are hindered by a lack of clear evidence on previous performance compared to alternatives. The Committee of Public Accounts noted that there is no clear evidence to conclude whether PFI has been demonstrably better or worse value for money for housing and hospitals than other procurement options.[22] In many cases local authorities and NHS Trusts chose the PFI route because the departments offered no realistic funding alternative. This led to the Committee's recommendation that departments should prepare and publish whole-programme evaluations. These should assess PFI against alternative procurement routes using clear value for money criteria to assist future decisions on the form of procurement, and the merits of including support services in the contracts.

22 Committee of Public Accounts, *PFI in Housing and Hospitals*, Fourteenth Report of Session 2010-11, HC 631, January 2011.

2.3 It is also important for a department to specify the information required at the outset of a project to help it make key decisions about the project. A recurring theme in our recent PFI reports has been a failure by departments to specify this information (**Figure 2**).

2.4 Inadequate data to make informed decisions is not unique to PFI. It affects all buying decisions. In our report on the Efficiency and Reform Group,[23] we found no current system to provide clear and up to date data on procurement across Government on a consistent basis.

2.5 Despite the shortfalls identified, there are some good aspects to PFI data. These include a Treasury PFI contract database, which means that key data about all PFI contracts can be consulted in one place. In addition, because payment is related to performance, PFI contracts generally have adequate performance data.

Skills and experience

2.6 Bodies often have limited in-house skills available to make critical decisions on complex projects. This can place the public sector at a disadvantage, both in negotiations before a contract is awarded and as major contractors seek to develop their income from the project, as we reported in 2008.[24]

Figure 2
Examples of lack of data to help decisions on whether the price was value for money

a The Ministry of Defence identified the potential to transfer significant risk to the contractor on the Future Strategic Tanker Aircraft PFI contract. It had access to some cost data but was unable to determine if it was paying an appropriate margin for the aircraft, as it never gained visibility of the subcontractor costs. The Committee of Public Accounts recommended that the Department should mandate an appropriate degree of openness and transparency from the bidders and develop a 'should cost' model to estimate how much it ought to cost bidders to deliver a contract.

b We also identified limitations in the data the Highways Agency used in its cost comparison between PFI and conventional procurement. These included that it assumed that operational and maintenance costs would be similar to those it had incurred on other projects and did not quantify the scope for efficiencies in the PFI or conventional procurement routes. The Committee of Public Accounts also considered that the substantially lower costs subsequently quoted by the PFI bidders for operations and maintenance raised significant concerns about the Agency's cost estimates and whether it was getting the best deals for these services in non-PFI contracts.

Source: National Audit Office

23 Comptroller and Auditor General, *The Efficiency and Reform Group's role in improving public sector value for money*, Session 2010-11, HC 887, National Audit Office, March 2011.

24 Comptroller and Auditor General, *Making Changes in Operational PFI Projects*, Session 2007-08, HC 205, National Audit Office, January 2008.

2.7 The general issue of skills has manifested itself in different projects on which we have reported:

- **The Highways Agency's project to widen the M25.** We noted that the Agency was over-reliant on advisers, in part due to insufficient commercial and technical skills.[25] The Committee of Public Accounts concluded that the Agency lacked the commercial skills to challenge its advisers, evaluate the quality of the advice it received, and assess whether its advisers were providing value for money.[26]

- **The Future Strategic Tanker Aircraft.** We found that, initially, the Ministry of Defence failed to properly resource the project team with in-house staff with appropriate experience. It later brought in its specialist Private Finance Unit, and has subsequently identified the Unit as key to providing appropriate commercial support to developing complex projects.[27]

2.8 The combination of skill shortages, local delivery and complex projects can jeopardise the realisation of benefits. In our 2009 report on the Building Schools for the Future Programme, for example, we noted that a general lack of local skills in procurement and programme management across the public sector was constraining capacity.[28]

2.9 Some departments and other public bodies are taking action to address skill shortages. In our recent PFI in housing and hospitals reports, we identified examples of actions to address skill shortages and improve decision-making. These included:

- joint procurement on behalf of ten district councils to build a range of supported housing (Kent County Council);

- establishing a large central team of PFI specialists who work across all PFI sectors (Leeds County Council); and

- regular forums of NHS Trusts to share experiences of PFI contract management.

2.10 Some PFI contracts are so complex they require considerable expertise to master. There is a risk to effective decision-making if only a small number of post-holders have detailed knowledge of the contract and they leave the project. On the Future Strategic Tanker Aircraft PFI project, knowledge of the complex contract was vested in just a few individuals. This risk has been addressed by developing a contract manual and raising staff awareness of the contract arrangements.

25 Comptroller and Auditor General, *Procurement of the M25 private finance contract*, Session 2010-11, HC 566, National Audit Office, November 2010.
26 Committee of Public Accounts, *Procurement of the M25 private finance contract*, Second Report of Session 2010-11, HC 651, February 2011.
27 Comptroller and Auditor General, *Delivering multi-role tanker aircraft capability*, Session 2009-10, HC 433, National Audit Office, March 2010.
28 Comptroller and Auditor General, *The Building Schools for the Future Programme: Renewing the secondary school estate*, Session 2008-09, HC 135, National Audit Office, February 2009.

Effective accountability, project assurance and empowerment

2.11 The Treasury and departments have had a range of valuable project assurance processes. Many of these processes, such as departmental private finance units, relate specifically to PFI. Our work has reinforced the need for ongoing independent scrutiny and challenge to decisions, concluding that:

- Government needs an independent system of assurance based on a higher evidence base than has been previously available.
- Because of the complexities and the passage of time, projects need to be regularly reviewed and may well need to change as they are being developed, for example if new solutions to the service need emerge or the costs of the project become unaffordable.

2.12 Good project assurance also needs the power to stop a project, or ask for significant changes, if it is not value for money. Our investigation highlighted no examples of red rated projects being stopped as a result of a Gateway Review.[29] The Cabinet Office and Treasury are seeking to strengthen project assurance through the recently created Major Projects Authority, which will focus on non-PFI projects, and the ongoing Treasury reviews of large PFI projects.

2.13 In 2006, we reported that major projects and capital programmes had not always received appropriate review at all stages of the Gateway Review process.[30]

2.14 Each local body is empowered to manage its affairs, but their projects are often part of nationwide programmes, where central government has oversight of the whole programme and may be providing financial support.

2.15 In our PFI in housing report, we noted a lack of clarity over the role of the Department of Communities and Local Government and the Homes and Communities Agency. Local authorities told us they did not always understand the functions of the different management bodies involved. In particular, different bodies sometimes requested the same information, resulting in confusion and duplication of work.[31]

29 The Office of Government Commerce process that examines and rates programmes and projects at key decision points in their lifecycle. A red rating signifies that, to achieve success, the programme or project should take immediate remedial action.
30 Comptroller and Auditor General, *Delivering successful IT-enabled business change*, Session 2006-07, HC 33, National Audit Office, November 2006.
31 Comptroller and Auditor General, *PFI in Housing*, Session 2010-11, HC 71, National Audit Office, June 2010.

Challenge to obtain better deals

2.16 We and the Committee of Public Accounts have repeatedly raised concerns about the lack of challenge to decisions on alternative methods of procurement. Appropriate challenge should make sure that decisions are taken on value for money criteria, rather than accounting treatment reasons. Under the accounting rules until April 2009, there was an incentive to use PFI as most projects did not appear on departmental balance sheets and were excluded from calculations of national debt. Our recent report on the procurement of Future Strategic Tanker Aircraft also highlighted how departments may be incentivised to use PFI because of affordability pressures on their capital budgets.

2.17 From April 2009, the public sector has adopted International Financial Reporting Standards to produce their accounts, and as a result, the majority of PFI projects are now included within the balance sheets of individual bodies. There remains an incentive to use private finance over other procurement options, however, as the rules still exclude PFI from statistical calculations of Public Sector Net Debt.

2.18 There is a need to revisit decisions and subject them to challenge where there are significant changes in market conditions. In 2010, we highlighted that bank finance costs had increased by 20-33 per cent. Whilst the Treasury had taken some action to consider the possible impact of these higher financing costs, it had not required a fully evidenced evaluation of the impact on all PFI contracts let in 2009.[32] Bearing in mind that business cases often showed marginal savings from using PFI, the Committee of Public Accounts recommended that the Treasury should intervene after any significant change in costs to assess whether PFI deals should go ahead.

2.19 Internal challenge alone is insufficient to provide assurance that a project or programme is best placed to deliver to time, cost and quality. Certain projects should have been subject to further independent challenge within Government, for example:

- The Highways Agency's calculations to support its decision to go ahead with widening when, in our opinion, there was a potential better deal. We estimated that a conventionally procured hard shoulder running option, with a more challenging approach to conventional operation and maintenance costs, could potentially have saved up to £1.1 billion (with some expected associated loss of benefits).

- The Paddington Health Campus Scheme was a complex scheme to build a health campus in north-west London with state of the art clinical accommodation. The scheme collapsed, however, after five years and £15 million had been spent trying to develop a robust business case.[33]

32 Comptroller and Auditor General, *Financing PFI projects in the credit crisis and the Treasury's response.*
33 Comptroller and Auditor General, *The Paddington Health Campus Scheme*, Session 2005-06, HC 1045, National Audit Office, May 2006.

2.20 The Olympic Delivery Authority followed best practice for the 2012 Olympics by actively seeking independent and expert challenge on its procurement activities. As well as participating in the Office of Government Commerce Gateway Reviews, the Authority established an external assurance unit to scrutinise its major procurement activities.[34]

34 Comptroller and Auditor General, *Preparations for the London 2012 Olympic and Paralympic Games: Progress report 2008*, Session 2007-08, HC 490, National Audit Office, June 2008.

Part Three

Delivering the intended outcomes

3.1 Once contractual arrangements have been entered into, it is essential to monitor the delivery of the intended outcomes. This needs to be done both on individual projects and at the programme level where there are many projects delivering the same services. For the public sector to act as an intelligent customer, it must assess whether projects are delivering the intended outcomes and then take action if they are not.

The use of data in the delivery phase

3.2 It is clear that public bodies need good quality data to gain assurance that intended outcomes are being delivered. Individual PFI contracts set out rigorous performance management mechanisms. There is, however, a less systematic approach to gathering performance information at the programme level. The Committee of Public Accounts noted in its report on PFI in housing and hospitals that a lack of good quality, centrally held, performance and cost data undermines departments' ability to monitor performance, to drive efficiency savings and effectiveness improvements, and to target support to local providers. For example, the Department of Health was unable to explain to the Committee why catering costs per patient per day, including delivering and serving the food, varied significantly (from £3 to £12). It did not know whether services provided more cheaply in some locations were better value for money, or alternatively poor quality, or reflected inconsistencies in the way costs were recorded.[35]

Making best use of skills and experience

3.3 In 2009, we highlighted contract management skills as one of the priorities across Government which needed attention.[36] In our report on PFI in hospitals we found that most NHS Trusts were managing their contracts well day-to-day but needed support with certain complex issues. The Department of Health's Private Finance Unit had provided valuable guidance and advice. It had also convened meetings of NHS Trusts where they could share experiences. The Department told the Committee of Public Accounts that its central team overseeing the programme of PFI hospitals was now smaller. It hoped, however, that NHS Trusts would contribute financially to a club which would procure contract management support.

35 Committee of Public Accounts, *PFI in Housing and Hospitals*.
36 Comptroller and Auditor General, *Commercial skills for complex government projects*, Session 2008-09, HC 962, National Audit Office, November 2009.

3.4 On the M25 project, the Highways Agency's reliance on advisers built up over time as the Agency lost key staff. This risked the advisers controlling projects and holding too much project knowledge.[37]

3.5 A central coordinating role drawing on accumulated experience can assist the delivery of intended outcomes and the achievement of value for money. This approach has been effective for PFI projects, where the Treasury has added significant value by standardising contracts. The Treasury also took action in 2008 and 2009 to maintain a flow of PFI contracts to stimulate national and local economies whilst continuing to apply standard PFI value for money tests. Part of its action was to set up The Infrastructure Finance Unit which was available to lend to projects to address the scarcity of debt finance.

3.6 Specialist private finance units within departments have generally provided helpful support to projects by staff who have experience of PFI issues. The Treasury and the National Audit Office have jointly set out a model of the current best practice of how departments are managing PFI programmes.[38]

Effective accountability for delivery

3.7 A key feature of PFI is that the private sector provider does not receive any payment until the underlying asset is constructed and services start to be delivered. This feature is intended to incentivise prompt and effective delivery. There is some evidence that this incentive is effective. National Audit Office surveys in 2003 and 2009 found, for example, that the majority of PFI contracts deliver to the time and cost expected by the public sector. There is also some evidence that the pre-tender stage may take longer, but there is a lack of comparable data across sectors as to why this may be the case.

3.8 Effective accountability in delivering intended outcomes is not just a question of delivering what the contract requires. It is also important to consider the entire project duration from initial identification of need through to final delivery. Previous plans on when services will come into operation are undermined if there are delays in achieving contract signature. There have been significant delays identified in recent National Audit Office reports:

- The Future Strategic Tanker Aircraft procurement took over nine years between initial work and signing date. The overarching cause of the delay was the scale and complexity of the deal. Specifications for a complex new service delivery model evolved until late in the procurement. We identified poor governance and oversight of the project in its early stages, with the Senior Responsible Owner not appointed until eight years after the project was first advertised to industry.[39]

37 Comptroller and Auditor General, *Procurement of the M25 private finance contract.*
38 National Audit Office and HM Treasury, *Managing complex capital investment programmes utilising private finance*, March 2010.
39 Comptroller and Auditor General, *Delivering multi-role tanker aircraft capability.*

- We noted delays of between 5 and 61 months in our sample of housing PFI projects, with average delays of 30 months. Local authorities' estimates of the time needed to procure projects were overly optimistic and some requested change to standardised contracts, which had to be approved centrally, adding to the delay. The time taken to approve business cases centrally had increased too, reflecting the Treasury's insistence on more robust scrutiny.[40]

Our experience of conventionally procured major public projects is that over-optimism was also common in estimating the likely time and cost of the pre-procurement phase.

3.9 Long procurement times can have a financial impact. Private sector bid costs will increase which may feed through into future contract prices. And, unless departments have engaged their advisers on a fixed price contract, delays at the pre-tender stage have significant cost implications for departmental consultancy budgets.

3.10 Delay risk adds to the risk inherent in any long-term project, which project assurance should address: that the outcomes initially intended from a project may no longer meet updated business needs. Changes in policy or other factors may affect the volume or nature of the services needed. In 2008, we highlighted this and the associated risk that the private sector may charge high prices for variations.[41] Further examples are:

- In our report on the BBC's management of three major estate projects, we found that the detailed scope of the three projects was not fully defined at the outset and there was a lack of control over contract variations on two of the projects.[42]
- In 2005, Brighton and Hove Council decided to close the College of Media, Arts and Technology as a result of falling rolls. The school was removed from the PFI contract at a cost of £4.5 million to the authority.[43]

The issue of whether an asset will be used for its full life is particularly important in PFI contracts because termination costs would include breaking long-term service contracts.

40 Comptroller and Auditor General, *PFI in Housing.*
41 Comptroller and Auditor General, *Making Changes in Operational PFI Projects.*
42 Comptroller and Auditor General, Report to the BBC Trust's Finance and Compliance Committee, *The BBC's management of three major estate projects*, January 2011.
43 Education and Skills Committee, Sixth Special Report of Session 2006-07, *Sustainable Schools: Are we building schools for the future?: Government response to the Committee's Seventh Report of Session 2006-07*, October 2007.

3.11 There are two further aspects of accountability to consider: evaluation and transparency over investors' returns.

- **Effective accountability** must include rigorous evaluation of the delivery of projects and programmes. In our report on PFI in housing, we found that the Department for Communities and Local Government's evaluation of the PFI programme was limited, partly because of delays and difficulties in collecting consistent data. The Department for Communities and Local Government told us it has now taken steps to improve data for evaluating PFI in housing. In our report on PFI in hospitals, we concluded that evidence indicated that PFI hospital contracts were achieving the value for money expected at the point the contracts were signed. But we also noted that the Department of Health's programme evaluation and support to projects had been limited by a lack of cost and performance data. As the subsequent Committee of Public Accounts report identified, local procuring authorities will be at a disadvantage compared to the private sector, unless departments provide sufficient central evaluation and support.

- **Transparency over investors' returns** and the investors' experience of managing the risks transferred to them in PFI contracts are not currently part of the Treasury's evaluation of the PFI programme. There is no contractual requirement for investors to disclose their returns, which might turn out to be more or less than they had initially expected, other than when refinancing. This is an issue which we expect to return to in our future work.

Part Four

Getting better outcomes for less

4.1 To achieve value for money, particularly given the current public finance constraints, Government must look to secure better commercial arrangements – both in new contracts and in existing projects. Getting better outcomes for less requires a mindset prepared to challenge and improve previous arrangements. In most cases, this will require public sector officials working collaboratively with their private sector counterparts, on both projects and programmes, to examine issues such as:

- the nature of the services required and how they might best be delivered;
- how the private sector can be incentivised to identify efficiencies where cost savings can be shared with the public sector; and
- how the Government can secure prices which recognise the volume of business it makes available to the private sector.

The use of information to drive better outcomes

4.2 In order to get better outcomes for less, the Government needs to have information on the range of contracts across Government. Information is particularly needed on the number of contracts and range of prices for similar items and the volume of business with particular suppliers. There are nearly 50 professional buying organisations procuring similar goods and services in Government. As a result, there is a risk that Government is not achieving the best prices based on its total volume of business. One of the positive features of PFI is that there is a database of some key information on most PFI contracts.

4.3 The Office of Government Commerce's Collaborative Procurement Programme, established in 2007, has led to some real improvements in the way public bodies buy goods and services. These include the introduction of framework agreements to cover the procurement of particular types of goods or services from pre-approved suppliers over a fixed period of time. However, a number of outstanding issues limit the efficiency improvements delivered. These include poor information which prevents evidence-based procurement decisions.[44]

44 National Audit Office and Audit Commission, *A review of collaborative procurement across the public sector*, May 2010.

Commercial awareness

4.4 The achievement of better outcomes for less is dependent on a cadre of suitably experienced commercial staff who can devise strategies for improving value from programmes and projects. The establishment of Private Finance Units to advise PFI project teams is an example which may be relevant to other areas of procurement. Achieving better outcomes for less also requires an ability to work collaboratively with the private sector. NHS Local Improvement Finance Trusts, for example, also 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.

4.5 Shortages of staff with appropriate commercial skills and experience placed the public sector at a disadvantage when managing contracts and negotiating contract variations. As we reported in 2008, this can result in opportunities for securing better value for money being missed and risk may not be managed effectively.[45]

Challenge to obtain better deals

4.6 The Government has significant purchasing power. It could use its purchasing power to negotiate better outcomes. Unless, however, it adopts a coordinated approach, the risk is that departments and public bodies fail to optimise this power. On PFI hospitals, the Committee of Public Accounts recently concluded that the Department of Health, by not negotiating with investment funds centrally, was not using its buying power to leverage gains for the taxpayer. The Committee noted that specialist investors have interests in large numbers of PFI projects. One fund has a substantial portfolio of hospital projects, giving it the prospect of economies of scale, with no corresponding benefit to the public sector.[46]

4.7 There has previously been little opportunity for public authorities to obtain further efficiencies during PFI contract periods which can be thirty years or more. There has generally been little evidence of a collaborative approach to identifying efficiencies with little use of open book accounting of private sector costs.

4.8 In recent months, the Government has sought to adopt a more challenging approach triggered by the current economic situation. The Cabinet Office has been in negotiation with Government's major suppliers and the Treasury has been speaking to PFI suppliers. In addition, in February 2011 the Treasury announced it is to pilot a review of a public sector hospital contract to identify savings and possible learning points for other projects.[47]

45 Comptroller and Auditor General, *Central government's management of major service contracts*, Session 2008-09, HC 65, National Audit Office, December 2008.
46 Committee of Public Accounts, *PFI in Housing and Hospitals*.
47 See http://www.hm-treasury.gov.uk/press_22_11.htm

4.9 Our PFI hospitals report recommended that NHS Trusts should work with their private sector partners to identify more efficient ways of delivering services where the cost savings can be shared. The Committee of Public Accounts recommended that the Treasury, in consultation with departments, should identify how value for money tests and incentives to improve maintenance could be built into the life of PFI contracts. The requirement for buildings being maintained to high standards over the life of the contract is supposed to be a key benefit of PFI. Yet around 20 per cent of NHS Trusts were not satisfied with the maintenance service. Services such as catering and cleaning are generally subject to value for money reviews during the contract period but maintenance is not. Maintenance contractors do not face the threat of losing the contract if they are uncompetitive.

4.10 It is not just in the operating and maintenance aspects of PFI deals that better outcomes can be obtained. The underlying finance also contains opportunities for better outcomes. In 2010, we estimated that the impact of the bank crisis on projects will continue to be felt over the next 30 years. Up to £1 billion of higher financing costs are potentially locked in for the life of recent projects compared to financing rates before the credit crisis. Higher financing costs are likely to persist throughout the operating period, even though the project operational phase normally represents a lower risk for lenders.[48]

4.11 The Committee of Public Accounts has asked the Treasury to find ways of lowering the cost of finance in the operating period. The Treasury previously acted on our reports, and those of the Committee of Public Accounts, to improve deals by arranging with the private sector that refinancing gains would be shared. If project finance rates improve, there may be the opportunity to refinance recent projects with high financing costs to reduce the cost of the projects to the public sector. Our report on the effects of the credit crisis recommended that the Treasury should consider portfolio refinancing to increase the potential refinancing gains, in which the public sector could share. The Committee of Public Accounts has also asked the Treasury to consider whether value for money would be improved by unbundling ongoing facilities services from the long contracts inherent in the PFI model.

48 Comptroller and Auditor General, *Financing PFI projects in the credit crisis and the Treasury's response.*

Appendix One

Scope and methodology

1 This report examined whether, based on our recent experience of PFI, the Treasury and departments acted as intelligent customers in overseeing procurement and management of PFI projects and programmes to deliver value for money. We draw on the findings from the five most recent National Audit Office PFI reports examined by the new Committee of Public Accounts (see Appendix Two).

2 We analysed the five National Audit Office and subsequent Committee of Public Accounts reports to identify the issues which were common to all reports. On the basis of the themes which emerged from our initial review of reports, we set out to analyse whether departments and the Treasury had acted as an intelligent customer in overseeing the procurement and management of PFI projects and programmes. A framework of questions was developed in order to analyse this question. These included whether the Treasury and departments had:

- **accurate data** needed to make informed choices; provide accurate estimates of time and cost; get 'better outcomes for less'; and secure value for money;
- **skills, capacity and experience** to assess whether complex major projects represent a good deal over the life of the contract;
- **effective accountability and project assurance with appropriate empowerment** to ensure that projects and programmes only go ahead where they will deliver value for money; and
- **challenged** the method of procurement, the scope of the deal and the business case assumptions **to identify opportunities for better deals.**

3 We used these themes within a framework to assess the National Audit Office's past reports to see if this was a common finding across Government. We also used this method to identify best practice and lessons learnt.

4 We also drew on other National Audit Office reports on non-PFI projects to further illustrate issues relevant to all projects:

- *The Efficiency and Reform Group's role in improving public sector value for money*, Session 2010-11, HC 887.
- *The BBC's management of three major estate projects*, Comptroller and Auditor General's Report to the BBC Trust's Finance and Compliance Committee, January 2011.
- *Assurance for high risk projects*, June 2010.
- *A review of collaborative procurement across the public sector*, National Audit Office and the Audit Commission, May 2010.
- *The Building Schools for the Future Programme: Renewing the secondary school estate,* Session 2008-09, HC 135.
- *Preparations for the London 2012 Olympic and Paralympic Games, Progress report 2008,* Session 2007-08, HC 490.
- *Central government's management of major service contracts,* Session 2007-08, HC 65.
- *Delivering successful IT-enabled business change,* Session 2006-07, HC 33.
- *The Paddington Health Campus Scheme*, Session 2005-06, HC 1045.

Appendix Two

The five PFI reports

Reports	Session	Scope of the report	Capital value	Financial close date	Contract length
Procurement of the M25 private finance contract	2010-11, HC 566	Highways Agency's 30-year private finance contract for widening two sections of the M25 motorway, and maintaining 125 miles of other roads and the Dartford Crossing.	£1.1 billion	May 2009	30 years
Financing PFI projects in the credit crisis and the Treasury's response	2010-11, HC 287	The effects of the credit crisis and the Treasury's response to it for government infrastructure PFI deals financed in 2009 and those yet to be financed.	£4.9 billion[1]	N/A	N/A
PFI in housing	2010-11, HC 71	Oversight of the housing PFI programme by the Department of Communities and Local Government, and the Homes and Communities Agency.	£4.3 billion[2]	N/A	N/A
The performance and management of hospital PFI contracts	2010-11, HC 68	The performance of the maintenance and support services and how they are managed once the buildings are open for use.	£6 billion[3]	N/A	N/A
Delivering multi-role tanker aircraft capability	2009-10, HC 433	Ministry of Defence's contract for air-to-air refuelling and passenger air transport, comprising 14 Future Strategic Tanker Aircraft, infrastructure, maintenance and training.	£2.6 billion	March 2008	27 years

NOTES

1 Includes the M25 private finance contract.

2 Sum total of central government credits awarded by the Department over six rounds between 1998 and June 2010.

3 As at April 2009.

Source: National Audit Office

A summary of the reports together with their conclusions can be found on our website.[49]

49 See www.nao.org.uk

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