National Audit Office

Report
by the National Audit Office

HM Treasury

Savings from operational PFI contracts

29 NOVEMBER 2013

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Contents

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Key facts

684 PFI and PPP contracts in England within the scope of the government's PFI savings review	**£207 bn** remaining unitary charge on the 684 operational PFI and PPP projects (at June 2013)	**£1.6 bn** signed savings reported to HM Treasury by departments (at June 2013)

£1.3 billion	HM Treasury confidence adjusted estimate of savings in addition to the £1.6 billion of signed savings, which are in the process of being agreed (after allowing for slippage, non-realisation or both).
118	contracts making up the £1.6 billion signed and £1.3 billion pipeline savings reported to HM Treasury.
566	number of contracts that have not yet reported any savings to HM Treasury.

Summary

1 The private finance initiative (PFI) is a way to finance and provide public sector infrastructure and capital equipment projects. Under a PFI contract, a public sector authority pays a private contractor an annual fee, the ‘unitary charge’ for the provision and maintenance of a building or other asset. The unitary charge may also cover services such as cleaning, catering and security in relation to the asset.

2 The Treasury has identified 684 contracts in England for which public authorities are currently paying unitary charges, typically over periods of 25 to 30 years. At the end of the contract, the public authority generally owns the asset. The 684 contracts are largely PFI contracts, but also include a number of other forms of public-private partnership contracts. For simplicity, we refer to all these contracts as 'operational PFI contracts', throughout the rest of the report.

3 A Treasury review, begun in February 2011, concluded that savings of at least £1.5 billion were possible over the remaining life of the operational PFI contracts, as a result of, for example, effective contract management, or more intensive use of the asset. In July 2011, HM Treasury issued detailed guidance to departments and other public bodies ('authorities') to help them identify savings in their operational PFI contracts. In April 2012, the Treasury required departments to start reporting to it on a quarterly basis from July 2012 on their progress in identifying and agreeing savings. The Treasury relies on authorities to check their own data and submit accurate information. The procuring authority retains the savings rather than returning them to the Treasury or sponsoring department.

4 By June 2013, departments had reported £1.6 billion of signed savings from operational contracts ('signed' savings are those that have formal agreement and which the departments and Treasury believe are the most certain). Most of these savings are forecast future savings, which will be realised over the remaining years of the contract, rather than immediately. In addition, departments are also reporting 'pipeline' savings which are less certain than the signed savings, but which the contracting authorities hope to turn into signed savings in due course.

5 In line with the Treasury's methodology for recording and reporting savings, we present all figures in this report in nominal terms[1].

[1] Discounting to present values would result in lower values.

Scope of our review

6 The Treasury asked us to review the £1,603 million of signed savings. We assessed the reliability of signed savings by reviewing a sample of 15 savings reported to HM Treasury, which included the six largest signed savings and which in total accounted for £1,372 million (or 86 per cent) of the £1,603 million. We assessed whether reported savings were supported by 'sufficient evidence', 'partial evidence' or had 'insufficient evidence'.

7 We also set out to comment on the Treasury's overall approach to supporting departments and other contracting authorities to identify and report savings on operational PFI contracts, and highlight examples of savings to help stimulate the identification of further savings.

8 We carried out a high level review of key documents rather than a full audit. Our work is not intended to fill any gap in quality assurance by departments, or serve as a substitute for an internal audit service.

9 There are some limitations on the scope of our review. It is important to be clear that:

a. For the most part, the reported savings relate to reduced future payments and therefore are not fully 'realised' when they are reported. Our work enabled us to form a view on the quality of the evidence underpinning the forecast signed savings, but it does not provide assurance that these savings will in fact be realised.

b. Our work was limited to interviewing representatives of procuring authorities and reviewing documentary evidence. Our work is not intended to give assurance about the impact of these savings on front-line services.

c. Some risks that transfer to authorities as a result of these savings may materialise and may increase authorities' costs. We have assured ourselves that authorities have considered the risks associated with these savings and their potential effects, but we have not audited the authorities' governance or management of these risks and their associated costs.

d. We did not examine the impact of departmental reviews of contracts prior to signature, which in some cases have resulted in better value contracts (paragraph 2.7).

Key findings

10 **We conclude there is 'sufficient evidence' for £1,232 million of the forecast signed savings. These savings were supported by relevant and reliable evidence and realistic assumptions.** This represents 90 per cent of our sample value of £1,372 million (paragraph 1.18 and Figure 3).

11 **We conclude there is 'partial evidence' for £48 million of the forecast signed savings. These savings were supported by some evidence but there were some uncertainties or measurement issues.** This represents 3 per cent of our sample value of £1,372 million (paragraph 1.19 and Figure 3).

12 **We conclude there is 'insufficient evidence' for £92 million of the forecast signed savings, given our concerns about the evidence base.** This represents 7 per cent of our sample value of £1,372 million. The Treasury told us before our review began that one authority had notified it that a signed saving of £48 million was being contested by the contractor. Another saving of £37 million lacks any supporting evidence. A third authority reduced its reported saving by £7 million after reviewing its calculations in response to our review (paragraphs 1.20 and Figure 3).

13 **The savings 'pipeline' of £1.3 billion should deliver further savings**. We looked at a non-representative sample of four of those pipeline savings which are most certain (termed 'agreed' savings). Based on our understanding of these savings we conclude that the Treasury's approach to recognise only a proportion of the savings for internal purposes is reasonable. There is a reasonable prospect that in due course some savings in the pipeline will be converted into signed savings (paragraphs 2.4 to 2.6).

14 **Of the 684 operational contracts, 566 have not yet reported any savings to the Treasury.** These 566 contracts have a total remaining unitary charge of £151 billion. Some of these contracts may not have been fully examined for potential savings. This suggests there is scope to secure further savings (paragraphs 3.1 to 3.4).

15 **There is scope for the two departments that sponsor the largest number of operational contracts to make further savings.** Between them, the Department of Health and the Department for Education have oversight of 376 contracts (55 per cent of all operational PFI contracts), but they have so far reported only £63 million of signed savings or less than 0.1 per cent of the total remaining unitary charge of £93 billion since the start of the savings initiative. Both departments have a challenge in getting local bodies (NHS trusts and local authorities) to engage with the government's initiative which is being coordinated by the Treasury, but this is worth pursuing as there is likely to be scope for further savings (paragraphs 3.7 to 3.8).

16 **Authorities we spoke to said the Treasury's reporting requirement had prompted them to maintain their focus on securing savings.** Those authorities that have reported the largest savings are the ones with the greatest existing skills.

The Treasury's guidance is likely to be most useful for those authorities without existing expertise who are just embarking on a search for savings (paragraphs 3.9 to 3.11).

17 Many savings reported to date derive from more effective use of assets. We found £178 million (13 per cent) of the savings we looked at were from reduced outputs or services, but many savings were from making increased use of existing assets. For example, the Ministry of Defence secured a £16 million saving by using excess capacity on an Army construction vehicle contract to provide vehicles for the Air Force and Navy at minimal additional cost. Intensive asset usage is something that other authorities may be able to replicate (paragraphs 4.5 to 4.6).

18 Authorities need the right skills and capacity to identify and negotiate savings. For example, Transport for London (TfL) has the commercial skills and dedicated resources to evaluate contract alternatives, and has reported savings of £476 million across three PFI contracts. TfL already directly operates services outside of PFI arrangements and so is well resourced to deliver inhouse the services covered by some of its PFI deals. A lack of skills and capacity in other authorities may be limiting their ability to identify and deliver savings (paragraphs 4.7 to 4.8).

Recommendations

Departments and authorities should:

a. **Adopt a spend-to-save approach by devoting skilled resources to actively managing their operational contracts.** This is good practice and will help identify opportunities for savings.

b. **Maintain up-to-date corporate records and knowledge of their contracts** to support effective contract management.

c. **Agree all contract changes in writing to give certainty and clarity to all parties.**

d. **Seek partnerships with other public sector bodies that have successfully identified and agreed savings, if they lack expertise themselves**.

Departments and the Treasury should:

e. **Be proactive in identifying those local contracting authorities that have the potential to secure savings and offer them the support they need to bring savings to fruition.** This could include facilitating mentoring relationships between authorities with a track record of agreeing savings and those with weaker expertise in this area.

The Treasury should:

f. **Continue agreeing the potential for savings with individual departments, to encourage them to identify savings on the many contracts yet to report any savings.**

g. **Ensure transparency in public reporting of operational PFI-related savings**. When publicly reporting progress in securing savings, the Treasury should:

- make clear the total amount of savings which have been realised to date and the amount of savings which are forecast;
- require departments to identify those savings which have already been reported elsewhere and then ensure that this is reflected in the numbers which the Treasury makes public; and
- report any instances where signed savings which have been previously reported have materially reduced in value.

h. Coordinate the production and dissemination of case studies which set out good practice in the identification and negotiation of savings.

Part One

Savings from operational PFI contracts

1.1 The private finance initiative (PFI) is a way to finance and provide public sector infrastructure and capital equipment projects. Under a PFI contract, a public sector authority pays a private contractor an annual fee called the 'unitary charge' for the provision and maintenance of a building or other asset. The charge may also cover provision of so-called 'soft services' such as cleaning, catering and security services for the asset. The unitary charge is typically paid over a period of 25 to 30 years, and at the end of this period the public authority owns the asset. Most elements of the unitary charge are fixed when the contract is signed. However, the charges for soft services can be variable and are often reviewed every five years or so.

1.2 For the purpose of this report, operational PFI contracts are those where asset construction is complete and service provision has commenced. HM Treasury has identified 684 operational contracts within central and local government. As at June 2013, the total charge still to be paid on these contracts was £206.6 billion.[2]

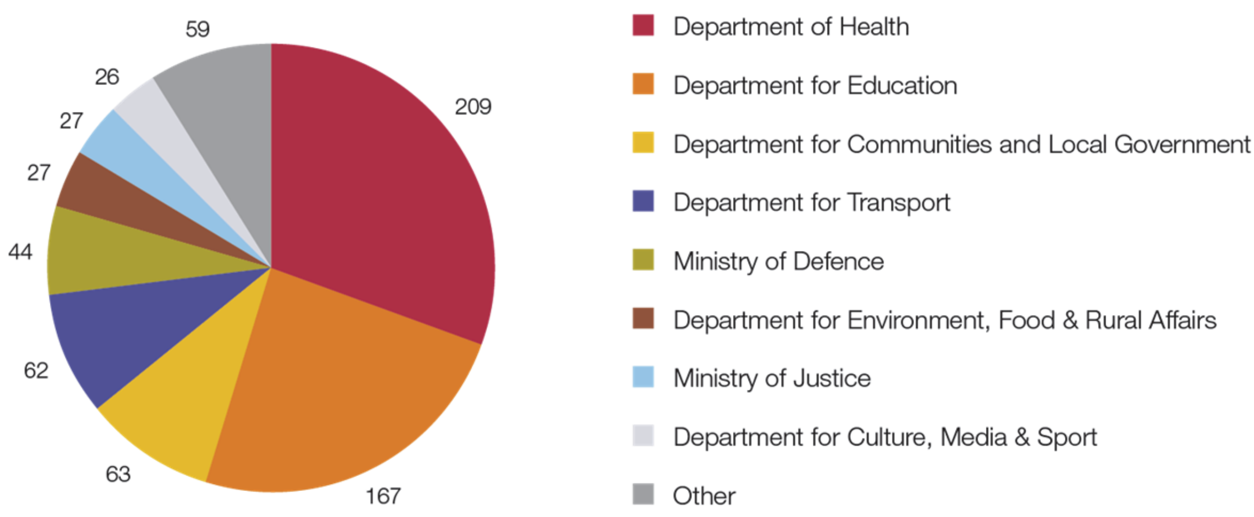
1.3 Two departments, the Department of Health and the Department for Education, sponsor more than half of all the operational PFI contracts. These departments provide part of the funding for many of the contracts that are managed by local bodies such as local authorities. The Department of Health sponsors 209 operational contracts and the Department for Education 167 contracts, see **Figure 1**.[3]

[2] The final unitary charge payment under these contracts is due in 2043-44.

[3] See Figure 5 for the full list of sponsoring departments

Figure 1

Number of operational PFI contracts by sponsor department



NOTES

1. 'Other' contracts are held by the Home Office, Department for Business Innovation & Skills, Department for Work & Pensions, HM Revenue & Customs, Cabinet Office, Department of Energy & Climate Change, Foreign & Commonwealth Office, HM Treasury and local authorities.
2. The value of the total remaining unitary charge by department is given in Figure 5.
3. For the purpose of this Figure, departments are deemed sponsors of a particular contract if it falls within the sector for which they have policy responsibility. Central Government departments have directly procured 110 contracts, while 574 contracts have been procured through local bodies.

Source: National Audit Office analysis of Treasury data

Pilot to identify savings

1.4 In February 2011, the Treasury's Infrastructure UK team, working with the Cabinet Office's Efficiency and Reform Group, launched a pilot review to assess potential for securing savings on operational PFI projects. The pilot looked at three Ministry of Defence projects and one Department of Health project. It was part of a wider review of public sector contracts arising from Sir Philip Green's efficiency review.[4]

[4] Efficiency Review by Sir Philip Green, 11 October 2010.
www.gov.uk/government/uploads/system/uploads/attachment_data/file/61014/sirphilipgreenreview.pdf

1.5 The pilot exercise concluded that significant savings were possible, and a commitment was made in July 2011 to secure at least £1.5 billion worth of savings from operational PFI contracts[5]. No timeframe was set for the achievement of these savings. The three main areas of savings identified were:

a. effective management of contracts, for example by reducing wasteful energy consumption, or ensuring that alongside the contractor the public authority takes a share of cost reductions (e.g. lower insurance premiums);

b. making efficient use of space, for example by subletting or mothballing surplus building space;

c. reviewing soft service requirements, to ensure the public authority does not buy more than it needs (e.g. frequency of window cleaning and redecoration).

Main savings exercise

1.6 In July 2011, the Treasury asked all Whitehall departments to examine their operational PFI contracts and to encourage the authorities they sponsor to do the same. The Treasury issued detailed guidance to help authorities identify potential savings.

1.7 By June 2013, 13 departments had reported a total of £1.6 billion of signed savings to the Treasury (see **Figure 2**). This £1.6 billion of savings came from 65 of the 684 operational contracts. Savings are described as 'signed' either when any agreed changes are supported by a signed contract variation, or in the case of savings that do not require contract amendment where there is other good documentary evidence backing up the claimed saving, for example, a contract to sublet surplus building space. All savings are reported in nominal rather than real terms.

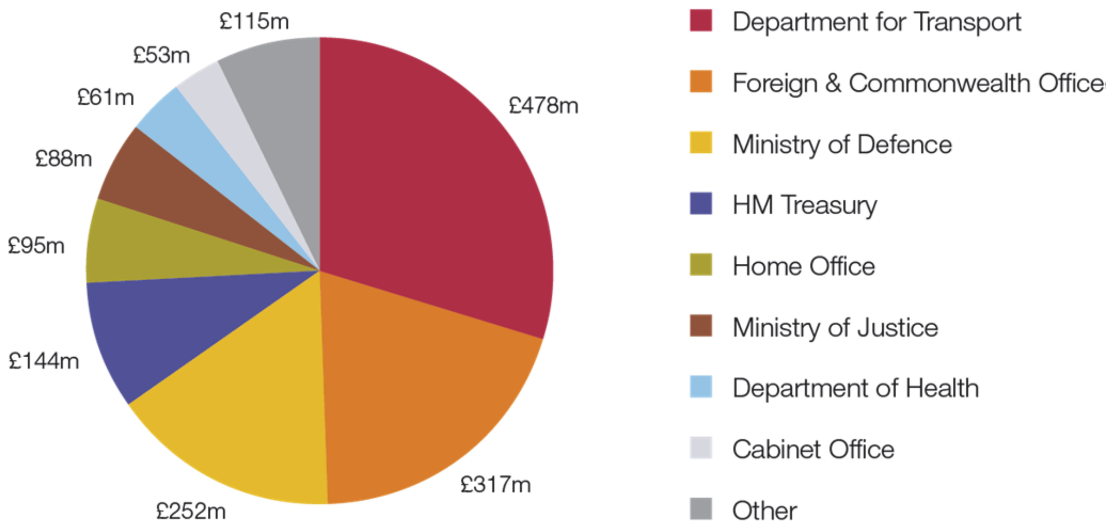
1.8 Although the savings are reported by public authorities to the Treasury, authorities have an incentive to identify savings, since they can retain any savings rather than returning them to the Treasury.

1.9 Departments report their progress in identifying and securing savings to the Treasury quarterly.

[5] Speech by the Commercial Secretary to the Treasury, Lord Sassoon, to the UKTI & Canadian Council for Public-Private Partnerships Roundtable on Exporting Public-Private Partnerships Expertise to Global Markets, 20 September 2011.

Figure 2

Source of signed savings of £1.6 billion, by sponsor department



NOTES

1. 'Other' reported signed savings come from: Department for Work & Pensions, Department of Energy & Climate Change, Department for the Environment, Food & Rural Affairs, Department for Education, and HM Revenue & Customs.

Source: National Audit Office analysis of Treasury data

1.10 The Treasury told us it does not have the resources to check the accuracy and validity of reported savings. However, it has issued guidance on the criteria and basis for calculating savings, and asks authorities to carry out their own due diligence and exercise appropriate caution when reporting savings. It also told us that it seeks assurance where it has concerns over reported figures, and requires authorities to report to it any changes in the status, basis or value of savings. Following the publication of this report, the Treasury has said it will share good practice with authorities to encourage further cost savings.

1.11 The Treasury's reporting requirements include a mechanism to identify savings already reported elsewhere, and so avoid double counting. For transparency and public confidence in the reported numbers it is important that any savings previously reported elsewhere are explicitly identified.[6]

[6] For example, rental income from subletting space in the Treasury building has been reported as part of the Efficiency and Reform Group savings and is also included in the £1.6 billion operational PFI savings. This will need to be made clear in any public announcement of signed savings.

Our approach

Assurance categories

1.12 We used the following assurance categories to indicate our assessment of the reported savings:

- **Sufficient evidence.** The calculations for the saving are clear, the evidence base is available, any assumptions made are realistic, measurement uses strong benchmarks (e.g. recent, actual cost data) and sufficient prudence has been exercised.
- **Partial evidence.** The saving has some uncertainty or the evidence base is not clear. For example if there is no recent or actual cost information to draw on, a best estimate of future avoided cost has been used.
- **Insufficient evidence.** The saving is not supported by documentary evidence, or the estimates or assumptions are unrealistic or contested.

Impact on frontline provision

1.13 The National Audit Office’s focus is on sustainable value for money, which we define as the optimal use of resources to achieve the intended outcomes. It is important to make clear how we are using the term 'efficiency' in this report. We used the following three categories to distinguish the extent to which outputs and outcomes would be affected by the savings we examined:

- **Cash-releasing efficiency savings:** These savings involve an expected reduction in costs while maintaining the same outputs or outcomes.
- **Other efficiency savings:** These savings generate an expected improvement in the outputs or outcomes delivered, while the cost is maintained at the same level or reduced. Savings in this category are the ones where we have been unable to identify the extent to which they are cash releasing, if at all.
- **Cash-releasing scope reductions:** These savings involve a reduction in outputs or outcomes in order to reduce costs. This type of saving does not typically improve value for money, although it does free up resources that can be used for other purposes.

Nature of our review

1.14 Using the Treasury's dataset, we selected a sample of 15 savings reported as having been signed. These savings covered £1,372 million (or 86 per cent) of the total £1,603 million savings. **Appendix One** gives further information on our methodology.

1.15 We reviewed the evidence underpinning each of the 15 savings, including the evidence relating to the maintenance of outputs and outcomes, in order to classify the savings by assurance category and impact on frontline provision. For this assurance exercise, we conducted a high level review of key documents rather than an in-depth audit.

1.16 Most savings are forecasts calculated over the remainder of the contract and although some savings start to accrue immediately many will only be realised during the remainder of the contract. This means that cash-releasing savings refer for the most part to future avoided costs[7].

1.17 Appendix Two sets out principles that we expect to see in reporting savings from operational PFI contracts.

Our findings on signed savings

1.18 We found there was sufficient evidence to support £1,232 million of the £1,372 million of the forecast savings we examined (or 90 per cent of our sample population). The calculations for the savings were clear, the evidence base was available and any assumptions made were realistic. Where benchmarks were used there was a strong evidence base. Our full findings are shown in **Figure 3.**

Figure 3

Overall findings from our sample

	Cash-releasing efficiency savings £ million	Other efficiency savings £ million	cash-releasing scope reductions £ million	Totals £ million
Sufficient evidence	801	253	178	1,232
Partial evidence	Nil	48	Nil	48
Insufficient evidence	92	Nil	Nil	92
Totals per saving type	893	301	178	1,372

NOTES

1. Assurance levels are defined in Appendix One and are discussed in paragraph 1.12.
2. A number of the savings reported were a mixture of cash-releasing efficiency, other-efficiency and cash-releasing scope reduction elements, and those savings have been split accordingly in the table.

Source: National Audit Office analysis

[7] It was not possible to calculate annual cash-releasing savings because of the many categories of reported data.

1.19 There was partial evidence for £48 million of the savings we looked at or 3 per cent of our sample population. The basis for determining the value of these savings is subject to some uncertainty because, in the absence of actual cost data, they are based only on an estimate of costs saved. All of these savings fell into our category of 'other efficiency savings' and were the result of good contract management which enabled authorities to get more benefit from their contracts for no additional cost.

1.20 Overall £1,280 million of the savings we looked at (or 93 per cent of our sample population), were supported by sufficient or partial evidence. However, we also found that £92 million (or 7 per cent) of the reported signed savings from the sampled population of £1,372 million lacked sufficient evidence. The £92 million arose from three cases which are described below:

- In the first case, HM Treasury told us at the start of our review that one authority (a department) had notified it that a signed saving of £48 million was being contested by the contractor. The contractor and department had agreed a two-year interim deal on indexation on the contract. The intention was to conclude a final agreement on indexation at the end of the two years. In its calculation the department assumed the lower cost base at the end of the two-year period would continue through to the end of the contract, which would lead to future savings of £48 million. However, the contractor contends that at the end of the two-year period, the contract cost base will revert to the level it would have been without the two-year adjustment. The department is currently in negotiations with the contractor to resolve this matter. This demonstrates the importance of making a clear written record of discussions with contractors.
- In the second case staff turnover and poor record keeping meant the current postholder could not locate any documentation or other form of 'corporate memory', to support a £37 million reported signed saving.
- In the third case, an authority reviewed the benchmarks used to calculate the savings on one very large contract and, in response to our review, reduced a saving of £315 million by £7 million (amounting to 2 per cent of the saving).

1.21 The population of savings making up the £1.6 billion is not homogenous, as the nature of each contract and the savings derived vary from contract to contract. Furthermore, we excluded the smallest savings from the population before picking our sample (to avoid the selection of small savings, which would incur an excessive audit burden). However, if we were to assume the same rates of savings identified from our sample of 15 savings apply to the total population it would indicate that there is sufficient evidence for approximately £1,440 million (90 per cent) of savings, partial evidence for £60 million (3 per cent) of savings and insufficient evidence for £110 million (7 per cent) of the total reported forecast savings.[8]

[8] Figures are rounded to the nearest £10 million to avoid spurious accuracy. Therefore figures do not sum to the total £1,603 million reported forecast savings.

Part Two

Savings in the pipeline

2.1 Alongside data on signed savings, the Treasury also gathers data quarterly from departments on 'pipeline' savings. These savings are not as certain as signed savings but are savings that authorities hope to turn into signed savings in due course. HM Treasury does not report publicly on the savings 'pipeline', but uses the information to monitor potential future savings for internal briefing purposes.

2.2 Because pipeline savings have a degree of uncertainty, the Treasury does not score them in their entirety as reported by departments. Not having a signed contract amendment means there is a risk that, prior to signing, a deal might change materially from the current agreement or fall through entirely. By recognising only a proportion of the pipeline savings, the Treasury allows for slippage and/or material adjustment to the savings, so as to prevent the value of the pipeline being overstated. Treasury refers to this adjustment as a confidence adjustment. As of June 2013, the value of the confidence-adjusted savings 'pipeline' stood at £1,281 million.

2.3 **Figure 4** sets out the different categories the Treasury uses to classify its pipeline savings.

Figure 4

Composition of the savings pipeline

Treasury classification	Definition	Value of savings reported to HM Treasury	Proportion of saving recognised for internal Treasury reporting purposes (%)	Savings as at June 2013, after confidence adjustment
'Agreed'	The authority and contractor have agreed in principle to a saving, but it is not yet underpinned by a legally binding contract variation	£1,120m	70	£784m
'Identified'	The authority has internal or business case approval for discussion with the contractor	£408m	60	£245m
'Proposed'	The authority has proposed savings for internal review	£373m	50	£187m
'Ambition'	A preliminary planning estimate	£164m	40	£66m
Totals		**£2,065m**		**£1,282m**

Source: HM Treasury data at June 2013

Review of 'agreed' pipeline savings

2.4 We conducted a desk review of a non-representative sample of four of the 'agreed' savings. We looked only at 'agreed' savings because these are the pipeline savings that are reported as being closest to signature. We looked at:

- two larger ‘agreed’ savings that were awaiting signature and were each around £100 million in value; and
- two smaller ‘agreed’ savings from two sponsoring departments included in the main sample.

2.5 In the four cases we looked at, the unadjusted pipeline savings appear reasonable, based on the nature of the saving and the rationale set down in the business case. However, the timing and therefore the extent of the savings which may be secured remains uncertain:

- in one case, the timing of signature depends on the outcome of other commercial matters under negotiation and;
- in another case a detailed business case has been prepared in conjunction with the contractor, but is still pending final scrutiny by senior management before it is signed off.

2.6 There remains a risk that these savings do not proceed to signature. However, we conclude that the Treasury's approach which scores only a proportion of the savings for internal purposes is reasonable, although we have not sought to validate the percentages applied to the reported pipeline savings to generate the confidence-adjusted value. There is a reasonable prospect that in due course some savings in the pipeline will be converted into signed savings.

2.7 Some departments have reported savings that do not fall within the scope of this savings initiative, because either the savings were achieved between January 2010 to July 2011 (i.e., before the ministerial commitment), or they arise from departmental review of projects managed by bodies those departments sponsor, prior to contract signature. For example, the Department for Communities and Local Government intervened with a number of authorities to improve the value of contracts prior to signature resulting in £102 million of reported savings. We have not audited these savings.

Part Three

The extent to which savings have been sought

3.1 The savings reported by departments to the Treasury (both signed and pipeline savings[9]) derive from just 118 of the 684 operational contracts. The remaining 566 operational contracts have a total remaining unitary charge of £151 billion. The extent to which departments have engaged with HM Treasury to date varies significantly.

3.2 **Figure 5** shows the remaining unitary charge by department (according to Treasury data), the number of contracts that each department has (or which it sponsors), and the total signed savings each department has reported to the Treasury as at June 2013.

[9] Signed savings derive from 65 PFI contracts. Pipeline savings derive from 53 PFI contracts.

Figure 5

Departments' remaining unitary charge, number of contracts and reported signed savings

Department	Total remaining unitary charge (£ million)	Total number of operational PFI Contracts	Reported signed savings (£ million)
Department of Health	69,397	209	61
Ministry of Defence	37,498	44	252
Department for Transport	27,715	62	478
Department for Education	24,023	167	2
Department for Environment, Food & Rural Affairs	17,901	27	39
Ministry of Justice (note 1)	6,694	27	88
Department for Communities & Local Government	5,720	63	0
Department for Work & Pensions	3,606	3	49
Home Office	3,604	23	95
Other local projects (note 2)	2,384	2	0
HM Revenue & Customs	2,383	6	22
Department for Business, Innovation & Skills (note 3)	1,672	18	0
Department for Culture, Media & Sport (note 1)	1,625	26	0
Foreign & Commonwealth Office	1,451	2	317
HM Treasury	751	1	144
Department of Energy & Climate Change	93	2	3
Cabinet Office (note 4)	48	2	53
TOTAL	206,565	684	1,603

NOTES

1. This is the position as reported at June 2013, the Department for Culture, Media & Sport and the Ministry of Justice are in discussion with the Treasury over the number of schemes and allocation of sponsorship.

2. Two local regeneration projects do not have a departmental sponsor.

2. The Department for Business, Innovation & Skills has only two projects in the public sector. A further 16 projects which amount to 99 per cent of the remaining unitary charge are managed by Higher and Further Education institutions which are classified as private sector by the Office for National Statistics.

4. The Cabinet Office saving comes from cancelling a PFI contract. The value of the saving is more than the value of the contracts because, alongside the unitary charge, some ancillary costs have also been saved.

5. Figures based on HM Treasury data at June 2013, and do not reflect subsequent changes.

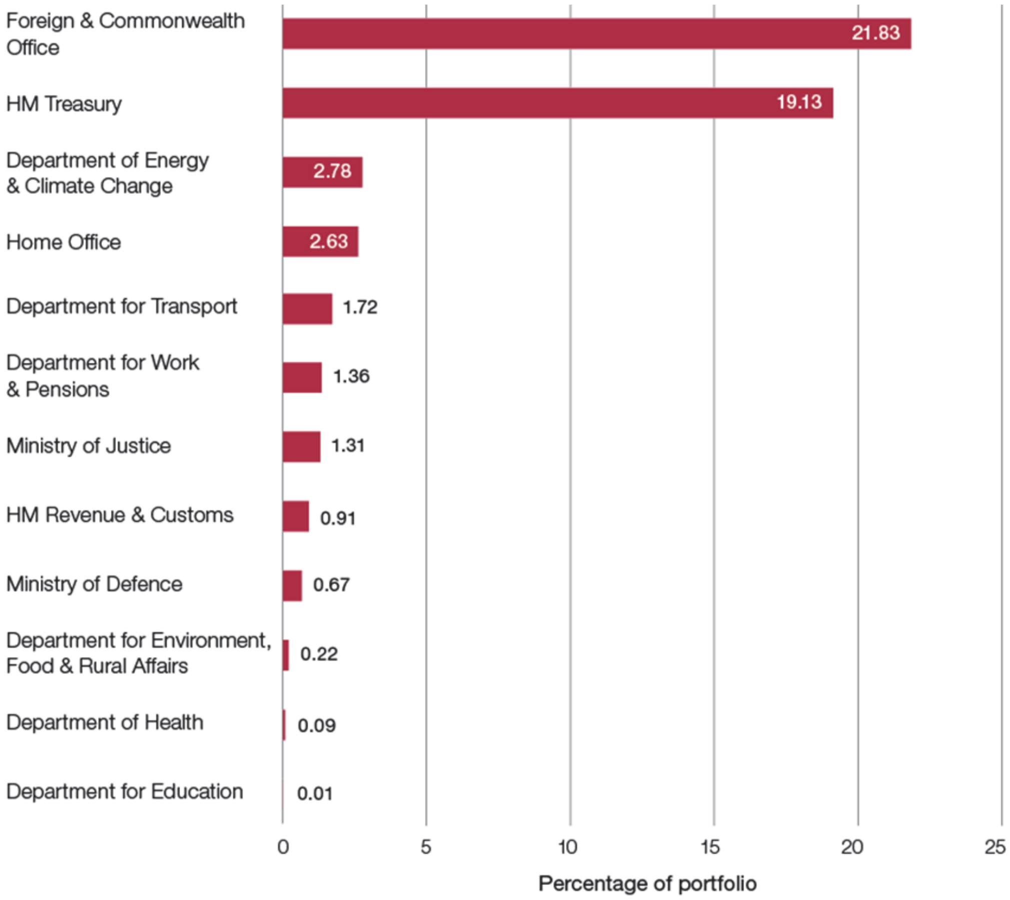
Source: HM Treasury data at June 2013.

3.3 The volume of contracts and the value of the total remaining unitary charge significantly varies by department. The Cabinet Office, the Treasury and the Foreign & Commonwealth Office have all reported savings in excess of 20 per cent of the total remaining value of their operational PFI contracts. The savings reported by the Foreign & Commonwealth Office and the Treasury relate to more intensive use of accommodation use.

3.4 **Figure 6** shows, by department, the value of signed savings reported to the Treasury as a percentage of the value of the total remaining unitary charge for that department's operational PFI projects. Thirteen departments out of 16 have reported savings of less than 3 per cent of the value of their total remaining PFI unitary charge. Three departments (the Department for Business, Innovation & Skills, the Department for Culture Media & Sport and the Department for Communities & Local Government) have not yet reported any signed savings to the Treasury under the current savings initiative. As noted in paragraph 2.7, the Department for Communities and Local Government has reported other savings that fall outside of the scope of this review.

Figure 6

Departments' reported signed savings as a percentage of their total remaining unitary charge



NOTES

1. This table only shows the £1.6 billion of signed savings that fall within this savings initiative.
2. The Cabinet Office is excluded from the above analysis as its saving is 112 per cent due to the cancellation of a PFI contract which has saved ancillary costs alongside the unitary charge.
3. The Department for Business, Innovation & Skills, the Department for Culture, Media & Sport and the Department for Communities & Local Government have reported no signed savings under this savings initiative.
4. The Department for International Development is not included as it has no PFI projects.

Source: National Audit Office analysis of HM Treasury data

3.5 Some contracts may have been evaluated and set aside as having too little potential. However, we are concerned that some contracts may not have been evaluated at all. This concern is based on the similarities we observe between contracts where savings have been reported and others where no savings have been reported. We conclude there is likely to be further scope for savings to be identified by authorities that have so far not reported any savings.

3.6 This lack of savings on so many projects is surprising given the fact that authorities can keep the savings they identify. The reasons for a low level of reported savings from some authorities may include:

- A lack of the necessary skills and expertise. The largest savings reported so far come from authorities with the skills to identify and negotiate savings, and the capacity to take some tasks back inhouse where it is cheaper to do so.
- A lack of resources to actively manage contracts. Authorities that have reported savings planned their changes to the contracts well in advance of key contract dates. One authority made good use of break clauses which, after planning and careful option appraisal, led to substantial cost savings. Devoting sufficient resources to contract management puts an authority in a much better position to identify savings.

It is also the case that some authorities may have agreed savings at a local level but not reported those savings to the Treasury.

Savings in sponsored bodies

3.7 There are two sponsoring departments that account for 376 operational PFI contracts. These are the Department of Health (with 209 contracts) and the Department for Education (167 contracts). In aggregate, these two departments sponsor over 55 per cent of the total number of PFI contracts in operation. The challenge for these departments is to stimulate the local bodies managing the contracts (NHS Trusts and local authorities) to engage with the savings initiative.

3.8 We highlight below the progress to date that the Department of Health and the Department for Education have made in reporting savings. The total reported signed savings to date by both departments since the start of the savings initiative is £63m, which is less than 0.1 per cent of the total remaining unitary charge of £93 billion. Both departments have projects that demonstrate that savings are possible, but given the value of their portfolios there is likely to be scope to make further savings.

In health:

- The Queen’s Hospital in Romford was part of the Treasury's savings pilot in February 2011. This, and other exercises, identified savings in the health sector before the start of the current initiative of £113 million.
- The savings initiative has identified further signed savings of £61 million across a number of health projects (Figure 2), with a further £65 million (confidence-adjusted) of reported pipeline savings.
- The total reported signed savings of £174 million on health projects (including those reported prior to the start of the savings initiative) amounts to just one quarter of 1 per cent of the remaining unitary charge payments for operational PFI contracts in the health sector, which stands at over £69 billion (Figure 5).

In education:

- Signed savings of £3m were identified before the savings initiative started in July 2011. Signed savings since the savings initiative began are a further £2 million.
- There is currently £15 million of confidence-adjusted savings in the pipeline progressing towards being signed.
- The total reported signed savings of £5 million on education projects (including those reported prior to the start of the savings initiative) amounts to just two-hundredths of 1 per cent of the remaining unitary charge for operational contracts in the education sector, which stands at over £24 billion (Figure 5).

Treasury's guidance

3.9 The Treasury's July 2011 guidance on savings from operational contracts recommends steps for conducting a savings review. It includes a flow diagram of the overall process, the relationship between the various guidance documents and a checklist covering the main areas to be explored for savings.

3.10 Those authorities that have reported the largest savings are the ones with the greatest existing skills. The Treasury's guidance is likely to be most useful to those authorities without existing expertise who are just embarking on a search for savings.

3.11 Departments we spoke to told us that the Treasury's requirement for quarterly reporting has prompted them to maintain their activity on securing savings and keep potential savings under rolling review.

Part Four

Scope for further savings

4.1 The savings reported to HM Treasury to date provide insight into the types of saving that other departments might be able to identify in their own contracts and those of the bodies they sponsor.

4.2 In Part Three we note the number of contracts and total remaining unitary charge by sponsoring department. Those departments who sponsor a larger number of contracts and have a high remaining unitary charge are likely to be the ones with the greatest scope for identifying further savings.

4.3 **Figure 7** shows the typical sources of savings that departments have reported to the Treasury so far. The actual savings available will vary by contract, and it is only by having a detailed understanding of each contract that the full potential for savings will be identified.

Figure 7

Types of saving we found

Nature of saving	Description
Asset utilisation	Improving how assets are used, such as increasing occupancy rates, as the Treasury has done in their offices at Great George Street.
Coverage	Incorporating other services into pre-existing PFI contracts to extend coverage. The Ministry of Defence was able to extend an existing Army contract to offer support to the other two armed services, at minimal additional cost.
Cost of finance	Exploiting the lower cost of public financing and substituting it for private finance. TfL were able to generate savings by bringing services 'in house' because of its prudential borrowing powers, coupled with early termination clauses, in some of its contracts.
Ancillary contract clauses (not related to service provision)	Where contract elements may be generous there may be opportunities to negotiate permanent or temporary cost reductions. One department in our sample negotiated a lower inflation index rate.
Redefining activities	Some activities can be redefined in a cheaper fashion for similar outcomes that do not affect the quality of the service.
Exercising rights	Many contracts will have clauses that enable authorities to reclaim money from the provider. One NHS trust within our sample was proactively seeking insurance rebates from their provider.
Hedging	Controlling escalating costs will save money. One PFI provider entered into an interest rate swap which generated savings for both the contracting authority, in this case an NHS Trust and the service provider by fixing into a lower interest rate.
Reducing service scope	Removing services from contracts with the agreement of contractor should lead to a reduction in the unitary charge.
Removing intermediaries	Costs can be reduced by removing intermediate suppliers, financing vehicles and management companies. TfL was able to remove intermediaries associated with two PFI deals in order to generate savings.

NOTE

1. The Treasury has a more detailed list of 30 areas that are a potential source of savings.

Source: NAO analysis of reported savings and HM Treasury guidance

4.4 Reductions to services or outputs were a relatively small proportion of the savings, accounting for just £178 million (13 per cent) of our sample population, see Figure 3. Below we have set out three alternatives to scope reductions that we came across in our review.

More intensive use of offices and headquarter buildings

4.5 Three of the savings (amounting to £481 million) came from more intensive use of accommodation. Our review shows that the long-term nature of operational PFI contracts has not prevented authorities from securing this type of saving.

More effective use of PFI assets

4.6 Many PFI contracts involve the provision of assets that may not be fully utilised at all times. The Ministry of Defence has secured a saving by making equipment available to the Air Force and Navy that is provided under a PFI contract to the Army, with minimal increase in costs. Although it is not easy to benchmark and quantify this type of saving, it is an excellent example of using assets more intensively.

Bringing services back inhouse

4.7 Public bodies, with the appropriate skills and capacity to do so, have taken services back inhouse. Transport for London (TfL) is responsible for the three largest reported savings to Treasury. TfL has good commercial skills, and a well-resourced commercial team that has actively evaluated options to change the ownership of PFI deals after construction and during operation.

4.8 TfL's savings are the result of bringing operational management inhouse by removing the private sector from a management role. TfL's prudential borrowing powers mean it has the flexibility in some cases to replace private sector capital with public borrowing where this is cost-effective. On two PFI contracts, TfL removed the financing companies associated with the contracts and dealt directly with key suppliers on substantially unchanged terms. This generated savings on financing costs (arising from lower debt repayments and the removal of future equity returns).

Appendix One

Methodology

Review of individual savings

1 We reviewed a representative sample of 15 project savings from HM Treasury's dataset of £1.6 billion of reported savings. We selected the six largest savings and then a further nine savings randomly selected using a monetary unit sampling technique to get good coverage by department and type of saving. Our sample represents 86 per cent of savings by value and 25 per cent of the number of projects reporting signed savings. We excluded the smallest savings from the sample population before sampling to avoid the selection of small savings, which would incur an excessive audit burden.

2 We reviewed the evidence underpinning each reported saving, such as signed contract variations, benchmarking and other calculations. We assessed the assumptions made and the level of prudence exercised to assess whether the reported saving was sufficiently supported. We also reviewed evidence relating to the maintenance of frontline services to distinguish between 'cash-releasing efficiency savings, 'other-efficiency savings' which have an unquantifiable cash benefit and 'cash-releasing scope reductions.

3 Some authorities have reported a number of different types of saving in a package. This form of reporting has made it difficult for the Treasury to identify the type of savings clearly. We have had to make some assumptions about which of our three types of saving categories is the most relevant where packages of savings have been reported.

4 We conducted semi-structured interviews with representatives of the authorities reporting the six largest savings and four of the smaller savings in our sample, to assess whether they had identified the risks to the valuation of their saving. We satisfied ourselves that these risks were considered in financial modelling and brought to the attention of the competent decision-making body. We did not form our own view on the value for money of accepting these risks because to do so would have required extensive fieldwork and analysis beyond the scope of our work.

5 The level of evidence to support each saving varied as the savings are not all cash-releasing, most have not yet been fully realised and some are based on estimates.

6 We categorised savings into one of three assurance categories to indicate the level of confidence we had in the reported savings:

- **Sufficient evidence.** The calculations for the saving are clear, the evidence base is available, any assumptions made are realistic, measurement uses strong benchmarks (e.g. recent, actual cost data) and sufficient prudence has been exercised.
- **Partial evidence.** The saving has some uncertainty or the evidence base is not clear. For example if there is no recent or actual cost information to draw on, a best estimate of future avoided cost has been used.
- **Insufficient evidence.** The saving is not supported by documentary evidence, or the estimates or assumptions are unrealistic or contested.

7 Because the savings we looked at were largely forecast savings rather than realised savings, our review does not do the following:

- Provide assurance that the savings reported will in fact be realised because the savings are, in the majority of cases, forecasts and are therefore subject to uncertainty.
- Confirm that frontline services have not been affected by the savings. Our work was limited to interviews and reviewing documentary evidence about predicted impact on frontline service delivery. Our work gives no assurance as to the actual impact on service delivery of these changes.
- Some risks that transfer to authorities as a result of these savings may materialise and may increase authorities' costs. We have assured ourselves that authorities have considered the risks associated with these savings and their potential effects, but we have not audited the authorities' governance or management of these risks and their associated costs.
- We did not examine the impact of departmental reviews of contracts prior to signature, which in some cases have resulted in better value contracts.

Our review of pipeline savings

8 We selected a non-representative sample of pipeline savings from the Treasury's spreadsheet as at June 2013. We used a different approach in our review of the pipeline ‘agreed’ savings to that for signed savings. In reviewing the pipeline savings we:

- discussed the type of saving with the authority and viewed the business case, where available, to form a view on its likelihood and timing.
- did not extrapolate from this sample to the whole population, or assign specific assurance ratings to these savings; and
- only considered the three further categories of ‘potential’, ‘identified’ and 'ambition' savings in order to understand the overall approach taken.

Other aspects of our review

9 We also:

- considered the Treasury’s overall approach to supporting authorities to identify and report savings on operational PFI contracts; and
- identified examples of savings to help stimulate the identification of further savings.

Appendix Two

Good practice for accurate public reporting of savings

The following table sets out our principles for good practice in publicly reporting savings, along with our observations on how these should apply to PFI contracts.

Risk	Comment	Additional note on application to operational PFI savings
Data quality	Data on quantity and unit costs should be taken from a reliable source or cautious estimates used.	A reliable source would include the PFI contract or contract financial model.
Properly calculated	Savings should be calculated using an appropriate economic or cost-accounting methodology and checked internally before publication.	Savings covering more than one year should make clear whether they are stated in nominal or real terms and how any present value has been calculated.
Net of costs	All transitional costs and any additional costs should be netted off from savings reported in the year in which the costs are incurred. Adverse effects on other programmes should also be recognised.	This should include the cost of any risks taken back inhouse.
Impact on Services	Any adverse effect on service quality should be reported. Any reductions in planned activity /outputs should be demonstrated not to have a material impact on overall outcomes.	Any impact on overall outcomes should be clearly reported, including those cases where the original service standard exceeded current requirements.
Calculated against a realistic baseline	Baseline should be a realistic forecast rather than a worst-case scenario. Ideally, departments should compare actual spending against previously approved spending plans e.g. at the beginning of the spending review period (the counterfactual).	The baseline should be based on the contracted payments, reflecting all unitary charge and other payments, as well as any indexation provisions.
Costs have not been reallocated	Savings should not be reported if spending has been reallocated to another similar activity either internally or in another publicly funded body. However, savings may be used for approved new services which would otherwise have been funded by Parliament.	

Cash-releasing	Financial or cash-releasing savings will reduce departments' annual expenditure. Efficiency savings should represent the same output at less cost. Non cash-releasing savings and other benefits, e.g. increased output or reductions in services, should be clearly distinguished.	In the case of PFI contracts, a cash-releasing saving may be accompanied by a change in the risks carried by the public body. Any 'contingent' aspect of savings should be clearly identified and quantified.
Realised	Reported savings should clearly distinguish between savings achieved to date and those anticipated in the future. It should be possible to reconcile the saving to budgets and to financial or management accounts, after allowing for planned new services.	
Sustainable	One-off or time limited savings should be reported separately from ongoing reductions in annual spend. One-off savings may be sustainable if they are part of an ongoing programme of similar savings.	Temporary reductions in the unitary charge should be clearly distinguished from ongoing reductions or other 'whole life' savings.
Scored only once	Savings should not be double-counted under separate categories or by different bodies. Savings reported under previous initiatives should not normally be reported again.	Any savings previously announced as a result of government negotiations with major suppliers should be clearly distinguished.

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