



National Audit Office

**REPORT BY THE  
COMPTROLLER AND  
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# Lessons from PFI and other projects

# 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, notwithstanding 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.<sup>1</sup>

**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<sup>2</sup> 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,<sup>3</sup> 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.<sup>4</sup>

<sup>1</sup> See [http://www.nao.org.uk/publications/0809/private\\_finance\\_projects.aspx](http://www.nao.org.uk/publications/0809/private_finance_projects.aspx)

<sup>2</sup> The network and systems in energy, transport, digital communications, flood protection, water and waste management.

<sup>3</sup> Infrastructure UK, *National Infrastructure Plan 2010*, October 2010.

<sup>4</sup> See [http://www.hm-treasury.gov.uk/iuk\\_cost\\_review\\_index.htm](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<sup>5</sup>*
- *Delivering multi-role tanker aircraft capability<sup>6</sup>*

We 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).

<sup>5</sup> Referred to as PFI in hospitals.

<sup>6</sup> 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.<sup>7</sup> This was raised as a concern by the Committee of Public Accounts in their recent report on PFI in housing and hospitals.<sup>8</sup> 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,<sup>9</sup> 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

<sup>7</sup> See [http://www.nao.org.uk/publications/0809/private\\_finance\\_projects.aspx](http://www.nao.org.uk/publications/0809/private_finance_projects.aspx)

<sup>8</sup> Committee of Public Accounts, *PFI in Housing and Hospitals*, Fourteenth Report of Session 2010-11, HC 631, January 2011.

<sup>9</sup> 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,<sup>10</sup> 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.<sup>11</sup>

### **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,<sup>12</sup> 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<sup>13</sup> 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.

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

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

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

<sup>13</sup> *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<sup>14</sup> 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.

<sup>14</sup> 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.<sup>15</sup>

## 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.

<sup>15</sup> See [http://www.hm-treasury.gov.uk/iuk\\_cost\\_review\\_index.htm](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.