



WORKING IN PARTNERSHIP

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WELCOME

to this first issue of PFI/PPP in Focus. The purpose of this publication is to give you an overview of key themes from our recent PFI/PPP studies and an update on our current work. It also highlights recommendations we have made and gives details of events we are running to promote good practice in PFI/PPP. I hope that you find it informative and useful.

Having joined the NAO in June 2005 from a career in the banking sector, I am now experiencing what it's like to be on the other side of the public private partnership and appreciating the challenges faced by the public sector when procuring and managing privately financed projects. Coming from a very large financial institution benefiting from high deal flow and teams of in-house specialists to advise on every aspect of a transaction, the contrast with a public authority undertaking perhaps their first and only PFI/PPP deal is striking. The work of the NAO in disseminating best practice through our reports, seminars and workshops has been and remains an important way of bridging the gap between the two parties.

The use of PFI and PPP continues to attract a great deal of attention and to excite a range of viewpoints. Irrespective of the wider debates about the merits of PFI and PPP deals, the role of the NAO is to provide independent and impartial analysis to Parliament. In total, we have published over 50 reports on a variety of PFI and PPP topics, covering deals with a combined value of over £77 billion. We continue to have an interest in the value for money obtained from individual deals and also in cross-cutting themes such as refinancing and benchmarking. Full copies of these reports and related materials are available from our website (www.nao.org.uk).

As part of our commitment to help departments bring about beneficial change we host an annual PFI/PPP conference (this year's will take place on 13th June 2006 – see page 14 for further details) and a range of workshops including our popular workshop on *Managing PFI Relationships to Achieve Success*. Further details of these events are set out in this newsletter. You may also find our recommendations database useful to your own work, and you can find this on our website.

Finally, as always, we welcome your input and ideas for areas that you think we should examine, and we are keen to respond to your needs. If you feel an NAO examination could improve the delivery of a service, help identify and spread good practice or highlight areas of concern, we would like to hear from you. Please do not hesitate to contact me directly at anna.simons@nao.gsi.gov.uk, or make contact with any other member of our PFI/PPP team.

Anna Simons

Anna Simons
Assistant Auditor General



RECENT NAO PFI/PPP REPORTS

Wider Markets Initiative (HC 799, Session 2005-06), 27th January 2006. This report looks at progress in implementing this initiative, which encourages public bodies to improve asset management and to seek opportunities for commercial exploitation of assets (see page 11 for further details).

Progress on the Channel Tunnel Rail Link (HC 77, Session 2005-06), 21st July 2005. Section 1 of the Channel Tunnel Rail Link (CTRL) was completed on time and slightly under target cost. Section 2 is on course to be completed on time and close to target cost. The report notes, however, that passenger revenues remain well-below forecasts and calls for new guidance as to how to make forecasts more realistic.

The refinancing of the Norfolk & Norwich PFI Hospital (HC 78, Session 2005-06), 10th June 2005. An example of an early refinancing which brought risks as well as benefits to value for money (see page 7).

Department of Health - Innovation in the NHS: Local Improvement Finance Trusts (HC28, 2005-2006), 19th May 2005. Our examination looks at whether LIFT is a suitable programme to support improved community-based health services that meet local needs while providing value for money. The report is positive about the benefits

of the innovative structure of LIFT - particularly the requirement that projects are agreed in the context of a local strategic plan and the flexibility it allows – but calls for the strengthening of accountability and performance measurement frameworks (see page 12).

Darent Valley Hospital: The PFI Contract in Action (HC 209, Session 2004-05), 10th February 2005. The report provides an update on what was the very first PFI hospital contract. The hospital opened two months early, to the price agreed in the contract and service performance has been satisfactory. The report highlights issues involved in developing better performance measurement systems, the senior management effort needed to manage a PFI contract in its early years and a refinancing (see page 8).

Accommodation for the Department of Work and Pensions: transfer of property to the private sector under the expansion of the PRIME contract (HC 181, Session 2004-05), 26th January 2005. The Department negotiated this deal with the existing contractor by introducing competitive tension into the negotiations. The outcome was £220 million cheaper than a credible commercial alternative.

CURRENT WORK IN PROGRESS

The following are expected to be published soon:

Update on PFI Debt Refinancing and the PFI Equity Market:

This provides an update report on how the new arrangements to share refinancing gains are working and recent developments in the PFI equity market (to be published on 21st April 2006 - see page 6).

National Physical Laboratory:

This report will look at the consensual termination of the PFI contract.

Evaluating the implementation of PFI:

This report will set out a methodology for evaluating the implementation of PFI across Government – see page 10 for further details.



THE NAO PFI/PPP TEAM

The NAO PFI/PPP team comprises around 20 professional staff under the direction of James Robertson, Patricia Leahy and David Finlay (see below). The team is made up of experienced public sector auditors and staff who joined the NAO from careers in banking, economics and private sector contracting

In addition to our core work of producing value for money reports, we offer a range of services to support our stated aim, which is to “help departments to bring about beneficial change to public services.” These include running workshops and conferences; and our website hosts a fully-searchable database holding all of the recommendations

made as a result of our work. We are also active on the international scene and chair the Working Group on the Audit of Privatisation for International Organisation of Supreme Audit Institutions (INTOSAI). Further details can be found on page 15.

We have deepened the independent assurance we seek when planning our PFI studies and when considering the conclusions reached to ensure that our reports are as helpful as possible for the Committee of Public Accounts and government departments. As ever, we would be interested in hearing your views on our work and on how we can help to improve the value for money of PFI and PPP deals.



JAMES ROBERTSON

Director of PFI

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James has been Director of PFI Value for Money Studies since January 2004. He is an economist by training and has worked previously in this capacity in the Employment Department, Department of Energy, Department of Trade and Industry, Department for Transport and, before joining the NAO in 1995, was Chief Economic Advisor to the Department for Education and Employment.



PATRICIA LEAHY

Director of PPP

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Patricia joined the National Audit Office in 1996 after working in the Treasury and investment banking. She has directed a range of PPP studies including three on the London Underground PPP as well as on the LIFT initiative for primary care services, the PPP for NATS, MoD's contract for the Defence Fixed Telecommunications System, the Radio Communications Agency's Joint Venture with CMG and the commercialisation of research. She has also carried out reports on privatisations and acquisitions.



DAVID FINLAY

Director of PFI Development

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David Finlay is Director of PFI Development at the National Audit Office and is responsible for the NAO's external relations with the PFI sector. He is a chartered accountant whose career has spanned both the private and public sectors. David was one of the founding members of the NAO's team of PFI specialists and has led many of their important PFI examinations. These include the recent NAO reports on the Darent Valley and Norfolk & Norwich PFI hospitals and their cross-government study on PFI refinancing. David also runs the NAO programme of workshops on managing PFI relationships.

FOCUS ON REFINANCING

Key findings:

- There have been refinancing opportunities on early PFI deals which have been successfully delivered.
- Refinancings can be complex and need careful scrutinising by the public sector.
- Any proposal which increases risk to the public sector needs to be rigorously assessed.

UPDATE ON PFI DEBT REFINANCING AND THE PFI EQUITY MARKET



In 2002 the government agreed with the private sector new arrangements which would provide for refinancing gains on PFI deals to be shared between the public and private sectors. In new deals refinancing gains would be shared 50/50. In deals already in existence the private sector agreed generally to provide the public sector with 30 per cent of any refinancing gain under the terms of a new voluntary code for the refinancing of early PFI deals. The new arrangements for sharing refinancing gains were introduced by the Office of Government Commerce which then had responsibility for PFI policy. Responsibility for PFI policy now rests with HM Treasury.

Our study has examined how the new arrangements to share refinancing gains have been applied to refinancings which have been completed since those new arrangements came into force. It also looks at the extent to which the OGC's estimates for amounts it expected the public sector to receive from sharing in PFI refinancing gains are being achieved. The NAO report will also cover recent developments in the PFI equity market including the emergence of the secondary market.

This report will be published on 21st April 2006



THE REFINANCING OF THE NORFOLK & NORWICH PFI HOSPITAL

HC 78, session 2004-2005, 10th June 2005

The refinancing of this deal generated gains, in net present value terms, of £115 million, and the internal rate of return to the shareholders of Octagon increased as a result: from 16 per cent to 60 per cent following the refinancing. The refinancing generated large gains for Octagon principally because they were able to significantly increase their external borrowings (from £200 million to £306 million). As these additional funds were not immediately needed to operate the project, this created cash resources which could be used to enable Octagon's shareholders to draw immediate benefits from the project, with the increased borrowings to be repaid out of planned profits later in the contract period. Octagon was able to secure better financing terms for a number of reasons: the risk of the enterprise was lower once the hospital had been successfully constructed, the PFI market was maturing, and borrowing rates had generally reduced.

In this early PFI hospital deal, the contractual arrangements had placed no obligation on Octagon to share any refinancing gains arising from the original deal. Octagon shared, however, approximately 30 per cent (£34 million) of its total refinancing gain with the Norfolk and Norwich University Hospital NHS Trust. This was in accordance with the voluntary code for sharing refinancing gains on early PFI deals which the Treasury had negotiated with the private sector in 2002. The Trust currently pays £37.8 million a year to Octagon.

There were, however, risks for the Trust in securing these benefits. It agreed to extend its minimum contract period by five years and accepted the possibility that its termination liabilities could increase by up to £257 million.

The NAO found that the terms of the bank finance for the original deal appear competitive for a bank financed deal at that time, although it might have been possible to improve the original deal. Alternative financing solutions were not seriously explored to ensure the financing terms remained competitive during a two year deal closure: this was because the Trust did not wish to further delay the project and was not convinced that the overall terms of the deal could be improved.

Following this refinancing, the Trust continues to pay a financing premium compared to current deals but, by entering into this deal in early 1998, it avoided construction cost inflation (which has been in excess of general inflation in recent years) and received the benefits of the new hospital early.

There are other factors, however, which could affect comparisons between the prices of early PFI deals and those of more recent deals. Some of these have yet to be fully analysed by the Department of Health, and the NAO recommends that the Department should carry out further analysis to identify how the pricing of all elements of PFI deals has changed over time, including whether the private sector is delivering cost efficiencies from their increasing experience of delivering PFI projects.

DARENT VALLEY HOSPITAL: THE PFI CONTRACT IN ACTION

HC 209, session 2004-2005, 10th February 2005

Darent Valley hospital was procured in 1997 under the first PFI hospital contract. It opened in 2000, two months early and for the price agreed in the contract. The PFI consortium THC Dartford has delivered the facilities and services the NHS Trust contracted for and to a quality that overall has been satisfactory. The Trust is also benefiting from a reduced annual contract price as a result of sharing in gains from a refinancing which THC Dartford completed in 2003.

The report notes that the shareholders of THC Dartford have received much earlier and larger benefits than had been projected when the contract was awarded. By increasing its level of borrowings, THC Dartford's refinancing yielded benefits, in present value terms, of £33 million. The Trust negotiated a £12 million share of these gains under what was one of the first applications of the new voluntary code for sharing refinancing gains which the Treasury and the private sector agreed in 2002. As a result of their additional benefits THC Dartford shareholders were able to realise £37 million at the time of the refinancing, just three years after the new hospital opened.

Although benefiting from the refinancing the Trust also faces new risks. The Trust agreed to extend the minimum contract period by seven years and to accept the possibility of increased liabilities in the event of the contract being terminated early. The Trust concluded that these arrangements were value for money taking into account that the new minimum contract period of 35 years is in line with current PFI hospital contracts and the Trust considered it very unlikely that the contract will be terminated early. But the NAO cautions that in future authorities should undertake further analysis before agreeing to a refinancing which involves increased levels of private sector debt and higher public sector termination liabilities.

On day to day contract management, the NAO concluded that, although the service performance overall was satisfactory, the Trust could have awarded lower performance scores leading to higher payment deductions for service lapses which occurred some in areas such as cleaning and catering. The NAO recommends that authorities should learn from the Trust's experience by eliminating, where possible, subjectivity in assessing performance to ensure that payment deductions are commensurate with the impact of poor performance on the authority and its patients. The NAO also pointed out that authorities should plan for the considerable senior management effort that will be needed in managing a PFI contract in the early years.



FOCUS ON ACHIEVING GOOD PRACTICE IN PFI/PPP

Key findings:

- A new NAO report will present an updated framework for assessing the design and implementation of PFI projects
- The Wider Market Initiative is under-employed and requires supportive leadership to succeed
- The LIFT model has delivered benefits, but the accountability and performance measurement frameworks need to be strengthened.

Current and recent studies with implications for good practice

A FRAMEWORK FOR EVALUATING THE IMPLEMENTATION OF PFI (in preparation)

The NAO is currently working to update a framework for assessing PFI deals first developed in 1999. The 1999 framework necessarily focused on issues arising during the procurement of deals rather than during the life of the contract as, at that time, few deals had entered into their operational phase. The updated version builds on the 1999 framework, drawing upon the experience of the many deals that have become operational since then.

The assessment framework is based on a matrix structure that divides the lifecycle of a PFI project into six phases (three before a deal is signed; three after) and six business management themes such as the fit with business requirements and risk allocation. An analysis sets out how the six business-management themes apply to each phase of the lifecycle, highlighting the key issues that an evaluator should consider in each area.

Whilst the framework is intended to be used for retrospective audit, it has the potential to be used also as a tool for the ongoing monitoring of projects. Service managers, lead project officers and Departmental Private Finance Units may all find it to be a useful tool: it provides a checklist and has been designed to complement but not replace existing guidance (such as that issued by the Treasury) or sound management of projects in general.

The report setting out this framework is expected to be placed on our website in May 2006.

Six phases of a PFI project

- Strategic Analysis
- Tendering
- Contract Completion
- Pre-operational Implementation
- Early Operational
- Mature Operational

PARTNERSHIPS UK - HM TREASURY: WIDER MARKETS INITIATIVE

HC 799, session 2005-2006, 27th January 2006

The Wider Markets Initiative began in 1999. The Initiative encourages government departments, agencies and non-departmental public bodies to make better use of their assets through the commercial exploitation of physical assets, including equipment, land and premises, and non-physical assets, such as intellectual property, data and skills. The main incentive is the right for departments to retain the revenues they generate.

From 2001, the Treasury contracted Partnerships UK to co-ordinate and promote this initiative. Performance across government has been patchy, however, with wider markets activities being conspicuous by their absence in many departments and agencies. Sir Michael Lyons commented a year ago that the Initiative was ripe for re-energising.

The report finds that most Wider Markets activities are taking place where the leadership has been supportive. These include projects that have had to overcome initial concerns about the suitability of the activity, or needed specific legal powers, before gaining business case approval. The benefits of successful wider markets activity include reducing the public sector's cost base and improving its skill base, leading to an enhancement of core public services.

Only one department in four, however, has actively promoted such activity so far and this has been as much driven by funding pressures as awareness of opportunities. A thorough assessment of wider markets opportunities is needed and should include the potential to market intellectual property, data-sets and know-how. Wider Markets activity requires further encouragement of a culture of well managed risk taking and the development of additional commercially skilled individuals.



DEPARTMENT OF HEALTH INNOVATION IN THE NHS – LOCAL IMPROVEMENT FINANCE TRUSTS

HC 28, session 2005-2006, 19th May 2005

An example of good practice in structuring a PPP is given by the NHS Local Improvement Finance Trusts (LIFT) model. Our examination addressed whether LIFT is a suitable programme to support improved community-based health services that meet local needs while providing value for money. The report is positive about the benefits of the innovative structure of LIFT – particularly the requirement that projects are agreed in the context of a local strategic plan and the flexibility it allows – but goes on to call for strengthening of accountability and performance measurement frameworks.

LIFT projects are designed to develop primary and social care services and facilities in England, funding for which has historically been inadequate and piecemeal.

Key recommendations from the NAO report include:

- When planning a new initiative, a systematic approach to evaluating advisory firms and the quality of contributions from individual advisors should be established. This would help achieve good quality advice and value for money.

- Effective reviews of Strategic Service Development Plans for LIFT schemes should be undertaken regularly, in accordance with Partnerships for Health guidance.
- Guidance about the initiative aimed specifically at key groups of stakeholders (in the case of LIFT – clinicians, Local Authorities, Primary Care Trust senior management and secondary and acute care colleagues) should be developed and disseminated.
- In the light of experience, it now seems that the accountability framework of LIFT could usefully be strengthened. It would be beneficial for the Department to establish principles and develop guidance defining responsibility for local oversight of the Strategic Partnering Board.

Topics the NAO will examine in 2006 include benchmarking and market testing. If you have had experience of this topic please contact David Finlay on 020 7798 7546 or david.finlay@nao.gsi.gov.uk

Can you identify good practice in your current work? If you can, we would be interested in hearing from you.

Please contact David Jackson on 020 7798 5477 or david.jackson@nao.gsi.gov.uk



BRINGING ABOUT BENEFICIAL CHANGE

The NAO is often perceived purely as a scrutinising body. However, our mission is actually to bring about beneficial change. This is why we devote a large part of our PFI work to promoting good practice, as you can see both from the reports outlined above and from our activities detailed on these pages.

PFI/PPP WORKSHOPS AND SEMINARS

As part of the NAO's commitment to help departments bring about beneficial change the NAO PFI/PPP team is able to offer a range of PFI/PPP training events to departments. These events can be run as workshops for individual project teams or seminars for larger groups of staff engaged in developing or managing PFI/PPP projects. The training events which can be provided are:

- **Managing PFI relationships to achieve success:** A practical workshop on improving public/private sector working relationships. Includes contributions from project leaders in both the public and private sectors and a business relationship expert.
- **An introduction to PFI/PPP financing (including refinancing):** A training event solely on refinancing can also be provided.

- **Senior executive briefing:** An overview of current PFI/PPP issues for senior officials including those who may have not previously been closely involved with PFI/PPP projects.

Since the 2004 launch, the NAO PFI/PPP team has now delivered over 20 workshops and seminars to project teams and departments including several NHS Trusts, the MOD, the Department of Transport, the Treasury Building and GCHQ PFI teams. Events have also been hosted by the Northern Ireland Audit Office, the Scottish Executive and the International Project Finance Association.

Further details and booking arrangements can be obtained from David Finlay, NAO Director of PFI Development, at david.finlay@nao.gsi.gov.uk

THE NAO CONFERENCE - 13 JUNE 2006

Each year, the NAO hosts a conference to discuss the latest findings from our reports and to consider the most topical and interesting developments in the PFI/PPP world. The event is well-attended with delegates coming from both central and local government bodies, consultancies, banks and other advisory bodies and from overseas.

This year's conference will take place on Tuesday 13th June 2006. It will be an interactive conference allowing those attending to vote on key issues and to pose challenging questions

to the panel of distinguished speakers. There will also be a series of specialist workshops on operational issues, financing, new forms of PPP and local community projects.

For details on how to book your place at the Conference, please visit the NAO website (www.nao.org.uk/conferences).

INTERNATIONAL WORK

The UK National Audit Office is an active member of the International Organisation of Supreme Audit Institutions, or INTOSAI.

We have a strong reputation for expertise in privatisation and public-private partnerships, and as such have chaired the INTOSAI Working Group on the Audit of Privatisation since it was formed in 1993. The role demands technical knowledge, credibility, and a touch of diplomacy too: the working group currently has 40 members (and growing), with great diversity in cultures, economic backgrounds, and legal and governance frameworks.

Our role as chair is to help identify and examine emerging issues, and to encourage members to share their knowledge and experience with the rest of the group. We organise

annual group meetings (most recently in Brasilia, in September 2005) and keep in regular contact with our fellow members.

The NAO is proactive in sharing its knowledge and experience of PFI and PPP with overseas bodies interested in assessing value for money. For instance, we have produced a set of guidelines on privatisation and related topics such as economic regulation and public-private partnerships. We have also started putting together a range of technical case studies to offer practical examples and advice to members.

More details of this aspect of the NAO's work can be found on the website at:

<http://www.nao.org.uk/intosai/wgap/home.htm>



GOT A QUERY?

NO TIME TO TRAWL THROUGH ALL OUR PUBLISHED INFORMATION?

TRY OUR PFI & PPP RECOMMENDATIONS DATABASE



THE DATABASE

Since 1997, we have published over 50 reports of our investigations into PFI/PPP deals. In these we have made around 1,400 recommendations covering a wide range of subjects related to these two important procurement fields. For the convenience of clients, contractors, financiers and others using, or interested in, PFI/PPP we have collected these recommendations into a database on our website, with the goal of it being used to support informed research.

KEYWORD AND TEXT SEARCHES

If you have a query about a PFI or PPP issue and want to discover what recommendations are relevant, you can search directly through the database. To aid your search we have classified our recommendations by pre-set keywords. We have also included a text search facility so that you can tailor searches to your requirements.

LINKS TO ELECTRONIC VERSIONS OF OUR REPORTS

The recommendations that correspond to your search criteria are referenced to the reports from which they are drawn. Your search may reveal a recommendation that you want to examine in the context of the related report. To help you, we have provided a link that will place the recommendation with others that appeared in the same report. A further link will take you to an electronic version of the particular report.

ADDITIONAL FEATURES

We have built two additional features into the database to provide you with more relevant information. The first is that PPP-related searches will also identify relevant recommendations drawn from our published investigations into privatisations. The second is the opportunity to search for PFI-related recommendations and conclusions drawn from the published reports of the House of Commons' Committee of Public Accounts, together with the related Treasury Minutes.

HOW TO FIND THE PFI & PPP RECOMMENDATIONS DATABASE

You can find our database of PFI and PPP recommendations at:
www.nao.gov.uk/recommendation

WWW.NAO.GOV.UK/RECOMMENDATION

WANT MORE INFORMATION ABOUT THE PFI & PPP RECOMMENDATIONS DATABASE?

Email us at: pfigroup@nao.gsi.gov.uk

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