National Audit Office

Report
by the Comptroller
and Auditor General

Cabinet Office, HM Treasury

Managing PFI assets and services as contracts end

HC 369 SESSION 2019–2021 5 JUNE 2020

Key facts

72

number of private finance initiative (PFI) contracts ending over the next seven years in England (excluding devolved governments)

£3.9bn

estimated capital value of PFI assets that will revert to public sector ownership at contract end over the next seven years in England (excluding devolved governments)

4 out of 9

surveyed authorities, which took ownership of the PFI assets at expiry, were not satisfied with the asset's condition

>4 years	number of years between the start of expiry preparations and contract end for 57% of PFI contracts surveyed (survey respondents)
55%	percentage of survey respondents who recognise they need more knowledge on asset condition
60%	percentage of survey respondents who recognise they will need to recruit external consultants to help with contract expiry
328	number of authorities (signatories of the PFI contract) which are responsible for a PFI contract across the UK, with 182 authorities responsible for one contract only
82%	share of PFI contracts local bodies are responsible for (versus central government) out of all 700+ PFI contracts across the UK
18%	percentage of all 700+ PFI contracts across the UK that are the responsibility of the 10 public authorities with the most PFI
>50%	percentage of all 700+ PFI contracts across the UK that are owned by the 10 largest investors in PFI (by number of contracts)
>33%	percentage of survey respondents who consider that disputes near contract end are likely, with 86% of disputes expected to relate to the quantity of rectification work

Summary

Our report

1 Private finance initiative (PFI) contracts are a form of public private partnerships used in the UK since the 1990s. PFI is a way to finance and provide public sector infrastructure and capital equipment projects, such as roads, hospitals and schools. There are currently more than 700 operational PFI contracts in place in the UK with a capital value of £57 billion.[1] This study focuses on the 571 English PFI contracts, excluding those for which devolved governments are responsible.

2 The management of PFI contracts involves different organisations across central government and local bodies. The public authority (the authority) which entered into the original agreement is primarily responsible for managing the contract, including the expiry process. Government departments can be involved as the authority or as a sponsor (sponsor department) for a local body that signed the contract. The Infrastructure and Projects Authority (IPA) provides a support function to departments and authorities as the government's centre of expertise for infrastructure and major projects. It reports to the Cabinet Office and HM Treasury. HM Treasury is responsible for PFI policy and fiscal decisions and co-owns the PFI strategy with the IPA.

3 PFI projects involve a new private finance company – a special purpose vehicle (SPV) – being set up. The SPV finances, builds, maintains and operates the assets over the contract term, usually 25 to 30 years. During this term, the authority makes payments, known as a unitary charge, to the SPV which cover debt repayment, financing costs, maintenance and any other services provided. The SPV is obliged to deliver the contract and because the PFI model is designed to be self-monitoring, the SPV is also responsible for reviewing performance and reporting back to the authority.

4 In October 2018, government announced it would no longer use the PFI model. Existing PFI contracts remain in place and the earliest ones are now starting to expire. These earlier PFI contracts did not always benefit from standardisation which HM Treasury introduced in 1999. Most PFI contracts result in the assets being returned to the authority once the contract ends. One potential benefit of PFI is that the assets should be well maintained throughout the contract life and therefore be in a good condition when returned to the authority. The main risks to value for money is that the assets are not returned in a satisfactory condition and that the continuity of service associated with the assets, if required, is therefore not assured.

1 The £57 billion represents the nominal value.

Scope of our work

5 This report provides information on managing PFI contracts as they come to an end and considers whether government is making appropriate preparations to manage the expiry of PFI contracts. Most PFI contracts expire from 2025 onwards, meaning there has so far only been a limited number of practical examples to learn from. As a result, we surveyed 107 of the 571 English PFI contracts that have or will expire over the next seven years and received 75 responses. Of the 107 contracts surveyed, 89 PFI contracts were still operational at the time the survey was conducted, and 18 had expired. Our fieldwork was conducted before the outbreak of COVID-19, so we do not assess the potential impacts on the expiry of PFI contracts.

6 The purpose of this report is to draw out the challenges and best practice that can most benefit those managing PFI contracts coming to an end. Throughout the report we have identified illustrative examples from specific PFI contracts. Although not representative of the full survey population, they provide helpful prompts to draw the reader's attention to some of the potential risks authorities may face, enabling preventative steps to be considered. This report is not intended to conclude on the value for money of individual contracts.

7 The report structure is as follows:

- Part One sets out the background to PFI, the contracts which are due to expire, and the roles and responsibilities of key stakeholders;
- Part Two examines the skills and capabilities of authorities for the expiry process and aspects of day-to-day management of the contracts relevant for the preparation process;
- Part Three examines the preparation for and delivery of contract expiry; and
- the Appendices set out our methodology, list of the 10 largest PFI contracts expiring in the next 10 years and the National Audit Office's (NAO's) catalogue of past PFI reports. The results of our survey are published separately.

Key findings

8 **The public sector does not take a strategic or consistent approach to managing PFI contracts as they end and risks failing to secure value for money during the expiry negotiations with the private sector.** Across the UK, 328 authorities are responsible for PFI contracts, with 182 authorities responsible for only one contract. These authorities are at various levels across government, with local bodies, such as individual NHS trusts and local authorities, managing 82% of contracts. As such, they receive varying degrees of support from sponsor departments or supporting bodies, such as the IPA. Around 30% of survey respondents have told us that they would welcome more support and want the opportunity to learn from other authorities; government is starting to address this. In contrast, ownership among private investors is far more concentrated. The 10 largest private investors in PFI own more than 50% of the contracts, and the top six management companies are responsible for almost 45% of the contracts. This concentration allows the private sector to take a portfolio approach to expiry negotiations which risks putting the public sector at a disadvantage (paragraphs 1.8 to 1.17 and 2.6, Figure 3 and Figure 8).

9 **There is a risk of increased costs and service disruptions if authorities do not prepare for contract expiry adequately in advance.** At the end of the PFI contract authorities will have to decide whether services, such as maintenance and cleaning, are either provided in-house, by a new contractor or by the current provider. If authorities do not prepare properly there is a risk to service continuity or they may have no choice but to extend the contract. Where assets do not return to the public sector, authorities will still need to decide if they want to continue to use the assets. If so, they will need to negotiate with the PFI company or procure alternative assets. For example, at the end of an accommodation PFI contract the authority had to buy the homes it still needed, running into the tens of millions of pounds. Some PFI school contracts have more unique challenges – as some schools have been reclassified as academies, the future ownership of the assets and the responsibility for administering the PFI contract are not aligned. Authorities may not be incentivised to use their resources to manage the expiry process effectively knowing that they will not retain ownership of the assets. This creates a risk of service disruption and increased maintenance costs after expiry, if assets are returned below the contractually stipulated condition (paragraphs 3.8 to 3.14, Figure 6 and Figure 12).

10 **Some authorities have insufficient knowledge about the assets' condition, which risks them being returned to the public sector in a worse quality than expected.** Around 55% of respondents recognise they need more knowledge of the assets' condition. It is the SPV's responsibility to maintain the assets and report to the authority, but the authority needs to monitor asset condition. Authorities can gain this knowledge by proactively monitoring assets during the life of the contract, but this does not always happen – 30% of survey respondents are not monitoring annual maintenance spending and 50% do not maintain an asset register. Many PFI contracts, particularly those signed before 2000, contain contractual limitations over what data can be requested from the SPV, such as maintenance expenditure and the ongoing assets' condition. Around 35% of respondents stated they had insufficient access rights to monitor the maintenance programme adequately. There is also evidence that PFI investors and sub-contractors are not cooperating with authorities to provide information – 20% of survey respondents who had asked for information considered the contractor had been uncooperative, with data requests being ignored or denied on grounds of not being a contractual obligation. Not continually monitoring the assets' condition increases the risk of assets being returned below the contract's stipulated quality. Four out of nine survey respondents whose contracts have already expired were unsatisfied with the condition of the assets they took ownership of at expiry (paragraphs 2.7 to 2.19, 3.22, 3.23 and Figure 4 and Figure 10).

11 **Many authorities start preparing for contract expiry more than four years in advance but there is a risk this is not enough time.** Most authorities are confident they have started early enough, with 57% of survey respondents preparing more than four years before expiry. Experience from expired contracts, however, suggests that preparation time is often underestimated, and the process should be started as early as possible. Preparation times will vary across contracts depending on the complexity and the treatment of assets on expiry. The IPA's guidance recommends preparations start seven years in advance. Highways England, which is managing the expiry of multiple PFI road contracts, is preparing seven to eight years in advance of expiry (paragraphs 3.15 to 3.21, Figure 13, Figure 14 and Figure 15).

12 **Authorities recognise that contract expiry will be resource intensive and require unique skills, and expect to fill gaps with consultants.** During the life of a PFI contract, the priority for each authority is to ensure the assets are operational and running smoothly. In the final years of the contract, authorities will need to deliver the contract expiry process alongside day-to-day management, creating additional pressure on resources – about 30% of respondents anticipate not having enough staff. The skills required to deliver the expiry process, such as contract negotiations and asset management, differ from those needed to manage the day-to-day running of the contract. About 25% of respondents consider they lack the necessary in-house skills to deliver the expiry process and 60% are planning to hire consultants. The government's piecemeal approach to hiring consultants, such as legal experts, may not represent value for money in the long term. Authorities told us they would appreciate standardised procurement documents and processes to support them when hiring consultants (paragraphs 2.2 to 2.6 and Figure 9).

13 A misalignment of investor and authority incentives at contract expiry creates a potential for disputes. Authorities will want to ensure they receive an asset in the best condition possible as this will minimise future maintenance spend. Meanwhile, PFI providers have an incentive to limit expenditure on maintenance and rectification work in the final years of the contract as any savings can be used to pay out higher returns to investors. This will be more likely where the cost of completing rectification work is greater than any performance penalty for not doing this work. For 35% of respondents, the main method to compel SPVs to complete rectification work is by withholding a portion of the monthly unitary charge. If any contractual rectification work remains outstanding at contract expiry, there are limited options for recourse, increasing the need to resolve all disputes before contracts end. More than one-third of respondents expect to have formal disputes – 86% of anticipated disputes relate to the amount of rectification and 75% to the cost of this work. Disputes can be costly for authorities and a positive outcome is not necessarily guaranteed (paragraphs 3.22 to 3.32 and Figure 16).

14 Early PFI contracts are likely to contain significant ambiguity around the roles and responsibilities of the parties at contract expiry. Only one-third of respondents stated that contracts are clear about roles and obligations of different parties at expiry. Around one-quarter stated their contract does not contain any information on how and in what condition assets should be returned. Poorly drafted clauses are often open to interpretation, which has resulted in differing views between authorities and PFI providers, particularly around the quality and useful life of assets upon return to the public sector. Where issues do exist, some authorities are making improvements. For example, Highways England proactively engaged with SPVs to jointly interpret and clarify ambiguous clauses, thereby avoiding the potential for disputes and legal proceedings (paragraphs 3.2 to 3.7, 3.18, 3.19 and Figure 11).

Recommendations

15 Only a small number of PFI contracts have expired so far and the public sector's preparedness and understanding of the risks varies greatly between the many authorities responsible for these contracts. Our findings suggest there is a lack of a consistent approach across these authorities, with no strategic central support on managing the end of contracts. Authorities also risk underestimating the time, resourcing and complexity involved in the expiry process. Progress is being made and there is still time remaining to make changes that will benefit the bulk of the contracts expiring from 2025 onwards. Many of these issues may become less prevalent in the longer term as the later PFI contracts benefit from better defined and clearer contractual terms.

16 Early preparations, and a collaborative approach between public and private stakeholders, can help to ensure a successful exit from these contracts. This will require all parties seeking to understand each other's goals, establishing a partnership approach on each PFI project, and sharing experiences on how to manage contract expiry across all levels of government. Our specific recommendations are:

Sponsor departments should:

a Encourage authorities to:

- start preparing for contract expiry on a timely basis;
- ensure the PFI contract is complete and all expiry provisions are well understood;
- develop a contract expiry plan that identifies all the critical tasks and obstacles that may prevent a successful exit; and
- escalate problems which cannot be resolved at a local level to the sponsor department in a timely fashion.

b provide direct financial support to authorities where required, with particular focus on funding dispute resolutions and hiring additional resources.

IPA and sponsor departments should:

c proactively coordinate and develop a programme of support that can be made available to authorities. This should include:

- building internal resource and sector-specific expertise;
- developing a range of different tools that can be deployed depending on the nature of support required, including specialist advice and guidance documents; and
- developing contract expiry training.

d develop an approach to identifying high-risk projects, such as those sitting with authorities that lack appropriate skills and capabilities. The IPA and departments should work with public sector stakeholders to assess how skill shortages can be addressed; and

e assess the costs and benefits of developing an electronic repository of PFI contracts which supports authorities to manage their contracts and helps sponsor departments and IPA to identify high-risk projects and enable a more consistent approach across government.

IPA should:

f assess whether any areas of the contract expiry process would benefit from a more coordinated and centralised approach. This should include:

- assessing the value for money of developing a new centralised pool of internal resources, such as lawyers and surveyors, that authorities can use;
- publishing contract expiry guidance and other useful documents such as terms of reference templates for engaging with external consultants;
- developing a consistent approach to resolving legal disputes including guidance on how an authority should balance the costs and benefits of taking legal action; and
- developing an investor strategy which manages the relationship with private sector PFI stakeholders – equity investors, management service companies, contractors – across all PFI contracts. Such a strategy could also consider working with other government bodies, such as UK Government Investments, who may have interactions with similar private sector companies.

HM Treasury should:

g provide funding to departments which assist financially constrained authorities in formal disputes where it is value for money and practical to do so.