



House of Commons
Committee of Public Accounts

Financing PFI projects in the credit crisis and the Treasury's response

Ninth Report of Session 2010–11

*Report, together with formal minutes, oral and
written evidence*

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The Committee of Public Accounts

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Powers of the Committee of Public Accounts are set out in House of Commons Standing Orders, principally in SO No 148. These are available on the Internet via www.parliament.uk.

Publication

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at <http://www.parliament.uk/pac>. A list of Reports of the Committee in the present Session is at the back of this volume.

Committee staff

The current staff of the Committee is Philip Aylett (Clerk), Lori Verwaerde (Senior Committee Assistant), Ian Blair and Michelle Garratty (Committee Assistants) and Alex Paterson (Media Officer).

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Summary

The 2008 credit crisis had an enormous impact on the Government's public infrastructure programme. Severe restrictions on bank lending at that time meant no sizeable Private Finance Initiative (PFI) contracts could be let. This affected the viability of a large number of infrastructure projects, including school and road building schemes, with a total investment value of over £13 billion.

The Treasury's response was to make project finance available by lending public money on the same terms as the banks. This approach reflected a fear that doing nothing would slow the flow of new PFI contracts, jeopardising the economic stimulus that would be generated by new infrastructure. Providing that stimulus was the Treasury's overarching priority.

However the Treasury did not put pressure on government-supported banks to either make lending available or reduce the extent of increased financing costs. Overall, bank financing costs increased by 20-33 per cent compared to bank charges before the credit crisis. This added £1 billion to the contract price, payable over 30 years, for the 35 projects financed in 2009. Furthermore Treasury did not require individual projects to submit detailed re-evaluations to assess whether contracts were still value for money.

The Treasury helped to reactivate the lending market for infrastructure projects by setting up its own Infrastructure Finance Unit in March 2009. This Unit was prepared to lend public money on the same terms as the banks, but lent to only one project – a large waste treatment and power generation project. We recognise, however, that this willingness to lend helped to re-establish market confidence.

But other alternatives to the high cost bank finance were not properly explored during the credit crisis. Greater use of Treasury loans, or direct grant funding, could have put pressure on banks to lower their charges. Neither did the Treasury adequately explore how lower cost finance sources such as life insurance and pension funds could be encouraged to invest more in PFI projects. The Treasury also could have made more use of funding from the European Investment Bank. The appropriate mix of financing sources for future project contracts, including public and private finance, is an issue that needs serious reconsideration.

We accept that the circumstances of the credit crisis, and in particular the need for economic stimulus, warranted the Government making lending available to projects that would otherwise have been threatened. Nevertheless, we remain concerned about other aspects of the Treasury's response to the lack of PFI project finance.

The impact of the bank crisis on projects will continue to be felt over the next 30 years, as financing costs are locked in for the life of each project (both construction and operation phases). Higher financing costs will persist throughout the operating period, even though the project operation phase normally represents a lower risk for lenders.

The Treasury needs to be better informed about the active market in the sale of PFI shares. At present, unlike debt refinancing, the Treasury does not monitor the extent of gains to private investors from selling their shares. If gains are excessive, this may indicate an

overpriced contract in the first place, raising concerns about value for money for taxpayers. On the basis of a Report by the Comptroller and Auditor General, we examined the Treasury on its response to financing PFI projects in the credit crisis¹.

1 C&AG's Report, *Financing PFI projects in the credit crisis and the Treasury's response*, HC 287 (2010-11)

Conclusions and Recommendations

1. **Contracts let since the credit crisis were over-reliant on expensive bank finance.** The Treasury failed to develop a sufficiently wide mix of finance sources, including grant funding, for infrastructure projects. Some contracts obtained funding from the European Investment Bank (EIB), which lowers some financing costs, but departments made less use of this resource than did other European Union countries. The Treasury failed to use its Infrastructure Finance Unit, which only made one loan, to promote a downward trend in the cost of private debt finance. The Treasury should expand the range of financing sources and assess the potential benefits from making further Treasury loans whenever commercial lending rates are unusually high.
2. **The Government did not use its negotiating position with the banks to assist PFI lending.** In 2009, banks increased the cost of financing PFI projects by between 20 and 33 per cent, adding £1 billion to the contract price over 30 years for the 35 projects financed. At the same time, the taxpayer was providing unprecedented support to the banking system. Yet the Treasury failed to set the banks lending targets for PFI projects. It should now identify ways in which better deals can be obtained, at least from the government-supported banks.
3. **The Treasury did not require a fully evidenced evaluation of the impact of the increased financing costs on value for money at the time the contracts were let.** The Treasury did not have full information on project financing costs in the credit crisis. Value for money is often marginal for PFI projects. The Treasury should ensure it has full information on financing costs from departments, and should also intervene after any significant changes in costs to assess whether PFI deals should go ahead.
4. **Life insurance and pension funds are an important alternative source of finance, but have been reluctant to fund PFI projects for a number of reasons.** The Treasury should identify the regulatory and other impediments affecting their willingness to invest in PFI projects and take steps to address them.
5. **PFI projects with low operating risks have locked in high financing costs for up to 30 years.** The high risk period is typically the construction period, but the high interest charge endures throughout the project life. The Treasury must consider unbundling service delivery from PFI contracts or find ways to lower the cost of financing the operating period.
6. **There is the opportunity for the Government to claw back up to £400 million if projects signed in 2009 are refinanced, but there is no certainty of this happening.** The Treasury should monitor market conditions and ensure that departments are ready to maximise these gains, as soon as conditions are favourable. In particular, the Treasury should identify groups of projects which could be refinanced at the same time. This portfolio approach would enhance the public sector bargaining position, reduce transaction costs and increase potential gains.

7. **Government also needs to get good value from equity finance. There is little transparency, however, about investor returns when selling shares – making the value for money of using equity less clear.** There has been an active market in selling PFI shares, with a large number of sales and a consolidation of ownership. This has led to portfolio gains that the Treasury has failed to monitor adequately. The Treasury should review whether investors are systematically realising gains on share sales, as well as refinancing debt.

1 The impact of the credit crisis and the Treasury's response

1. Banks stopped lending to government infrastructure projects during the 2008 credit crisis. In seeking to manage this situation the Treasury found that the market conditions were unprecedented, fast moving and hard to forecast.²

2. The lack of private finance held up 110 PFI projects with an investment value exceeding £13 billion. Two-thirds of the pending projects by value were in four sectors – waste treatment facilities (30 per cent), schools (15 per cent), transport (12 per cent) and housing (11 per cent).³

3. In early 2009 the banks were prepared to lend again but in smaller amounts than before the credit crisis. Major projects had to rely on a large club of banks if private finance was to be used. This lack of competition, together with increases in the banks' own cost of funds following the credit crisis, contributed to the banks increasing their financing charges for government projects by 20-33 per cent and transferring risks back to the public sector. This was despite the fact that the banks had received substantial financial support from the Government during the credit crisis, and that lending to projects where the Government is the customer is a very safe form of lending.⁴ There have only been two cases of projects being terminated with banks suffering losses.⁵

4. After taking some time to consider options, the Treasury established The Infrastructure Finance Unit (TIFU) in March 2009.⁶ The purpose of the Unit was to lend where there was a lack of available finance from the private market. The Treasury lending would be on commercial terms, with the lending temporary and reversible. The Treasury intended its lending facility to increase the pool of finance available to projects but did not want to interfere in the market's pricing of the use of bank finance. The Unit provided one loan of £120 million to the Greater Manchester Waste PFI project in April 2009. The Unit did not provide any more loans thereafter as projects were then able to secure all their debt finance from the banks.⁷

2 Q93

3 C&AG's report, Figure 3

4 Q4

5 Qq81-82

6 Q3, Q40

7 Q22

5. Following the credit crisis, departments were heavily reliant on expensive loans from the banks. The Treasury told us that doing without the banks would have involved a change in the form of procurement for most projects. The Treasury argued that any such change would have caused unacceptable delays.⁸

6. The Treasury's new National Infrastructure Plan, published the day before our hearing, recognised that a one per cent reduction in the cost of capital for infrastructure investment could save £5 billion each year.⁹ Notwithstanding the market difficulties, the Treasury should have done more to try to obtain finance for infrastructure projects in 2009 on less expensive terms:

7. Firstly, the government financial support to the banks and the low credit risk of lending to government projects should have provided levers to negotiate better financing terms. The Treasury did not, however, press the banks to lend at lower rates.¹⁰

8. Secondly, the Treasury did not consider making more loans to projects in order put pressure on the banks to reduce their rates. If the banks had felt the threat of being replaced by Treasury lending and losing the opportunity to earn interest, it is likely this would have created competitive tension to drive financing rates down.¹¹

9. Thirdly, whilst the Treasury did increase the amount of loans provided by the European Investment Bank (EIB), other countries have made greater use of the EIB, whose loans are provided on cheaper terms than commercial bank loans. Over the five years from 2005 to 2009, Italy and Spain borrowed Euro 35.1 billion and 41.4 billion, respectively, compared to Euro 20.8 billion for the UK.¹²

10. Fourthly, greater use could have been made of temporary grant funding to replace expensive bank loans – an approach which enabled the Newham school project to go ahead at the end of December 2008.¹³

8 Q46

9 Q100; HM Treasury, National Infrastructure Plan 2010, October 2010

10 Qq1-4

11 Qq23-31

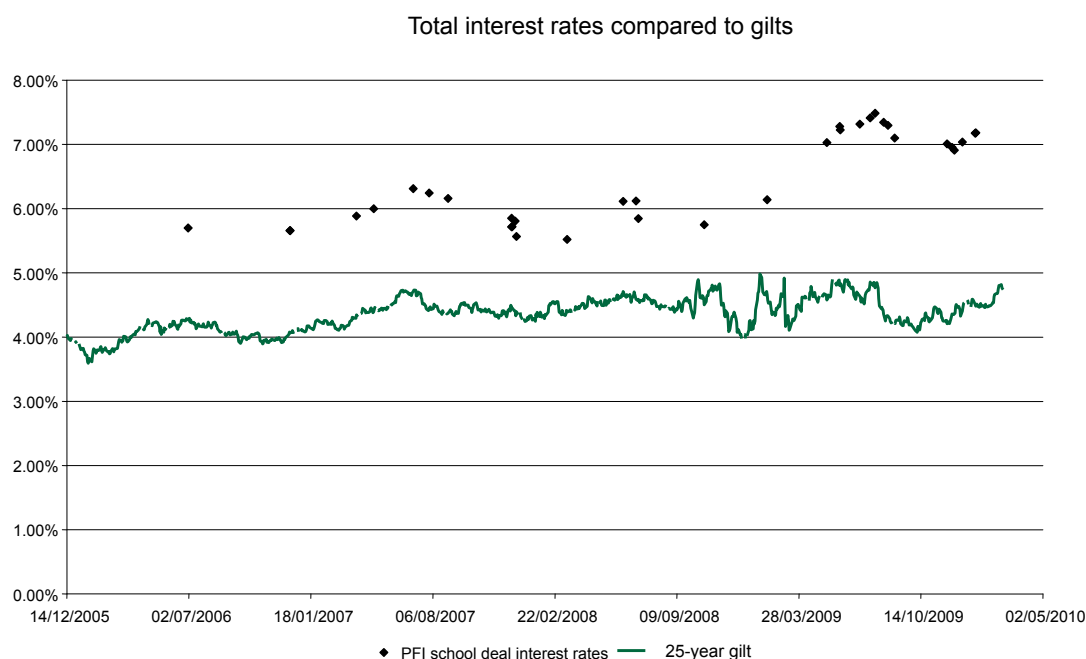
12 Qq55-57; European Investment Bank Group, Annual Report 2009, Volume 3, Statistical Report Table F

13 Q47

2 Re-evaluating infrastructure contracts following the credit crisis

11. Some 35 privately financed contracts were let in 2009 during the height of the credit crisis. Higher financing costs increased the cost of a typical contract by 6 to 7 per cent compared to commitments entered into before the credit crisis.¹⁴ When benchmarked against the rates available from the financing markets just before the credit crisis, the higher bank charges on the 35 contracts were around £1 billion.¹⁵ The Treasury and departments saw these substantial cost increases as unavoidable, and the result of market pricing. Figure 1 shows the increased cost of loans for school building projects in 2009, compared to the Government's long term borrowing cost.

Figure 1 The increase in PFI school borrowing costs after April 2009



Source: C&AG's report, extracted from Figure 10

12. Despite the higher project costs from increased bank charges, there was only limited re-evaluation of the value for money of existing PFI projects. A project's value for money was only reassessed if it needed departmental support to meet cost increases of more than 20 per cent or £20 million.¹⁶ Out of the 35 projects that closed in 2008 and 2009, the Treasury-chaired Project Review Group sent back only three projects to make improvements before being approved.¹⁷ No PFI projects were cancelled over that period. Nor did the Treasury

14 C&AG's report, paragraph 21

15 Q38, Qq129-130

16 Qq13-16

17 Q34

alter existing value for money procedures when it eventually issued updated guidance on PFI procurement in August 2009.¹⁸

13. Although the Treasury told us it was not under political pressure to approve contracts, there were clear drivers which created a need to close contracts despite the high financing costs. The Government's overriding policy priority in 2009 was to boost the economy by letting infrastructure contracts. The Greater Manchester Waste PFI project, delayed by almost a year, was an example of a project that had the potential to help the economy by creating 5,000 jobs.¹⁹ That project, responsible for treating 5 per cent of national waste, was also under legal and regulatory pressure to avoid further delay.²⁰ It is not unusual for other policy imperatives to take precedence over value for money concerns, as we concluded in our recent report on the multi-role tanker aircraft. In that case, the Ministry of Defence wanted to procure specialist aircraft, and used the favoured procurement route of PFI even though it was not appropriate for such a unique project.²¹

14. The Treasury asked Partnerships UK to evaluate whether the increase in bank financing costs undermined value for money across the board. Partnerships UK analysed the Outline Business Cases for a sample of PFI projects, but did not examine all aspects of financing costs.²² It concluded that projects were likely to remain value for money if the interest margin which banks add on to the cost of funds for risk was below 3 per cent.²³ Based on this finding, and normal department project review procedures, the Treasury was satisfied that all 35 PFI projects let in 2009 were still value for money.

15. We remain unconvinced that there was sufficient evidence to support this view. This Committee, and our predecessors, have often been concerned about the value for money case for using private finance. We would, therefore, have expected a significant increase in financing costs to have prompted the Treasury and departments to question more closely the value for money of the privately financed contracts let following the credit crisis.

16. The Greater Manchester Waste PFI project was approved as value for money, despite financing costs that included risk margins well above the 3 per cent value for money ceiling identified by Partnerships UK. In the Manchester waste project the risk margin started at 3.25 per cent and after 21 years increased to 4.5 per cent. These higher margins reflected a project that was unique in terms of scale and technology. The Treasury told us that this project was value for money, without the need to make any assumption that high cost financing would be replaced at a lower cost in future.²⁴

18 C&AG's report, paragraph 1.16

19 Q9

20 Qq5-8

21 Q6, Q141

22 C&AG's report, paragraph 24

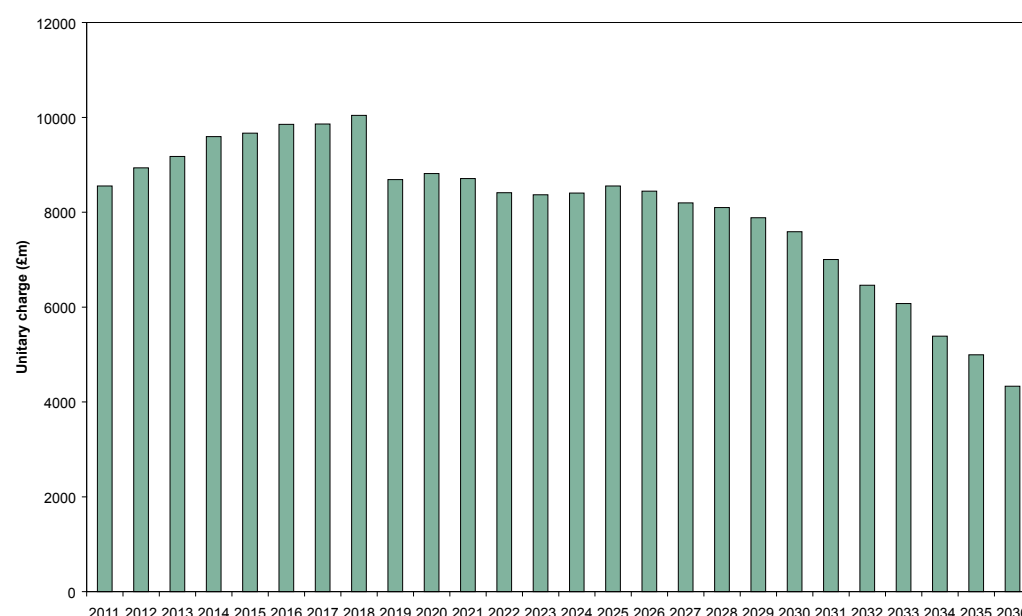
23 Qq20-21

24 Qq10-11

3 Opportunities to improve value for money in the financing of infrastructure projects

17. The public sector has been heavily reliant on the use of private finance to procure infrastructure projects. In 2010-11, the total annual charges payable in that year were £8.6 billion. The future commitment over the next 25 years amounts to £210 billion in cash terms (Figure 2).²⁵ New infrastructure is forecast to cost £40 billion a year over the next five years, to be funded through a mix of public and private investment.²⁶

Figure 2: Next 25 years' estimated payments under PFI contracts



Source: Budget 2010: the economy and public finances – supplementary material

18. To the extent that private finance is used to fund future infrastructure investment, it is imperative that the Treasury develops other financing solutions to reduce reliance on expensive bank financing. In addition, steps need to be taken where possible to reduce the high bank financing costs of the contracts which have been entered into since the credit crisis.

19. The Treasury is considering a wider mix of financing sources for future projects. The proposed new Green Investment Bank is an example.²⁷ On future contracts there is also a case for engaging with financial institutions, such as pension funds or life insurance companies, at an early stage to finance a PFI project for its whole life. The Newham school

²⁵ Qq179-182

²⁶ Q157

²⁷ Q30, Q100, Q152

project, after a short period of temporary grant finance, was financed by a life insurance company at an attractive margin.²⁸ Direct grant funding can help to relieve a project from the banks' high financing charges, even where it is used for only a limited period of time. A financing competition, like that used on the Treasury Building project, can also help achieve better financing rates, if the project is not restricted to a limited choice of financing sources.²⁹

20. In terms of attracting finance from pension funds and life insurance companies, the regulatory requirements for the assets that can be held by these financial institutions differ from those applicable to banks. Some of these regulations, relating to the classification of financial interests in private finance projects, act as a barrier to pension funds and life insurance companies' greater participation in the private finance market.³⁰

21. Another concern is the persistence of high finance costs throughout the entire life of a PFI project. A high cost of finance applies throughout the operating period, even though this phase represents a lower risk for lenders than the construction phase.³¹ This means that the impact of the bank crisis will continue to be felt by PFI projects over the next 30 years as the high bank financing costs are locked in for the life of each project. There is a strong case for unbundling the construction and operating phases, enabling risk to be priced separately on each of the two key stages of any deal.³²

22. As an immediate response to higher finance costs, the Treasury increased the public sector share of refinancing savings. This means the public sector would capture more of the gains if, at a future date, expensive finance can be replaced by lower cost finance. Banks are willing to refinance their project loans so that they can recycle their capital.³³ New contracts previously provided for 50 per cent of such savings to be shared with the public sector authority. For new contracts since October 2008, the authority share will be 50 per cent of gains up to £1 million, 60 per cent between £1 million and £3 million and 70 per cent of any gain above that.³⁴ The Treasury believes that there will still be an incentive for the private sector investors to refinance despite now being entitled to a reduced proportion of the refinancing gains.

23. Eventually, the Government may be able to realise up to £400 million in savings from refinancing projects that closed in 2009. However, these gains, which depend on market conditions, are not certain and departments need to be ready to act when conditions are favourable. The Treasury has introduced new arrangements since October 2008 whereby the public authority has the contractual right to request a refinancing, a right which is exercisable once in any two year period.³⁵

28 C&AG's report, Appendix Four, Case B, p4

29 Q84

30 Qq191-192

31 Q109

32 Qq70-72

33 Q76

34 Q73

35 C&AG's report, paragraph 2.12, p25

24. The Treasury is considering the possibility of implementing the National Audit Office recommendation of grouping different PFI projects together to refinance them as a portfolio.³⁶ Financial institutions with long-term interests like pension funds and insurance companies are likely to be attracted to purchasing debt in a group of similar projects. This would also enhance the public sector bargaining position, reduce transaction costs for all parties and increase the potential gains for sharing between the private and public sectors. The Treasury cannot mandate the private sector investors of different projects to participate in a portfolio refinancing. It can, however, increase the likelihood of these transactions taking place by explaining the benefits that such transactions can secure for both the investors and the public sector.³⁷

25. In many projects, investors are realising gains on equity sales of shares in PFI projects as well as through refinancing debt. These gains sometimes arise on complex portfolio transactions. Unlike refinancing gains, there is no requirement for gains from equity sales to be shared with the public sector. If investors are systematically making gains on share sales as well as from refinancing, that would suggest they are regularly earning higher profits than were expected when contracts were signed.³⁸ This would in turn indicate the taxpayer is not getting a good deal from the original contract. The Treasury does not have a full picture of the situation because it does not monitor the extent of these gains.

36 Q175

37 Qq176-178

38 Qq130-134

Formal Minutes

Wednesday 1 December 2010

Members present:

Rt Hon Margaret Hodge, in the Chair

Mr Richard Bacon
Stella Creasy
Jackie Doyle-Price

Matthew Hancock
Rt Hon Mrs Anne McGuire
Ian Swales

Draft Report (*Financing PFI projects in the credit crisis and the Treasury's response*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 21 read and agreed to.

Conclusions and recommendations 1 to 7 read and agreed to.

Resolved, That the Report be the Ninth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for printing with the Report.

[Adjourned till Tuesday 7 December at 3.00 pm]

Witnesses

Tuesday 26 October 2010

Page

Andrew Hudson, Accounting Officer and Director, Public Services, **Charles Lloyd**, Former Head of Policy, PFI and **Andy Rose**, Head of Financial Markets, Infrastructure UK, HM Treasury

Ev 1

List of printed written evidence

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2	Strategic Rail Authority	Ev 14
3	Department for Transport, Local Government and the Regions	Ev 44:Ev 60

List of Reports from the Committee during the current Parliament

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2010–11

First Report	Support to incapacity benefits claimants through Pathways to Work	HC 404
Second Report	Delivering Multi-Role Tanker Aircraft Capability	HC 425
Third Report	Tackling inequalities in life expectancy in areas with the worst health and deprivation	HC 470
Fourth Report	Progress with VFM savings and lessons for cost reduction programmes	HC 440
Fifth Report	Increasing Passenger Rail Capacity	HC 471
Sixth Report	Cafcass's response to increased demand for its services	HC 439
Seventh Report	Funding the development of renewable energy technologies	HC 538
Eighth Report	Customer First Programme: Delivery of Student Finance	HC 424
Ninth Report	Financing PFI projects in the credit crisis and the Treasury's response	HC 553

Oral evidence

Taken before the Committee of Public Accounts on Tuesday 26 October 2010

Members present:

Margaret Hodge (Chair)

Mr Richard Bacon
Stephen Barclay
Jackie Doyle-Price
Joseph Johnson

Mrs Anne McGuire
Austin Mitchell
Ian Swales
Nick Smith

Amyas Morse, Comptroller and Auditor General, National Audit Office, and **Ed Humpherson**, Assistant Auditor General, National Audit Office, gave evidence. **David Finlay**, Director, National Audit Office, and **Paula Diggle**, Treasury Officer of Accounts, were in attendance.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

Financing PFI projects in the credit crisis and the Treasury's response (HC 287)

Examination of Witnesses

Witnesses: **Andrew Hudson**, Accounting Officer and Managing Director, Public Services and Growth, HM Treasury, **Charles Lloyd**, ex-Head of Policy PFI, HM Treasury and **Andy Rose**, Head of Financial Markets, Infrastructure UK, gave evidence.

Q1 Chair: Welcome. We are a relatively new Committee, with, I think, only two familiar faces to those of you who have appeared before, so we look forward to hearing the evidence you have to give on this really important topic. Can I start the ball rolling? Having read the National Audit Office Report, one of the things that struck me was that the banks stopped lending in 2008 and then when they started again they very much raised their lending rates. At that time the Government was propping up the banks, giving them quite a lot of finance to keep them going and I can't really understand whether or why there were not much tougher negotiations with the banks to ensure that they kept their loan rates to these PFI projects much lower than they have turned out to be. Did you try? If you did, were you unsuccessful? If you didn't, why didn't you?

Andrew Hudson: What we were trying to do through this period in which loan rates, following the global turmoil in financial markets, were rising around the place, was to ensure that the projects that went forward were still value for money and that certainly, I am sure, robust negotiations would take place between the procuring authorities and the banks, but this was in the context of, as I say, rising loan rates right across the board. As the NAO Report brings out on Figure 2 at page 6, while loan margins on PFI projects certainly rose, that was true and was broadly in parallel with loan margins on international projects' financed loans. So the discussions that were taking place ensured that the margins were below the going rates, so to speak, for international project finance. Our job was also very importantly to ensure that these projects remained value for money for the taxpayer and we took a number of steps to ensure that.

Q2 Chair: We will come to that. I would just really like a straight answer: did the Treasury engage in discussions with the banks to say, "We want to keep these infrastructure projects going because of the macroeconomic impact that they would have, but we do not expect you to charge these much higher loan rates that brought into question the value for money of the projects at that time." Did you engage in tough negotiations, saying to the banks to whom we were lending pots and pots of money, "We expect the PFI projects to have lower loan rates?"

Andrew Hudson: Well, since Andy Rose was most closely involved at the time, I will perhaps ask him to speak from his closer experience.

Andy Rose: There were a number of discussions with the banks at the time about how they were funding themselves, the cost that they were incurring themselves and whether shorter-term lending or a structure known as mini perm lending might have been appropriate. We did not find a consensus among the banks that, to maintain the market of banks that were supplying, there was a viable way of reducing the costs, and this is largely due to the bank's own funding costs, which went up during that period. As Andrew just suggested, the chart in the NAO report has highlighted that this was a global phenomenon, not PFI-specific.

Q3 Chair: So you did attempt negotiations and you failed?

Andy Rose: We had several discussions with the banks about different structures that might be incorporated to reduce the cost of funding but because what was actually driving this was their own cost of funding, this would have required the banks to lend at a loss. In that respect we were unable to persuade them to lend at a lower rate.

 26 October 2010 Andrew Hudson, Charles Lloyd and Andy Rose

Q4 Chair: It seems to me that at that time PFI projects were probably the most secure projects to which the banks could lend. I cannot even think of Derek Hatton ever refusing to pay any money that was owing on project finance. We were the most secure, and I cannot understand that in that context we found it impossible to secure better loan rates, which would have made these much more viable projects in terms of value for money. I just don't get it. Either we were not tough enough or we were conned. I don't know quite how we ended up with these much, much higher loan rates.

Andy Rose: The nature of the PFI contract is that, while Government are backing the payment, it is a performance-based payment and the borrower in a PFI contract is actually the private sector and these are on the verge of investment-grade rating. So while the payment is sourced from the public sector, it is quite a complex project financing that the private sector is undertaking and these, as I say, are typically structured around or just above investment grade, so it is quite a complex financing and that is why the NAO's comparison to international global project finance is, from our point of view, the correct one.

Q5 Stephen Barclay: Could I just take you away from the general to the specific and turn to Appendix 4 please and the case of the Greater Manchester Waste Disposal Authority, which was the key one, I think, taken forward by TIFU. There it says that one of the key drivers of the deal was not the issue of value for money but the EU Land Directive; the need to reduce waste by 50% on 1995 levels by 2013 and that this scheme was covering 5% of national waste. I'm just trying to understand to what extent you were looking at these objectively as value for money deals, or whether there were other things driving the need to complete.

Andy Rose: I think there are two answers to that, which I will split if I may. One is from TIFU's point of view in particular, TIFU did not have a policy role; TIFU was there to provide liquidity to the market. The policy around VFM for each individual deal is a decision for the authority and supported by the policy team within Treasury, so I think it's wrong to say that VFM was not a driver for all PFI deals—but I will defer in terms of that particular one—because TIFU was very much set up to respond in a commercial manner, rather than establish policy for Treasury.

Andrew Hudson: Charles will be able to help on the policy side.

Charles Lloyd: If I could just add to that; I was Head of Policy at the time. Obviously in the case of the Greater Manchester Waste Disposal Authority deal there was an external imperative to building that facility, and indeed other facilities in the sector, as there is in many PFI deals. That does not mean that we do not look for value for money in the transaction. We know that waste facilities have to be built; there is some choice about the method of procurement and financing for that transaction, and we would apply the same value for money test to a deal which has to be built for EU reasons as we would apply to a deal that has to be built for any other public sector reason.

Q6 Stephen Barclay: Sure. What I am driving at is I am just trying to understand what pressures were driving this, because when, at a previous hearing, we looked at the multi-role tanker aircraft, instead of using the 3.5% discount that was the Treasury guideline in 2004, an out-of-date 6% was used because the MoD just did not have the money for these planes, but there was a military requirement. So there was a defence imperative to get on with this deal. What I am trying to understand with this one is whether there was a legal and regulatory driver that was, in essence, shaping the thinking. Linked to that: what were the sunk costs on this deal at the point where you were deciding whether it was value for money?

Charles Lloyd: Well, to take the first point, there certainly were external drivers, as I think we've discussed, so that is established. I don't know the precise quantum of the sunk costs. On the authority side—that is Greater Manchester Waste Disposal Authority—there will have been quite substantial sunk costs incurred in its advisers and its own resources going into the deal. We can find out what those are and let you know what—

Q7 Stephen Barclay: As a ballpark figure? This is a contract worth £3.8 billion. If it didn't go ahead how much would have been spent in very broad terms?

Charles Lloyd: I would estimate on the public sector side something in the region of £5 million to £10 million would probably have been spent.

Q8 Stephen Barclay: Okay. In terms of jobs, because this was in the North West, so there was probably a political driver—there were a lot of marginal seats up there in 2009/10—this was a project covering 36 recycling facilities across 23 sites. How many jobs would have been linked into this going ahead?

Andy Rose: I believe the authority's press release at the time articulated 5,000 jobs.

Q9 Stephen Barclay: So about 5,000 jobs—

Andy Rose: That is my understanding—

Q10 Stephen Barclay:—in the run up to a general election. Okay. Could I then just come to the figures, because at paragraph 1.7, page 16 of the report, it says, "A review of a sample of Outline Business Cases by Partnerships UK estimated that all cases remained value for money at higher bank rate margins of 3%". However, if we look at this deal the margins start at 3.25% and go up post-year 21 to 4.5%. What I am driving at is when you assessed those as value for money, were you including refinancing within that assessment?

Charles Lloyd: No. We never include the possibility of refinancing gains within value for money assessments, simply because it is speculative; we do not know whether those deals will be refinanced or not.

Q11 Stephen Barclay: So what assessment were you making about refinancing on this deal?

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Charles Lloyd: We were not assuming the possibility of any refinancing gains. Can I just make one point on that? We would never assume and we would never ask an authority to assume the possibility of refinancing gains. Our role, if you like, is to set out how authorities should go about doing their value for money assessments, rather than doing the individual value for money assessment on every deal that went through during this period of time.

Q12 Chair: But you approved every deal?

Charles Lloyd: We approve every deal when it goes into procurement. So we take deals through something called the Project Review Group, which approves that they should go into procurement, yes.

Q13 Chair: Sorry—post credit crunch, when the credit crunch started, if something had already been approved for procurement you didn't draw it back to look again for value for money?

Charles Lloyd: As the NAO report makes clear, we did not draw every deal back. We did not ask every project to come forward with a new assessment of whether it was—

Q14 Chair: You did not?

Charles Lloyd: We did not.

Q15 Chair: Did you ask any project to come forward for reassessment?

Charles Lloyd: We did.

Q16 Chair: Which ones?

Charles Lloyd: We ask any project where what is called the PFI credits they require go up by either 20% or £20 million—all of those come back for reassessment. We also did the exercise that the report describes, which was asking PUK to do an overall evaluation of whether the movement in margins was likely to have created a systemic problem for us.

Q17 Chair: 20% is a jolly high figure to start worrying as to whether you're getting the VFM, isn't it?

Charles Lloyd: It's quite a high figure. There are a number of things that we would be trying to balance here, including not requiring projects to come back on a time-after-time basis for relatively small changes, so I guess it is a matter of judgment as to whether 20% is the right figure.

Q18 Chair: 20% is small change?

Charles Lloyd: No, 20% is quite a material change; I think that is why we do want those to come back.

Q19 Chair: Who set that figure?

Charles Lloyd: The Treasury set that figure.

Q20 Stephen Barclay: What was the tipping point for you, percentage wise, at which you would have assessed it not being value for money?

Charles Lloyd: One tipping point for us would have been the 300-basis-point figure identified in the PUK report. On the basis of the sample they looked at, we were aware that, if margins went above 300 basis

points across the market, there was likely to have been a systemic problem for us; that is, many deals might not on that basis have been value for money.

Q21 Stephen Barclay: So all those that went above that tipping point you assessed, did you?

Charles Lloyd: We were certainly closely involved in deals that went above that, of which there were very few. Greater Manchester Waste Disposal Authority is one we have looked at—that is a unique deal for size, scale and technology—but the great majority of deals were in the region of 250, 260 basis points throughout the credit crisis.

Q22 Ian Swales: That deal itself was financed through this new Infrastructure Finance Unit that had to be set up. As I understand it, that effectively took public money and converted it into the private money going into that deal. Why did only one project get put through that unit at the time?

Andrew Hudson: Remember, this was a very febrile time in the markets. What actually turned out was that the effect of TIFU making that intervention in the one deal had the effect of helping the market after that to work more conventionally again. The fact that market players knew that the Government were ready to make further loans if it judged it appropriate had the effect of stimulating market movement, which was one of our objectives. TIFU intervention was always intended as temporary and reversible.

Q23 Ian Swales: Do you think the market moved because they got frightened that they saw the Government starting to finance projects themselves?

Andrew Hudson: I don't know about frightened. Again, I will ask Andy who was most active in TIFU at this point.

Andy Rose: From the feedback we have received, the problem was a lack of supply of finance, and again, TIFU was not set up to lend in competition with banks. The policy at the time was that it was there to lend where there was no availability of finance from the private market, and in reality the only time that manifested itself clearly was on Greater Manchester. Because there was a lack of supply of bank finance at the time, the tension in the negotiations, I think the public sector felt, was very strongly on the side of the banks, so I think the answer is it had a material difference in that it created some competitive tension. Authorities were able to say to banks, "If you don't accept that point we have the option of going to another party," and we are aware of a number of cases where we were informed that that had a very powerful effect.

Q24 Ian Swales: Do you think the taxpayer as a result has had a better deal on that project than it otherwise would have done and if so why not do more in that way?

Andy Rose: I think, again, the driver was liquidity; it was not there to drive down pricing. So the—

Q25 Ian Swales: Well, what is the answer to my question: has the taxpayer as a result of this crisis had

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a better deal on that project than they otherwise would have done?

Andy Rose: Well, I think this is my point; I think the project would not have gone ahead at all had TIFU not lent. TIFU lent £120 million, and that was a gap because the other banks were not able to fill it. It is hard to answer the question because I think the answer is: at that stage the risk is the deal would have been cancelled only due to a lack of available funding.

Q26 Ian Swales: Has that £120 million been converted into a commercial loan now?

Andy Rose: TIFU only lent on a commercial basis. The policy of the intervention was temporary and reversible, so TIFU was staffed only with senior project finance specialists from the private sector market that negotiated a commercial deal and entered into the loan agreement on identical terms to other commercial lenders.

Q27 Ian Swales: So the taxpayer is sitting on an asset that is generating a commercial interest rate now?

Andy Rose: Absolutely.

Q28 Ian Swales: So is that not a good idea?

Andy Rose: I think the key was to try and keep the private sector in the market, so I think, with the evidence of 49 deals having occurred since, it was very, very important not to distort the private sector market where the private sector market could deliver, and the target of the intervention was only where there was not money available from the private sector.

Q29 Ian Swales: Does that unit still exist?

Andy Rose: It still exists but at the last spending review it has been identified that no further funding will be made available other than to honour the legal obligation on the draw-down on that Manchester loan.

Q30 Ian Swales: Is that not something we should be looking at? The Olympics and the Crossrail projects have a combination of public and private finance; should we not be doing more of that?

Andy Rose: Well, I think there are a number of initiatives currently being considered. Again, in the Budget and the spending review there was an announcement that the Green Investment Bank was looking at mechanisms. Again, the concept of the Green Investment Bank is still being developed, but I think the Government is looking at a number of possible interventions. The TIFU intervention was targeted on the PFI market, and given that 49 deals have closed since then without TIFU being asked to lend, I think the decision was made that allocating scarce public finances to TIFU going forward was not the right decision.

Q31 Mr Bacon: Couldn't the taxpayer be having that margin on all those deals? This one deal unblocked this pipeline and the other 49 deals that were at risk have suddenly been found resources. Isn't Mr Swales right that the private sector suddenly got rather scared that the Government was quite capable of doing it itself and at better value for money for the taxpayer?

I think it was Mr Hudson who said that the deals were valued on the basis of just above investment grade, or perhaps it was you, but at the end of the day we all know you have to go through the inconvenience of building the prison, hospital, motorway or whatever it is before you get the payments starting to flow. But once you have done that it is almost like buying a gilt, isn't it?

Chair: Quite.

Mr Bacon: In fact, when *Investors Chronicle* described the PFI market as the hidden golden egg, it was precisely for that reason, because you were paying only just above investment grade, but you were getting something that was pretty much gilt-edged. Isn't that right?

Ian Swales: Has there ever been a default on a PFI payment?

Charles Lloyd: In my 18 months in the Treasury there were two deals in the operational phase—so the construction had completed and the asset was being managed—that terminated for poor performance. So there are risks to these deals in the operational phase and they do manifest themselves.

Q32 Joseph Johnson: Just continuing on a point that Mr Barclay was making earlier, this was a pre-election period where there were a fair number of politicised lending decisions by the Government, in the view of many commentators. I would like to know, please, what role did the Treasury play in green-lighting the 35 projects that followed the one that was unblocked by the TIFU unit?

Andrew Hudson: Well, the Treasury played our normal role as we do at all times in ensuring value for money with appropriate projects, with projects either being approved by the relevant spending teams or, for a number of projects, particularly local authority ones, going through the Project Review Group, which Mr Lloyd chaired.

Q33 Joseph Johnson: So, chosen out of a universe of how many potential projects?

Andrew Hudson: I think pretty well all of these projects would have Treasury scrutiny at one stage.

Charles Lloyd: All PFI projects would be scrutinised by the Treasury, typically—

Q34 Joseph Johnson: Sorry—the ones that got green-lighted, the 35, were chosen out of a universe of how many potential PFI projects?

Charles Lloyd: I am not sure I know how to answer that question. There were 35 that closed in the period that we are looking at. In that period other transactions were going through the Project Review Group. There were—I think in my time—three deals that were brought to the Project Review Group to commence procurement that we said no to initially, because we thought they were not ready, either on value for money, affordability or some other grounds.

Q35 Joseph Johnson: Right. Of the 35, do you know how many were in what you might call marginal seats, seats where the incumbent had a majority of less than 3,000?

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Andrew Hudson: No, because that is not a consideration that we would have needed to know about or wanted to know about.

Q36 Mrs McGuire: Can I ask you a question? Was there any political influence at all brought to bear in deciding which PFI projects? I think we are going down a line of questioning here that I think we need some clarity from you on. Was there any undue political influence that you felt uncomfortable with in green-lighting these projects?

Andrew Hudson: Not that crossed my desk.

Charles Lloyd: None whatsoever from my point of view.

Andy Rose: None from my point of view.

Mrs McGuire: Thank you.

Q37 Nick Smith: Isn't that nice and categorical? Given the further £500 million-plus that was paid for the high cost and use of bank finance during this period—lots of extra money being spent at the time—why did you not get a better mix and use more public money for these investments?

Andrew Hudson: At that time the then Government was actually investing more public money through the capital programme, so that was happening as well. The decision on these projects was whether they were still value for money, within the context of the ministerial statement that they should go ahead where they were value for money. The choice in front of us wasn't whether we could continue these deals at a lower or higher borrowing rate; the choice was do we go ahead, accepting—as we have explained earlier in the hearing—that rates were higher because the banks' cost of finance was higher. Our job was to ensure that these were still value for money and we've talked about some of the steps that we took to ensure that.

Q38 Nick Smith: We understand it was a very difficult time and there were big charges for extra finance, but the world had changed and there was an opportunity here to save between £500 million and £1 billion by providing it through the public sector. Why didn't someone say, "Hmm, let's perhaps jump off this horse and do this differently"?

Andrew Hudson: As I say there has always been a mix of provision of types of funding for infrastructure projects. The Government did increase its own capital spending at the time and we also looked to bring in other sources of finance. So the European Investment Bank, for instance, contributed £1.1 billion across a total of seven projects over the period in question, so this wasn't, to use your metaphor, the only horse we were on. But the judgment was it still had a role to play, albeit accepting that that is at higher cost to the taxpayer, but we took steps to ensure that the projects that went ahead still represented value for money for the taxpayer.

Q39 Austin Mitchell: You answered Anne's question by saying there was no political pressure, but you were presumably under pressure from the top given the fact that everything is stalling and we desperately needed a stimulus to the economy to get this show

back on the road. Presumably there was such a pressure?

Andrew Hudson: Well, it's not a question of pressure, but there was a ministerial statement by Yvette Cooper as the then Chief Secretary, who said in March 2009 in a written ministerial statement, "The Government believes it is vital to get these infrastructure projects under way as swiftly as possible to support jobs and the economy this year as well as delivering proper public services."

Q40 Austin Mitchell: So it wasn't a pressure, it was a desperate, sweet plea from a lovely person. Why did it take you nearly a year to get the show on the road? Lehman collapsed—the table is on page 15—in September 2008. You don't issue the guidance note until August 2009; what took so long?

Andrew Hudson: We were working on these projects through the autumn and winter and judging what the best response to the new situation was. In terms of getting this show on the road, the key intervention of TIFU making the loan to Greater Manchester took place in March or April 2009 so we'd taken action at that point and that had begun the process of unblocking the market, which led to the 35 deals being completed in 2009–10.

Austin Mitchell: Okay.

Andrew Hudson: So, far from doing nothing until the application—

Q41 Austin Mitchell: Okay, and then you put the frighteners on with the Manchester deal, which is a graphic way of putting it. I wonder how far the dominant consideration was to keep the private sector in at all costs; in other words to keep PFI going and feeding the private sector in the way PFI does. Did you consider alternatives—there are a number of alternatives—that I and an obscure organisation that I chair were suggesting at the time—like bringing pension funds in to invest in PFI contracts or printing the money. We are now going through quantitative easing, and the Bank of England is buying back its own debt; why can't Government write cheques to itself to carry through these projects?

Andrew Hudson: As I say, there's always been a mix of provision here. The Government did—

Q42 Austin Mitchell: Yes, but did you consider these specific alternatives?

Andrew Hudson: We considered a number of alternatives. We did encourage schemes to look for as wide a range of financing sources as possible. We've never thought that the PFI was the only show in town. I mentioned that we took steps to get the EIB more closely involved. Colleagues may be able to say more in a minute about whether we involved pension schemes. PFI clearly has a part to play. There is clearly an appetite for it, viz. the fact that 35 deals went through, and we thought it was important to keep that source of finance as part of the mix, provided that the schemes were value for money.

Q43 Austin Mitchell: The private sector has to be fed, hasn't it? We have to keep it happy?

Chair: Well—

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Q44 Austin Mitchell: Did you consider printing the money?

Andrew Hudson: It's not a question of printing money; the alternative would have been to go ahead with Government-funded capital and the Government took a judgment as to how much it was prepared to do there and where that was most appropriately spent and that went through the—

Q45 Austin Mitchell: So even though that could have been done at a lower rate of interest, you are still rejecting it, under Government instruction?

Andrew Hudson: Government borrowing, remember, was running at an extremely high level—

Q46 Austin Mitchell: I remember. They are constantly telling us. I am asking whether you considered using that as an alternative at the time, in view of the desperate need for stimulus?

Andy Rose: The policy at the time wasn't to accelerate deals; it was to make sure deals went ahead when the only thing that was stopping them going ahead was the availability of finance. I think as the NAO Report acknowledges, because the procurement rules are quite tightly drawn, to change the procurement methodology would have caused quite considerable delays because you would have had to re-procure most of those projects. Given that the policy at the time was to ensure those deals that were ready to go went, if the only thing stopping them was finance, to cause delays by re-procuring I think would have been inconsistent with that policy.

Q47 Chair: Can I just ask you three questions arising out of that, because in one or two circumstances you did change tack. You decided in those circumstances that the Newham school would be better brought on balance sheet and do it as a straightforward publicly funded deal. What were the circumstances in which you decided—during this credit crunch period—that you would terminate PFI procedures or that you would look for another route for financing these particular projects?

Charles Lloyd: I would say there were two situations where PFI deals did not proceed: one is where they were not affordable to the authority concerned, so they just didn't have the budget to allow them to proceed because cost had gone up; the other was where they were not value for money. Many deals struggled during this period on both of those grounds. Obviously, 35 did come to close but many others didn't. Just to pick up the Newham one specifically; this was a schools transaction. It had been structured as a PFI deal. At the very last minute the lender dropped out of the picture. A case was made to us there that what we should do is allow that to close on a conventional design and build basis, but with the plan to switch that into a PFI very shortly after the financial close and, indeed, that is what happened in that particular case.

Q48 Chair: Let me just pick you up on the value for money, because as I understand it, the imperative is to keep the capital programme going because of the macro-economic circumstances. Value for money is

questionable on all these deals in the traditional way in which you assess PFI, because your loan charges are 6% to 7% higher according to this Report and the margin on PFI is 5% to 10%. I'm not sure you could make a value for money case for any of the 35 deals, could you?

Charles Lloyd: Our view is that you could make a value for money case on all of the 35 deals.

Q49 Chair: How did you base that?

Charles Lloyd: We based it on two main things. One was the piece of PUK work that we commissioned which indicated that margins would have to rise to about 300 basis points for there to be a systemic value for money problem, and the other was that authorities follow the very substantial value for money guidance that exists from the Treasury and that they are required to go through before their own accounting officers or Section 151 officers sign off on these transactions.

Andrew Hudson: I would also just point out that we are grateful for the NAO's endorsement of this, that the report at paragraph 28 says, "It is our opinion that in the circumstances the extra finance costs of projects financed during 2009 were value for money." And—

Q50 Chair: Just to interrupt. It says that and I understand that and this is not, in a sense, us being critical of you. It says that, in the circumstances, the overall policy objective was to maintain this capital expenditure for macro-economic reasons. That seems to me a different test to the one you would have applied to PFI projects in 2003–04? That's the point I'm making. Am I right or wrong?

Charles Lloyd: I don't think you're right on that point. The TIFU intervention was designed to redress a particular problem in the market, the problem of liquidity and lending capacity. The approach we took to all of these transactions, consistently, through the market was that we should solve that problem—and we think we did—but that deals should only come to financial close if they were, on a conventional assessment basis, value for money.

Q51 Chair: Let me ask you another question, because looking at the way in which many of these 35 projects were financed, there appears to be no competition over accessing the finance. Indeed, for many of the projects they have to woo a number of banks, and I can't remember the term you used—there are bank clubs. You developed this concept of bank clubs to try and entice a sufficient number of banks in to then fund the deals. Now that seems to me again to offend the principle behind PFI, which is that competition in the banking system will give you a better deal. The projects were grappling around looking for funders.

Charles Lloyd: It was a very difficult market.

Q52 Chair: So there was no competition?

Charles Lloyd: Well, I wouldn't say there was no competition. That depended on the scale of the deal. To take two examples, the M25 transaction—the biggest that closed in the market—required pretty much every bank in the market including the EIB to come in to allow that to close. Smaller schools

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transactions typically had one, two, sometimes three or four banks in them, and there, although it was very difficult to follow our conventional funding competition guidance in those circumstances, strenuous efforts were made, on a sort of book-building basis, to try and get the best value for money for the financing of those transactions.

Q53 Chair: Strenuous efforts were made. So you would say there was sufficient competition in there to meet the conventional principles of a PFI?

Charles Lloyd: No, I wouldn't. It was a very, very difficult market. So it was difficult to try to persuade banks to come into a conventional funding competition.

Q54 Chair: Yes.

Charles Lloyd: So we had to try, and authorities who were at the front line of this had to try whatever approach they could, but with a competitive tension wherever possible.

Q55 Stephen Barclay: Both Mr Lloyd and Mr Hudson mentioned in the last few minutes the European Investment Bank, which is a not-for-profit investment bank that lends on more favourable terms. Did you make full use of the European Investment Bank?

Charles Lloyd: We made substantially more use than we had done in the period prior to the credit crunch. Treasury collectively put, I would say, quite a lot of pressure on the European Investment Bank to step up and get involved with more transactions, so they brought a lot more funding forward. They became involved in sectors that they had not previously been involved in. I think we did a great deal. Was there anything else we could have done on the margin to get them involved? It is difficult to say. Their main issue is that they're resource constrained. They have a certain number of transactors. Those transactors were in demand all around Europe, as you can imagine, to be involved in deals of this sort. We were trying to get at least our fair share of that resource.

Q56 Stephen Barclay: Sure, but more is better, but is not best, isn't it? So if we look at say Italy and Spain, which have a similar share of ownership of the European Investment Bank as the UK, would we have had a comparable lending approach to those countries?

Charles Lloyd: I don't know the answer to that.

Andrew Hudson: We can research that—

Q57 Stephen Barclay: If you can let us have a note—because it would be odd, would it not if, for the sake of argument, £6 billion was going into Spain and Italy, but £4 billion was going into the UK, as ballpark figures?

Andrew Hudson: Yes.

Q58 Stephen Barclay: Could I just—oh, go on Ian, and then I'll come back.

Ian Swales: Go on, you finish.

Stephen Barclay: To me it looks like we were asking the banks to face both ways. On the one hand we were

asking them to build up their capital and on the other hand we were saying to them, "We want you to lend for 25 years." It strikes me that the last thing the banks would want to do is loan for 25 years at a time when they are reluctant to lend to each other, and therefore they are going to be charging a huge premium in order to do so, which goes back to my point about Appendix 4 and the fact that the margins were so big. Just coming on to it, again as to whether we made full use of the European Investment Bank and its favourable terms, which strikes me as a good starting point, the capital ratio of the EIB at the time of the credit crunch would have been around 26%, would it not, that sort of figure? Mid-20s?

Charles Lloyd: Again, I don't know, I'm afraid.

Q59 Stephen Barclay: Okay, let me rephrase it. The capital ratio of the European Investment Bank would be much more favourable than that of commercial banks.

Charles Lloyd: I mean, it is certainly a well-capitalised entity, yes.

Q60 Stephen Barclay: So it's easier to get them to lend than it is to get the commercial banks to lend?

Andrew Hudson: From that point of view yes, but as Charles Lloyd explained a few minutes ago there are constraints on the European Investment Bank as well. I well understand your point about were we getting our "fair share" of its lending, and we will research and let you have a note of that. We did try and there are different constraints on them from those that we've talked about on the commercial banks.

Q61 Chair: "We will research"—were you or weren't you? I mean, it is quite an interesting question. Rather than us wait two years for the answer, you must know now: could we have got more out of them?

Andrew Hudson: As Charles says, that's hard to judge. We had a number of discussions; we worked hard; we certainly stepped up the share compared with what had historically happened in the UK. They lent well over £1 billion to seven projects, crossing several different sectors. Could we have got more? Hard to judge. Did we get our fair share? We tried hard. In terms of sort of "our share" compared with our contribution and size of the economy or whatever, that is what we will let you have a note on.

Q62 Stephen Barclay: I was asking about in terms of share ownership, but seven out of 35—

Andrew Hudson: Yes.

Q63 Stephen Barclay:—and how we benchmark. My final question in terms of the EIB is just around what happened to their pricing compared with what happened to the commercial banks' pricing? My perception would be that the increase in the EIB pricing was modest compared with that of the commercial banks. Is that a fair view to have?

Andy Rose: Absolutely. The way that the capital markets were working at the time, it was a real flight to quality, and EIB because of its ownership is viewed as a very strong quasi-sovereign AAA, so in the flight

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to quality in the capital markets there is no question that the EIB's access to finance and its ability to pass it on was beneficial.

Q64 Stephen Barclay: Given that the first one of these, the first TIFU one, which was the Manchester waste authority one, had the EIB involved, it just strikes me as odd, if we were getting value for money, that we didn't maximise that in the subsequent deals.

Andy Rose: Again I think the comment being made is that, in the conversations I was involved in, the Treasury was pushing very hard on EIB to step up its lending; the feedback, as Charles indicated, was around the resources they were able to apply. So the deals they tended to do were the larger more complex deals, such as Greater Manchester. They did do some schools deals as well, but they tended to focus their resources on the larger, more complex deals.

Q65 Ian Swales: Can I just return to this question of risk? Has anybody ever defaulted on a PFI deal for financial reasons?

Charles Lloyd: Would you mind expanding on what you mean by for financial reasons, sorry?

Q66 Ian Swales: Has anybody ever failed to do the payments on a PFI deal because they didn't have the money to pay?

Charles Lloyd: I don't believe so, no.

Q67 Ian Swales: So you said there had been two operational reasons for PFI problems, but there's never been a financial reason?

Charles Lloyd: No, the Government or a local authority has never defaulted on their obligations under that.

Q68 Ian Swales: So PFI is gilt-edged, 100% secure, based on its record so far, financially speaking.

Charles Lloyd: Well, I would say the credit risk—

Q69 Ian Swales: Credit risk.

Charles Lloyd:—of the counterparty is low or negligible.

Q70 Ian Swales: Okay. I think all three of you have used the word "complex" at some time during this morning. Do you think the taxpayer's getting the best value for money by tying up the 100% secure capital financing with the risk of the operational contracts that go alongside most PFI deals, or do you think it would be better if they were separated?

Andrew Hudson: Sorry, just to make sure I understand the—

Q71 Ian Swales: Well, a PFI deal for a school, as I understand it, isn't just about building the school, it's about operating the school. Would it be better to separate the financial costs of building a school to the ongoing operational contract that goes with it in terms of value for money to the taxpayer?

Charles Lloyd: Can I have first go at that? I suppose my answer is I don't think so. One of the underlying almost philosophical points about PFI is you need to have the same party incentivised to both deliver and

maintain the asset, so one counterparty to the Government entity that is responsible for minimising the cost of that asset and securing its performance over the whole life of it, or you run risks of building something cheaply and then finding it expensive to maintain in the long term.

Andrew Hudson: Which had been the experience of the public sector over the years. Now, I think we're getting better at managing our own capital programmes and one of the emphases in the spending review capital settlement that was announced last week is to make sure that assets are properly maintained. Not having that link that Charles Lloyd has just talked about was one of the problems that PFI addresses by making the special purpose vehicle and behind them, the banks—

Q72 Ian Swales: My question is about the risk premium that you have to pay for large amounts of finance, given that, as Mr Bacon said earlier, this is only very, very slightly worse than a gilt-edged investment. Are we paying too high a risk premium for these projects? Certainly through this period it appears that we were.

Charles Lloyd: We would certainly do whatever we can to try and reduce the risk premium, both at the construction phase and the operational phase. One way to do that is to try and get these deals refinanced after the construction period at a cheaper rate in the operational period, where I agree with you, the risk has been diminished. That historically has happened a lot. This Committee knows very well the Government have benefitted from that to an extent over the years. I think we are very enthusiastic; we would like to see more refinancing. It is a difficult market for that at the moment.

Q73 Ian Swales: When PFI first started it was legendary how much money you could make by doing a PFI scheme and then refinancing it. What proportion of that refinancing benefit now comes back to the taxpayer?

Andrew Hudson: Well, this is something which has increased over time, so for projects, for the most recent projects reaching financial close since October 2008, the authority share will be 50% of gains up to £1 million, 60% between £1 million and £3 million and 70% of the gain above that. So that has been stepped up over time and, of the projects that the NAO report has talked about where they have quoted this potential extra cost of between £500 million and £1 billion, they also say that some £400 million might be recouped through refinancing—

Q74 Ian Swales: What would you describe as the source of that refinancing gain? Why does it occur?

Andrew Hudson: As Charles was saying, it is at the point where the risk to the lenders reduces, but do you want to explain in a bit more detail?

Charles Lloyd: I think there are two things. One source is the diminution of risk at the point where construction of the asset is completed. The second source is changes in the market. So clearly if rates or margins or loan tenures go down between the point where the deal was signed and the point where

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refinancing is looked at, there can be a gain. Progressively there's—

Q75 Ian Swales: I've done work in the commercial construction industry and they think a margin of 4% or 5% on a construction projects is fantastic. Would you say that these refinancing gains are of that order or are they much greater?

Charles Lloyd: I think that varies according to what is happening in the market, principally. Historically we have seen substantial gains in refinancing. More recently on the whole it has not been possible to refinance these transactions because many of them were signed at a time when loan margins were 70 or 80 basis points, so less than 1%. Loan margins in the market now are 2.5%, so it's not possible as a general matter to refinance and make a profit at the moment. Obviously, we hope it will be possible in the future and we've increased the refinancing gain sharing to give Government more of that share if it does happen.

Q76 Chair: If we've done that, don't we then make it more difficult for banks to participate in the market, because it's less advantageous? If the Government takes a greater share of the gain out of refinancing, there's less incentive for banks that traditionally participate in that market?

Andy Rose: The banks prefer the shorter-term lending, as articulated earlier. They actually prefer that. The person who's incentivised by the refinancing is the owner of the equity and again, when we came up with the 70:30 balance, we wanted to come up with a balance that recognised that Government had paid more and therefore was entitled to recapture more, but retain the incentive for the private sector to do the refinancing. The banks, frankly, are very pleased to be refinanced as they can recycle their own capital and not be tied into very long-term lending, so striking the 70:30 that Andrew alluded to was an attempt to come up with the optimal balance of recapturing more on behalf of the taxpayer, but retaining the incentive for the private sector to refinance.

Q77 Mr Bacon: Talking about long-term funding, one obvious source of long-term funding is pension funds, who are looking for long-term funds to match their long-term liabilities. Now, what effort was made to start marketing PFI finance deals to those sources of finance or are they only of interest once the risk is reduced, as Mr Rose discussed?

Andy Rose: Well, there has been an active dialogue with pension funds for as long as I've been in the market, which is a very long time. The reality is that pension funds at the moment from a debt perspective do not have the analytical capability to analyse the construction risk, and therefore what they would rather have for their investors and their pension holders is long-term stable cash flows that are more likely in a refinancing—

Q78 Mr Bacon: So a major potential source of refinancing?

Andy Rose: I think it's a terribly important area for us to develop and there is an enormous dialogue with

them; I do think it's a very, very important area to develop.

Q79 Ian Swales: We have just established that, as a lender, the track record is that the risk is nil. Financial risk is nil.

Andy Rose: I think Charles—I'm not sure that—

Q80 Mr Bacon: Mr Swales and Mr Lloyd, were the two projects that you were talking about the National Physical Laboratory and the Shrivenham Joint Services contract?

Charles Lloyd: No.

Q81 Mr Bacon: Which were the ones you were talking about?

Charles Lloyd: There was a Cornwall Schools Project and something called the Defence Animal Centre, both terminated in 2009.

Q82 Mr Bacon: When they were terminated, why were they terminated?

Charles Lloyd: They were terminated because the performance of the private sector was unsatisfactory.

Q83 Mr Bacon: Right. Okay. So they weren't terminated because in some way the authority failed to make its payments, which would be a good reason.

Charles Lloyd: Absolutely not. No.

Q84 Mr Bacon: I remember we looked at it on this Committee, both the National Physical Laboratory years ago and the joint services college in Shrivenham, where Laing construction decided to build it on a swamp, except they didn't know it was a swamp and indeed they went out of business and had to be bought. That is a different kind of risk; it is an operational risk. Mr Swales is talking about the finance risk and indeed the finance risk is very low, and what we are still interested in—I've always been interested in this—is whether we can prise away the finance risk. One of the first PFI deals we looked at when I was on this Committee was the competition for financing the Treasury building PFI, which was the result of an NAO Report. I see Mr Finlay nodding. The report concluded, unsurprisingly, that if you have a competition for the finance you get a better rate than if you don't. 300 basis points is quite a lot in financing terms, when you consider that we are really talking about near gilt.

Charles Lloyd: Can I make one point on risk? Although the risk of the authority or the Government defaulting on the loan is very low, the Government will only pay what they are due to pay under the contract, and it is the performance under the contract that matters. In those two examples I gave, the banks—notwithstanding they got their payments—had to write off significant amounts of their loans because the performance of the business they had lent to was unsatisfactory. So there is risk on this finance: it is not a credit risk; it is a performance risk.

Andy Rose: Can I come back? The long-term fixed-rate investors are very sensitive to the view of the rating agencies—

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Q85 Mr Bacon: We know how good they are, don't we?

Andy Rose: I had the feeling you might say that. They are very sensitive, particularly when they are the pension trustees and people like that. The reality is that when the rating agencies look at these long-term transactions they certainly do not look at this as no-risk transactions. They do look at these as quite considerable risk because these are very complex. As you said, there is performance risk and quite a high degree of gearing in—

Q86 Mr Bacon: Certainly, and I think I'm right in saying there were AAA-rated monoline insurers that were basically getting into trouble, so—

Andy Rose: Absolutely. That was the model from 1997 to 2007, as far as I'm aware. All the PFI transactions done in the capital markets were with the benefit of what was then, as you suggest, a AAA rating from the monoline insurers.

Q87 Mr Bacon: Going back to the EIB point, which I wanted to ask earlier, why then did you not take more advantage of this flight to quality? Mr Lloyd said there weren't enough transactors. I take it you mean corporate finance professionals, project professionals, who could run these deals? Why didn't you, because—you're back in PwC now I think—you were yourself a secondee, your predecessor as Head of PFI Policy at the Treasury was from Deloitte; he was a secondee? His predecessor, Mr Abadie, was also a secondee from PricewaterhouseCoopers. Why didn't you guys say to the EIB, "I know, we know lots of these project professionals. Why don't you take 10, 15, 20 or 25 of them, second them into the EIB for a bit, run more deals"—because you've said the number of transactors was the limit—"until we get things settled down?" Then you can go back to the private sector and take advantage of the genuine quasi-sovereign ratings that the EIB was able to get for raising its own funds. Couldn't you have done more of that?

Charles Lloyd: We did some of that. Speaking for PwC, we seconded people into the European Investment Bank at that time. I think it's really a question for the EIB about the extent to which they are prepared to—

Q88 Mr Bacon: We are a shareholder. I was actually talking about HMG. Wasn't HMG prodding the European—I'm sorry about all these three-letter acronyms—but wasn't HMG prodding EIB and saying, "Look, we're a shareholder in your bank; why don't you get more people from places like PwC?" Were you doing that, Mr Hudson?

Andrew Hudson: I wasn't. Could we have done more of that? I don't know.

Q89 Mr Bacon: Mr Lloyd was doing it. That's because he wanted to keep the deal flow going.

Andrew Hudson: Sorry, I'm thinking—well, indeed.

Q90 Mr Bacon: You wanted to keep the deal flow going as well, so why didn't you do it?

Andrew Hudson: I think we—

Q91 Mr Bacon: Because you would have more deals going more cheaply, because the EIB—

Chair: Bureaucratic inertia, I think is the answer.

Andrew Hudson: I understand the point. I don't know whether that was considered at the time. What I would say is that the Treasury had a huge number of other preoccupations at the time. So it is an imaginative idea—

Q92 Mr Bacon: Like keeping the money coming out of the bank holes in the wall—

Andrew Hudson: And keeping the banking system, as a whole, afloat, so I hope it wasn't simple inertia but there were some other priorities in that space.

Q93 Mrs McGuire: I'd like to turn back my question to something that Austin highlighted, which is the length of time that it took you—that it appeared to take you—to respond. Given that there was a storm raging around some of our financing of infrastructure projects, did you feel that you were just like one of these big tankers that just didn't know how to turn? What I am trying to, I suppose, elicit from you is what lessons did you learn from that period—one hopes we won't face another period like it—because just to say, "Well, we did it over a six-month period," frankly, is not good enough. The Chancellor of the Exchequer at the time was warning in September 2008, I think, that we were about to face the greatest economic crisis that any of us would ever have countenanced. What would you have done differently to respond far more quickly than, frankly, you did?

Andrew Hudson: I think it is always easy with hindsight—there are always things that you say you could have done more quickly and in a minute I will ask Andy, who was in the thick of the discussions on the financing at the time, to say more. My perspective is that what was happening in the markets was unprecedented, very fast moving and hard to read. We were trying to balance first of all identifying what the appropriate policy should be on these deals, and advise Ministers on that, and also think about what financing options we had. In the end, the TIFU approach was the one we went for. That process did take a certain number of months. In the course of that, we commissioned work to get some better idea of the value for money implications of the higher margins that were emerging; we commissioned PUK in the winter to produce a report, which came out in early January, that gave us a handle on how far margins could rise before threatening the value for money assessment. It wasn't that nothing was happening at this point. We were doing some detailed work that enabled us to put together the policy response for Government and the TIFU intervention which then kicked in in March-April. I don't know whether Andy wants to—

Andy Rose: I think it's fair to reflect just how uncertain things were post Lehman. There really was a high degree of uncertainty about what was going to happen thereafter and I think—from my understanding—what did Treasury do? I think Lehman happened in September. Over the next three or four months there was a lot of analysis about the value for money. There was also a lot of analysis

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about different responses. TIFU wasn't the only response considered by Treasury.

Q94 Mrs McGuire: What other options were on the table?

Andy Rose: Looking at shortening the term of the financing to create an embedded refinancing is the term, technically a mini perm financing; ways to look more at the pension funds and the capital markets. For a number of reasons, TIFU was chosen as the preferred intervention, which was put in place over January and February. That then took to March. TIFU made its first loan in April. One of the, I think, very important things was advising procuring authorities to have more flexibility in their OJEU notices so they weren't tied into one particular financing. There was encouragement to look at more capital contributions from more authorities, which reduces the price by changing the mix. There was the issue about increasing the refinancing gain that the public sector took, and also giving the authorities the right to call for a refinancing, which they didn't have before. So I think to call it a "tanker" wouldn't be the word I would use, because I think there were a number of things. I think lessons learnt: again, I think it's just really important to reflect on how uncertain things were for anyone who was very close to the finance community. We were entering a world that none of us had ever seen before.

Q95 Mrs McGuire: So you were being so cautious because you were frightened you might make things worse?

Andy Rose: I don't think setting up TIFU was cautious. I think a lot of people would say it was quite a bold move.

Andrew Hudson: Yes. It was a very big change from previous practice. Just reflecting as Andy Rose has been speaking, I'd rather be sitting here saying that knowing what we know now we could have perhaps have moved a little quicker, than sitting here explaining why we rushed into something which turned out to fail, which the TIFU intervention didn't, or to be wholly misjudged.

Ian Swales: If it was such a good idea, why did you only do one project through TIFU?

Q96 Mr Bacon: Going back to why didn't you get more of the margin on more of them: admittedly it was the taxpayer who was going to pay for it, but the net effect down the line would have been overall to reduce the cost. If you could get most of that margin by providing the funding through the Treasury directly, obviously that sent a signal to the private market that, if they didn't step up to the plate, you would. That did probably scare them, I'm sure it did. It probably gave them confidence I suppose, which was a good thing in circumstances where nobody had any confidence—

Chair: It is a very attractive market.

Mr Bacon:—but it gave them confidence to buy a near gilt, but once you got the structure going if you could do one, you could do two. If you could do two, you could do four. If you could do four, you could do

35. In doing so you would have then extracted all of that extra margin and you'd have ended up with TIFU making an enormous profit that they could have then repaid to the Treasury.

Andy Rose: Because that was not the policy at the time. The policy at the time was very clear: it was temporary and reversible; it was to only finance when there was not available finance from the private sector. I think going further would have done two things. I think it would have changed the risk transfer mechanism in a lot of projects, rather than just by necessity in one, because it is the taxpayer lending into Manchester. I think the other thing is there was a risk that it would unsettle the rest of the market. Again, 49 further projects have closed, and I estimate 25 different banks have participated in those 49. I think if the other banks saw this as an unlevel playing field then there is a real risk that they would not have stayed in the market the way they have, which from my point of view was consistent with the policy at the time.

Q97 Chair: But it might have met another objective of better value for money with lower loan rates.

Andy Rose: Well, it would have achieved better value for money by Government taking back the risk as a lender by driving down price, but that I think would have had a material change on the risk profile had that been across the whole market.

Q98 Mrs McGuire: Just on the same line, were you astonished at how quickly you unblocked the market—

Andy Rose: Yes.

Q99 Mrs McGuire:—with this one loan, and does that give you any feeling that perhaps you should have been tougher on the banks from the beginning? It is like miracle at Manchester, frankly.

Andy Rose: No, I think again the reality of the market with hindsight is there were two very, very large projects and, again, we talked earlier about competition; there is competition on the smaller deals. There wasn't competition really on the much larger deals and I think that was quite difficult and club deals have been referred to earlier. I think, with hindsight, with Greater Manchester and the M25, which between them had approximately £2 billion of finance to be raised, a lot of banks were very uncertain post-Lehman about the markets, and I think once those two deals closed successfully and banks and procuring authorities knew that TIFU was there, that gave confidence to the market, and personally it did surprise me how quickly the banks recovered.

Q100 Austin Mitchell: I can see your predicament. You are correct in saying that you were bound by policy at the time, even if the policy was insane. You were bound by it. Or daft, should I say? Daft. Mr Hudson said the situation was difficult to read—not quite true because two people, Vince Cable and I, read it perfectly. He did better out of it than I did, because he was better at publicity.

Mrs McGuire: Talking about miracles.

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Austin Mitchell: You were being screwed by the banks, to put it in simple terms. Now, the problem is, having succumbed to that screwing, what we do now in the future, because it is my argument, and I think it is Richard Bacon's, that you weren't inventive enough at the time. Now the report says at 3.2 on page 26, that as a result there may have been a long-term increase in the cost of using private finance. A long-term increase. Now, the infrastructure report just out, which is a very good one actually—I hate saying this, but it's good—says in the introduction, this is page 4, paragraph 3, that there's meant to be a reduction in construction costs, but there also needs to be a reduction in the costs of capital, and a 1% reduction in the average cost of capital would result in an annual saving of £5 billion. Now it is you jokers that are paying out these huge sums on capital projects through PFI. Aren't you going to have to be much more inventive about finding alternatives to bank financing, perhaps involving the pension funds, perhaps even printing money, which is what I suggested, but you are certainly going to have to cast around for a way of reducing those costs.

Andrew Hudson: Well, the National Infrastructure Plan raises a number of new ways of providing finance for infrastructure, spanning private and publicly funded infrastructure. Indeed, yes, we are looking at those new ways, being more inventive, and things like the Green Investment Bank will have a part to play with public funding behind it. There are other things set out here which the private sector will want to think about, and part of the purpose of the Plan is to set an environment in which the private sector will feel more confident about financing infrastructure. Andy may want to say more about some of the specific ideas.

Q101 Austin Mitchell: And you will be working to reduce those costs on PFIs?

Andrew Hudson: Well, the mechanisms we have to reduce our costs on PFI are the refinancing provisions which we talked about, which were strengthened a couple of years ago. So that's what we'll be looking to do, as and when market conditions permit.

Q102 Austin Mitchell: Not for new projects?

Andrew Hudson: Well, for new contracts we need to continue with public funding reduced all round; we need to be tougher than ever at driving value for money, but I would not want that to imply that we have not been rigorous in that before.

Q103 Chair: There's a queue of people wanting to ask questions. The loan rates aren't going down so does this mean there is no future for PFI?

Andy Rose: Well, again—

Q104 Chair: We are in a much more stable financial market, but the loan rates are staying high.

Andy Rose: I think there are a number of issues; if I may just touch on a couple of them? On the "screwed by the banks" point, the reality is the banks were passing on a lot of their own increased funding costs, rather than making enormous profits at that time, because it is a reality that their own funding costs in

the long-term capital markets were increasing dramatically. In terms of looking at new funding sources: we are absolutely keen on bringing pension funds into the market and interestingly there was a recent transaction earlier this year, which was the Southmead Hospital in Bristol, where the bidder ran a competition between bank finance and bond finance and the bank finance came out cheaper. As Treasury we did not think it was appropriate to tell the Southmead Trust to pay more for the bond finance than the bank finance. So there is competition in the market and the bond finance was more expensive.

Q105 Austin Mitchell: Not much.

Andy Rose: Not, not much, but remember this is money raised by the private sector and the public sector has a huge interest in that it pays unitary charge and therefore had they selected the more expensive finance that would have been passed on to the Southmead Trust. I think the IUK document, and I work for IUK, as Andrew suggested, looks at a number of different markets and not just PFI but very much economic infrastructure as well, where a lot of the finance is raised in a very different way; it is more private to private. These aren't concessions left by the public sector. Yes, I think looking at reducing the cost of capital—there will be a regulatory review undertaken over the next few months—is critically important. Yes, absolutely we need to continue to explore different forms of finance.

Q106 Chair: Can I just ask the question: is there a future for PFI in this? You are looking at all these alternatives; given where we are on loan rates, is there a future for PFI?

Andy Rose: Again, I think it goes back to the selection of the authority of a prudent methodology and whether that's value for money. The view, as Charles articulated earlier, is that, based on individual deals at these margins, it can be value for money, yes.

Q107 Chair: Amyas, Jo and then Stephen.

Amyas Morse: Thank you Chair. I just want to make sure of some of the points in the report. Although we said that the additional funding costs in the special circumstances and with the policy direction were overall value for money, we made some, I thought, intentionally trenchant points. First of all it wasn't just additional financing costs, it was also transfer of risks by the banks to the Government. So they took the chance to improve their position there. Secondly, going forward we are very clear that we think much tougher criteria need to be applied in assessing value for money on PFI projects in future and, if there are changes in the financing cost component, the margin of tolerance that the Treasury will accept before requiring a restated business case should in future be much narrower. We made all of that very clear, so I think we should let the market decide if there is a future for PFI and if it doesn't meet those tough criteria then let the answer be what it may. If I may, one thing, Chair, is I thought Mr Swales's comment about the very substantial amount of the value in any PFI deal that represents the maintenance and operating

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agreement—I felt we passed by that without really hearing a very full answer, if I may say so.

Q108 Chair: Mr Hudson.

Andrew Hudson: I think on Mr Morse's points—the more exacting tests—I stressed all along that we have been rigorous in assessing value for money but, as I said just now, public money is a whole lot tighter and we certainly need to keep our eye very much on that ball. As to the threshold, whether we should have a specific number and what that should be, that's under consideration and we're going to put out some more guidance shortly, but we'll draw together the lessons of the whole of this episode, and we'll take a final decision on whether to have a specific threshold above which projects need to come back for re-approval or some demanding test, but not a point estimate, in the course of that piece of work.

I'm sorry if we didn't cover between us the point that Mr Swales was driving at, and Charles Lloyd may want to say a bit more, but the way I see it is that through the construction phase there is a considerable risk and that is reflected in the premiums that are paid. After that, the risk comes down; it isn't eliminated altogether and, as Charles explained, there are reasons why the financing, the design, the building and the operating are held together in these contracts, because that gives the incentive for the private sector provider to take the right decisions at the design stage and the right decisions in preparing its operations to provide best value for money over the lifetime of the project. That's why the financing is integrated but with these strengthened provisions for the public sector to benefit once the risk reduces as the construction is completed.

Q109 Ian Swales: My point was really that the fantastically complex structure of these deals means that the whole risk is tied together. You have people assessing everything from the construction of something to how something might operate in 20 years' time. As the report says, that can deter people from getting involved, including pension funds, because they may not have the resources to assess all that risk. So my question was: is there a way of unbundling it so that we get the proper risk premium separately on the two key stages of any deal?

Andrew Hudson: Do you want to say a bit more about how these risk premiums are worked through?

Charles Lloyd: Yes, I suppose conventional capital procurement in Government is an unbundling of the risk, so we get a construction contract and then offer an operations and maintenance contract. That is certainly one way to do it and indeed the great majority of capital is procured in that way, as opposed to on a PFI basis. The problem with that though is that the public sector, the client, sits in the middle and at the point where the construction risk switches to the operations and maintenance risk, what is passed back to the public sector is the risk that the building was built inadequately in the first place or was not suitable for the most efficient form of maintenance. Yes, absolutely, we can do that, but we shouldn't do that and pretend there is no risk in that to the Government.

Q110 Ian Swales: Well all I'm saying is it's two packages, not one, isn't it on most of these projects? The building of a hospital is entirely separate to the operating of the hospital—

Charles Lloyd: But if you—

Ian Swales: Sorry, just to finish my point—with usually completely different commercial players carrying out the work. So, Shepherd Construction might build a hospital, but they are not going to operate the hospital.

Ed Humpherson: Can I make an intervention here and ask, Mr Lloyd, particularly about the bundling of facilities management services into PFI contracts, because I think that goes to the heart of the point Mr Swales is making. It is not simply a bundling of capital with the maintenance, but it's the bundling of the capital with the maintenance, which one understands makes some sense, with things like security and cleaning and catering, all of those things, which add to the complexity.

Q111 Ian Swales: Just to emphasise that point, as we heard earlier we've never had a default on a body not being able to pay for the construction. We have had two cases, I think you said, where it's the operation that falls down. So the two risks are different.

Charles Lloyd: So, to pick up on Mr Humpherson's point, I think there is a clear case for combining in a contract the construction of an asset and then the maintenance of that asset

in order to get the cheapest whole-life cost. There are different issues that arise when you look to also bundle into the contract what we would call soft services: cleaning, catering, security, IT helpdesks and all of that. We've issued a lot of guidance on this in the past, which I think has made clear that the Government, the Treasury, do not insist that those services get bundled into those contracts. Each authority is expected to make an assessment of whether there are benefits in bundling those services together or not.

Q112 Chair: Is there a value for money issue there as to whether or not you do? Have you looked at that? So is it better trying to untangle this debate? Were you not to incorporate those into the PFI would you get better value for money or not? Have you looked at that?

Charles Lloyd: I think the answer to that would probably vary significantly between sectors. So if I take a couple of sectors, in the prison sector I think there is quite a case for integrating all services so that you have one provider who is providing every service to do with that asset. Indeed that has been the model. I think in other cases—hospitals, schools are ones that come to mind—where in any event the Government's policy has been that the front-line delivery of services remains a public sector job—teachers, nurses, doctors and so on—there is more room for discussion and debate.

Q113 Mr Bacon: It is not that uncommon to unbundle. I visited the new Belfast cancer centre some years ago, where they had done the building and the machines that go inside it in different ways. One was

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conventional and one was PFI. I can't remember which way round it was, although originally they had assumed they'd do it all in one group, they found it was better not to. When Mr Swales said there are two components here I think he was perhaps even understating, because there are three: there is the original construction, there is the operating, and then there is whether you keep it at all or whether you sell it off into the secondary market. The House of Lords Economic Affairs Committee said more work should be done on this.

Now, Mr Hudson, a minute ago you were saying there is of course a way to share with the taxpayer the gains once the risk is reduced, but it says in paragraph 3.9, "Treasury guidance currently permits such equity sales without the sharing of resulting gains with the public sector." Are you going to change your guidance on that? Why shouldn't the taxpayer get a share of gains from equity sales? At the moment there is an incentive. This happened with the Norfolk and Norwich Hospital; they refinanced the project. At the time they refinanced it they put an extra £100 million, £106 million of debt on top of it. Interest rates were falling at the time; the internal rate of return went from 18% to over 60%. Essentially they extracted all their profit or most of their profit from the 35-year deal up front. Well, you don't have much interest then, once you've already got all your profit out of it, in whether you run the contract in the way that PFI theology says that you should over the life of the contract. In fact, the House of Lords called for further investigation of any impact on service delivery that may result from the sales of shares. So if you believe—which you do, because you just said so—that taxpayers should share in the gain, for example from the reduction of risk and the consequent refinancing, why don't you do the same for equity sales?

Andrew Hudson: Well, that is something that we are working on as to how we would respond.

Q114 Mr Bacon: It says, "The Treasury has yet to publish research on the contribution made by equity investment at various stages in the life of a public-private partnership." When will you be producing research?

Andrew Hudson: I don't have a date for that yet, Mr Bacon, but it's something that we're working on.

Mr Bacon: Right.

Q115 Joseph Johnson: Turning back to TIFU please. The credit crunch hit in full in late 2007. TIFU wasn't set up until March 2009, 15 to 18 months later. If I understood your earlier answer, I think you were saying it's no longer going to be funded going forward as of the spending review. What steps are you taking to ensure that, in the event there is a new freeze-up in capital markets and in bank lending markets, there won't be a similar hiatus that causes UK PFI projects to suffer from lack of access to finance?

Andrew Hudson: Well, I think having gone through the process of setting up TIFU and working out how it might operate, what the appropriate governance is, although it is not being funded at the moment, it

would be much quicker to turn that facility back on again.

Q116 Joseph Johnson: Are you retaining the staff that were associated—

Andrew Hudson: Yes.

Andy Rose: One of the things that IUK has enabled us to see, and particularly the mandate it has around looking at the critical area of inward investment for the £200 billion that was articulated yesterday, is that an enormous amount of work with finance expertise is required. So examples are working with UKTI on inward investment, working with BIS on the Green Investment Bank, working with DECC on the electricity market reform—areas where we think finance expertise is critical to be successful. So we have retained a degree of operational flexibility in that capability is retained and employed in IUK, but no funding is currently provided by Treasury.

Q117 Joseph Johnson: I suppose what I'm driving at is it would seem, from the decision to cease funding of TIFU, that you've reached a sort of epiphany in terms of your understanding of what the role of the Government is; whether it really is the role of the public sector to lend to itself in order to enable private players to cream off the very rich returns that are available from participating in PFI-style projects, or whether you actually do believe that that is a good way of proceeding.

Andrew Hudson: I was just going to say that the policy was always that TIFU's activity should be temporary and reversible. As it turned out there was only the one loan and, given the present state of the market and the work that is going on on other financing sources that we've talked about, we felt that it was time to be clear that there wasn't funding for other projects.

Andy Rose: Yes, I think a lot of it is to do with the statements around the spending review, where public finances are just more constrained. I think TIFU can only be credible if it has a budget that it can lend, and to allocate funding to an entity that had not lent for a year and a half, I think, people felt was inappropriate.

Q118 Jackie Doyle-Price: Going back to what you said earlier, Mr Rose, about when the contract regarding the M25 widening was concluded successfully, if we look at the figures in the report we see that there was a massive increase in costs by 23%, and that much of this was down to increased financing costs. On what basis can you say that was concluded successfully?

Andy Rose: Well, first of all I'm aware that there is an independent report due on that so I won't comment too much. What I meant is that, from a TIFU perspective, the money was made available from the private sector, and therefore it was completed without TIFU being asked. In that case, the Department for Transport had made money available should it be needed and that was never used, but I am very conscious that there is a separate report pending on that transaction.

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Q119 Jackie Doyle-Price: What I'm trying to get to is the degree of challenge—that you really considered the value for money aspects of this in terms of securing this as a way of finance, because this is a considerable increase in cost from what was originally—

Andy Rose: Again, from a TIFU point of view, we were very clear to separate the policy role that was held by Charles and the transaction role. So TIFU was staffed by senior project finance specialists from the market with the hope that it would give confidence to taxpayers that money was lent very professionally. We did not take a policy view about value for money because we didn't want the market to see policymakers only, and there was a very clear separation between TIFU's activities and the policy activities of Charles. When I talked about it being successful, I meant the private sector delivered that transaction without recourse to TIFU.

Q120 Jackie Doyle-Price: So you are talking about success in terms of negotiating a contract, rather than seeing it against the broader scheme of—

Andy Rose: To be fair, I'm coming from a very narrow perspective and my comment was that at that stage my role was solely to lend when asked to and there was a very comprehensive process that we went through before a lending request would come into TIFU.

Q121 Jackie Doyle-Price: Perhaps Mr Lloyd might have an observation to make on this particular case.

Charles Lloyd: Yes. The Treasury was heavily involved in the M25 transaction, both through my team and through the spending team, as you would expect given the scale of the transaction. I would say that our principal role was to make sure that DfT and the Highways Agency, which was the authority for it, had done everything it could to create the maximum amount of competition for the funding of that deal, and had applied our value for money and our other PFI guidance appropriately. We were heavily involved in working with them to ensure that they did assess value for money, that their accounting officer was aware of the value for money consequences and the price increases, and considered all of that. It's for the DfT and the Highways Agency accounting officer to come to a view, in the first instance, on value for money, but we wanted to make sure that they were aware of those issues and thought about them properly, and no doubt the NAO will comment on that in due course.

Chair: Austin then Ian, and then I just want to draw it slightly into the future before we come to a close.

Q122 Austin Mitchell: I've just got a couple of requests for information. Mr Hudson, in your answer to Richard Bacon on why you haven't made arrangements to get some return for the taxpayer from these refinancing deals—which have been going on a long time, are clearly profitable, and exposed by *Private Eye*, my usual source of information, for a long period—you say you are still thinking about how you can get some return for the taxpayer. That's absolutely extraordinary. This is a major racket. Much

money has been made out of it, and you haven't decided yet how you can get a return for the taxpayer. Now can you supply us with information—

Mr Bacon: I wasn't talking about refinancing, I was talking about equity sales.

Q123 Austin Mitchell: You were saying refinancing is a cost.

Mr Bacon: They already get a share of the refinancing gains. They don't get a share of the equity sales gains.

Q124 Austin Mitchell: Right. Can you give us an indication of how many deals of this kind there have been, in sales of the equity and refinancing? Not now, but if you can give us a note.

Andrew Hudson: Refinancing, in terms of the financing costs of the projects, we have taken steps over the years to increase the share that goes to the public sector. We don't keep a central track of how much the public sector has recouped from that, not least because the projects are spread over probably hundreds of local authorities.

Q125 Austin Mitchell: Do you not issue any guidance?

Andrew Hudson: It is not just guidance; we have a standard practice agreed with the market as to what the refinancing gain share is. The point I was answering Mr Bacon's question on was a more specific area of equity stakes and so on, and that's more complicated, and that's where work is still going on. I don't know whether Charles Lloyd can answer this point.

Charles Lloyd: Just to comment briefly on it, obviously refinancing is a major source of profit to equity, and we've addressed that in the way that Mr Hudson describes, but equity can make profit in other ways as well, by trading its shares. Until this point in time, the view the Government has taken is that there is a benefit in having a liquid secondary market in equity in private finance transactions. It enables, for example, the contractors, who often invest in this up front, to recycle their capital, to put capital into other new projects in due course, and it's clearly in the Government's interest that there is a liquid market. The more liquidity, the cheaper the price of equity is. So I think—

Q126 Austin Mitchell: Surely it's in the Government's interest also to get a return on this?

Charles Lloyd: I think if the Government were to say, "We will have a slice of the profit that equity makes, absent refinancing," you have to trade off on that the disincentive effect for those sales to take place. That's a judgment, and so far Government have always come down on the view that liquidity in the market is good and outweighs the initial income we might get from clawing back some of that profit.

Q127 Austin Mitchell: There's no indication of the scale?

Charles Lloyd: I'm sorry?

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Q128 Austin Mitchell: You've no indication of the scale; the number of cases in which there hasn't been—

Charles Lloyd: There has been a lot of secondary equity trading transaction activity over the past several years, so it is fairly common for equity in these transactions to be sold.

Q129 Austin Mitchell: Okay. Well, the second question, for information: we're looking at projects which were stopped by the credit crunch in this report, but the report says, in paragraph 1.9 on page 17, that "delayed projects were also vulnerable to the credit crisis". It instances the M25, where costs increased by over £600 million because of delays in the contract, which then had to be refinanced. Do we have an indication, or can you give us an indication, of how much extra costs accumulated because of refinancing problems like that?

Charles Lloyd: I suppose the best estimate at the moment is probably the NAO's work, which looks at the cost of finance pre-credit crunch and the cost of finance now, and estimates that in those projects which have closed, costs are now £500 million to £1 billion higher than they would have been at the lows of the financing markets.

Q130 Austin Mitchell: But you don't have a list or information you could give us?

Charles Lloyd: We have a list of all projects that have closed, and I suppose we could look at, hypothetically, what I think the NAO must have done, and hypothetically what they would have cost had they closed in, let's say, 2007 and what they actually cost now.

Amyas Morse: Pardon me, Austin. What we explained before the hearing is that it depends. We looked at around a range between £500 million and £1 billion because that depended where you take the starting point in the marketplace to be. I think going back a bit, the very keen market just before the financial crisis, that would give you £1 billion, and if you went back a bit further, it would be £500 million. So that is why there is a range. Can I just say on equity sales, our understanding, as we sit here and try and estimate, is that we think there have been a very substantial number of equity sales, at least 150 different equity sales that we can pick up, and some of those equity sales were sales of portfolios of equities rather than individual equities. There is a very active trading market in equity stakes in countless instances.

Q131 Chair: Is it your view, is it the NAO view, that there is a potential there for some money back to the taxpayer out of that?

Amyas Morse: Perhaps I can put that a different way. Because people aren't doing these trades for fun, therefore I'm assuming that they're doing it to realise gain. Therefore, if you were able to establish that there is a pattern of systematically realising gains through trading equity as well as refinancing debt, you would imagine there might be a case, and I gather already from what Andrew Hudson has said that it has been considered, of saying, "We want to capture some of that gain from private—"

Q132 Chair: Do you agree with that, Mr Hudson?

Andrew Hudson: It's clearly something that we keep an eye on. Charles Lloyd has explained the reasons why Government policy so far has been not to seek to intervene in that particular bit of the market. If we can say any more, then we will let you have a note.

Q133 Chair: Just to pursue that, at present there is no review taking place that would suggest that, in the equity market in PFIs, we would look to the Government recouping some benefit from the profits made?

Andrew Hudson: We work on it in the sense that we keep an eye on how this market is working.

Q134 Chair: But that's very vague, isn't it?

Andrew Hudson: It's not a review as such. There is no review as such going on at the moment.

Q135 Mr Bacon: Mr Hudson, do you keep an eye on who the owners are? Do you know who all the owners are of these assets that are providing public services?

Andrew Hudson: We do.

Charles Lloyd: Yes, we do.

Q136 Mr Bacon: So you wouldn't have North Korea buying one of our hospitals without our knowing about it?

Charles Lloyd: We don't try and manage through the contract who the owners are.

Q137 Mr Bacon: I'm talking about after the initial construction phase and possibly any refinancing. I'm talking about whether, in the secondary market, once the asset has been sold and perhaps sold again—and the C&AG said that he was aware of 150 or so such transactions—and perhaps sold again two or three times further, do you, at each stage, up to and including the most recent owner, know who the owner is?

Charles Lloyd: We know who the owners are. Other than in a very small subset of sensitive defence contracts, the contracts don't contain arrangements precluding certain categories of people from owning that equity.

Q138 Ian Swales: Can I just ask, because I think we need to move on to the end, just one specific question, because I think that there's quite a bit of confusion about policy. In March this year, a new hospital was announced for the area between Stockton and Hartlepool, costing £460 million. The Trust was told it would be funded directly by the Department of Health. Does that make any sense to you?

Andrew Hudson: There will always be a judgment; there's always been a mixed economy, if you like, in terms of some facilities in different sectors being provided through public money, some through PFI. That's a judgment as to what's appropriate in each case.

Q139 Ian Swales: Why would a £460 million hospital suddenly be funded by the Treasury, as

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opposed to PFI, which I understood was the normal way of doing these things?

Andrew Hudson: I'm afraid I'm not familiar with that particular example, but it would be a judgment based on the availability of public finance and a value for money judgment.

Q140 Chair: Why don't we get a note on that one?

Andy Rose: I think it's fair to agree with the NAO. The NAO suggests there should never be an assumption that PFI is value for money, and I think that has always been Treasury's view; that there is no assumption. I don't think the default situation is it should be PFI—

Q141 Mr Bacon: It was in the case of the tanker. Sir Bill Jeffrey described it as "the conditions we were operating under at the time", which is the best euphemism I have heard for the former Prime Minister.

Andy Rose: My understanding is that that decision was made a very long time ago. I don't think in current Treasury methodology there is anything that says there should be a presumption that it should be PFI.

Chair: I don't think it was that long ago.

Q142 Stephen Barclay: But you weren't re-assessing these, so you were basing it on an earlier presumption. You were saying, because of the urgency of the market, we are not calling these back in for reassessment.

Andy Rose: That's the PRG, which is around local authority transactions, where it is. On FSTA, it is my understanding that that decision to go down that route was a long time ago and I believe that was not reassessed.

Q143 Stephen Barclay: Well, the project team advised against it in 2004 on the Air Tanker.

Q144 Ian Swales: There are different policies adopted for different things. We also heard that various things are under review at the moment. Do you regard this review as being total, or are there some sacred cows in terms of policies and things where we won't be looking under the stones?

Andy Rose: I think the reality is there's been quite a lot of change over the last six months, from the General Election to the Spending Review to the National Infrastructure Plan. There's also a cost review ongoing. I think it's quite a good time to review quite a number of things. I think there will be an update to the market about some of the mechanics, about how PFI works; there will be an update on the value for money guidance. I think it is quite a broad review; I wouldn't necessarily say that it encompasses everything, but I think the reviews at this time will be quite broad.

Q145 Chair: This takes us into the future, really, because we had the infrastructure report yesterday. There is going to be a steady decline in capital infrastructure over the Spending Review period by, I think, nearly 30% when we get to 2014–2015.

However, am I right in thinking that the imperative will be to keep as much of that as possible off balance sheet? Can you answer that first?

Andrew Hudson: Whether something is on or off balance sheet is a technical categorisation issue. The aim is to use that capital spending and it's explained which Departments it's going to, in the best possible way to fund the key projects.

Q146 Chair: No, it isn't technical, because you will not be able to afford to get it on balance sheet if we're to get the cuts in public spending that the Government seek to achieve.

Andrew Hudson: Well, the amount—

Q147 Chair: It may be technical in the sense that you want it to stimulate other activity in the private sector. I get that. On the other hand, given the constraints on public finance, you won't be able to do that through techniques that are traditional, on-balance sheet capital investments. Can you?

Andy Rose: I think it's important to recognise that many of the markets covered by the National Infrastructure Plan are more in the areas of economic infrastructure, where the money is raised by the private sector, such as the large utility companies in the energy market. The PFI is not part of—

Q148 Chair: But the £40 billion, if you stick to the £40 billion that will be our per annum capital investment from Government by 2014–2015, where's that going to come from? On balance sheet? Off balance sheet?

Andrew Hudson: The public sector capital is on balance sheet.

Q149 Chair: That will all be on balance sheet?

Andrew Hudson: Yes.

Q150 Chair: So there won't be a PFI element to that at all?

Andrew Hudson: Some PFI is on balance sheet. I think 24% of transactions have been on balance sheet; the rest, three-quarters or so, has been off balance sheet. The key thing in judging whether a PFI project goes ahead, now as before, is whether it's good value for money, because it has to be paid for, and in the case of PFI it's paid for from a Department or local authority's resource budget, rather than from its capital budget, so that all needs to be paid for out of scarce resources. That will only go ahead, on or off balance sheet, if the Department judges that it's value for money.

Q151 Chair: I'm trying to work out the role of PFI in the future, as we come out of the credit crunch. We've said that loan rates remain high, so that will become a disincentive to go down the PFI route. Right or wrong?

Andy Rose: Could I just clarify? I beg your pardon. The £40 billion per annum, some £200 billion in the National Infrastructure Plan, the vast majority of that is delivered by the private sector, and it is not public sector capital at all. PFIs, I think, will be used selectively in certain sectors, where it's proved value

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for money, but the vast, vast majority of that £40 billion per annum is not public sector capital; it's raised by the private sector for investment in, for example, water, energy, digital and areas like that. That number is a much broader arena than just the areas previously handled in PFI.

Q152 Chair: In which areas can you see PFI playing a continuing role, given where we are on loan rates, which I don't think are likely to change during the CSR period?

Andrew Hudson: I think it could still have a role in the various sectors where it has had a role over the years. Certainly authorities making these judgments will have to be very rigorous and apply the exacting tests that the NAO are calling for, in judging whether it's still value for money. They have every incentive to do that, because for most Departments, if not all, the revenue budgets, out of which future PFI projects will have to be funded, are also constrained, the same as, as you say, public sector capital is constrained. The point of the National Infrastructure Plan is to look at this in the round, as Andy says, covering public and private sector, and look at some other things we can do to try and get the infrastructure we need, by whatever means, spanning public and private, at the best possible cost? Mr Swales talked about are there any sacred cows? The one sacred cow, as far as I'm concerned, is to get the best possible value for money for every pound the taxpayer spends, which obviously is a shared interest round the group.

Q153 Chair: 'Twas ever thus.

Andrew Hudson: 'Twas ever thus, but at a time when public spending is severely constrained, it's all the more important that we redouble our efforts on that. Some of the things that the plan talks about, like looking into why we appear to have a substantially higher cost of construction in this country than some of our competitors, looking at how we can get the cost of capital for infrastructure projects down, looking at things like the Green Investment Bank as another way of bringing a certain amount of public spending to bear on getting better infrastructure for green projects, are all moving in this direction of getting the best mix. What that mix will be, will vary over time and will vary from project to project.

Q154 Chair: With the new localism, will you be allowing local authorities, whatever the new health bodies are, et al—GP Commissioning, whatever they are, commissioning bodies—will you be allowing them to take the decisions in this infrastructure world, or will you be retaining central control of all this?

Andrew Hudson: The final decisions have always been for authorities, because in the end, for local authorities, it is the Section 151 officer who has statutory responsibility for advising the council on whether something is value for money. We do certainly plan to keep going with central guidance, with the availability of central support, and with review mechanisms, because we feel that those have helped to drive better value for money across the board.

Q155 Chair: You won't stop projects at those sort of levels, at local authority level or whatever health service level we're talking at?

Andrew Hudson: Charles can perhaps explain how the Project Review Group has operated.

Q156 Chair: I know how it's operated in the past, but it's a very centralist mechanism for controlling the process of infrastructure investment. We now have a Government that says it wants to localise and decentralise this all; I'm just wondering whether this will be true of infrastructure or whether we will carry on with the current centralist controls?

Charles Lloyd: I'm out of the Treasury now, so I don't know. I suppose, in an area that creates as much attention as PFI does, my own view is that I would be surprised if there wasn't some continuing degree of Treasury scrutiny of those transactions. Exactly what that will consist of will be for others to decide, rather than me.

Chair: Okay. Anne, then Stephen.

Q157 Mrs McGuire: Can I just ask for some clarity on the £40 billion, because the implication in the Commercial Secretary's foreword to the national plan implies that that is Government money, whereas I think Mr Rose said that that was a mixture of private and public money.

Andrew Hudson: I think the—

Andy Rose: Sorry, can I clarify? There are two £40 billions, unfortunately. There is the £40 billion per annum, which is a mixture of public and private over the five years, and then there is the total of £40 billion that is public spending. Unfortunately, there are two £40 billions. When Lord Sassoon said "We are committed to invest over £40 billion in supporting project investment," that is more the public spending, where again the focus was on economic infrastructure that led to growth. The £40 billion per annum is more the total expenditure, which is the £200 billion that is referred to elsewhere.

Q158 Mrs McGuire: Which is a mixture of public and private? Or is that totally private?

Andy Rose: No, that's a mixture.

Q159 Mrs McGuire: That's a mixture. Could I just develop a wee bit the questions that the Chair has asked you about the future? If public authorities find themselves between a rock and a hard place here, i.e. there's constraint on public spending, that the market is too high, do you have any idea of what our infrastructure development is going to be like in terms of education, hospitals, whether or not these public authorities will be in a position to make decisions about investing in that type of infrastructure project? Or will we be, in fact, seeing a situation, which once happened, where there were very few schools built and even fewer hospitals?

Andrew Hudson: As far as public spending is concerned, the Government have set out the capital plans for both health and education, and that will govern what the public sector can spend over the coming four years. As to whether those Departments choose to go ahead with further PFI schemes, I think

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there's been a lot of attention paid to Building Schools for the Future. There's a review under way, but the intentions there are clear. On the hospital side, there's a certain amount of public sector capital available, and the Department will no doubt be considering how it wants to use its future resource budgets, and whether building further hospitals is something it wants to give priority to compared with other calls on the resource budget.

Q160 Mrs McGuire: I'm not quite sure if that's a yes or no.

Andrew Hudson: It's—

Q161 Mrs McGuire: That's definitely a Sir Humphrey answer. Can I ask one more question on construction costs? I think sometimes it's quite easy to draw international comparisons, as have been done in the foreword. I wonder whether or not there will be an attempt to judge construction costs, not just in terms of how much money they cost, but whether or not we have a regulatory regime in this country that makes our construction industry one of the safest industries in Europe. All of the higher construction costs are not just about the way the financial market operates in the UK, but relate to—there is still all sorts of room for improvement—some of the lowest rates of fatalities and injuries on our construction sites anywhere in Europe. Will the Treasury be considering that aspect of the construction costs?

Andy Rose: There is an extensive review being led by Terry Hill from Arup, and IUK are supporting that; as you suggest, the cost of construction is not just a simple number. It encompasses an enormous amount of areas. I think there was something posted on the Treasury website yesterday or before, but the final report should come out late December—I think that is the current estimate. As you suggest, it will address the issue that the cost of construction is not just a simple number, but encompasses an enormous amount of issues. I'm sure that things like health and safety will be factored in, so that will not be left out of consideration.

Q162 Stephen Barclay: Could I just take Mr Rose back to something he said earlier, about a recent PFI deal where bank finance was chosen over bonds. Is there any difference in the regulatory treatment of risk between banks and insurers?

Andy Rose: I'm not an expert; I'm sure there may well be.

Q163 Stephen Barclay: What I was trying to drive at is, is there any regulatory arbitrage? We talked earlier about the desirability of getting pension funds into these long-term investments. If you look at the earlier projects like the Channel Tunnel, that was driven by the insurance market and bonds, and there was a potential backlash after Equitable Life. I'm just trying to understand: is there a difference in treatment in the way the same risks are being assessed between the way banks are financing it and the insurance market is?

Andy Rose: Again, I am not a regulatory expert but I'm sure all the regulators for different markets apply

capital differently. From the purpose of the Trust that is paying for it, that's a completely different thing. My point was, are we beholden to the banks? No. We do look at, and encourage authorities to look at, a range of funding options, and then run a competition. Are there reasons that those prices vary, that are driven by regulation and capital allocation? Very possibly, but—

Q164 Mr Bacon: This is a very interesting point—I don't know, maybe for Mr Hudson to answer. Surely the point is, if there are differences, it might be that pension funds are not as eager as they perhaps could be, because there are regulatory inhibitions that perhaps need not be there. To take a slightly different case, the reason the French and German banks filled their boots with the Greek Government bonds wasn't because they trusted the Greek Government, it was because Greek Government bonds were regulated as if they were the same risk as buying UK gilts, or German Government bonds, and therefore the bank had to set aside the same amount of capital as it would if it were buying UK gilts, but gets a better return, because everyone knows that Greek Government bonds are dodgy, so the yield is high. So I think that's the point Mr Barclay is making. If, in the same way, or in the reverse way, pension funds were being inhibited from investing in these vehicles, because of regulatory constraints, you're the guys who've set the regulations, at the end of the day.

Andy Rose: I think it's a much broader discussion about the appropriateness of the regulatory regime for insurance companies and pension fund investors, which, again, I don't feel well enough versed to—

Q165 Stephen Barclay: But Treasury is the driver; clearly, the FSA, and even the Bank of England, will set the regulatory landscape in conjunction with European authorities. But HMT has a big say in this, and my point is: the policy you're setting, again, is pointing in two different directions. Linking on to that, what concerns do you have that Basel III will put up the cost of finance for banks?

Andy Rose: It is back into the same area of regulation, and again I think Basel III has developed quite a lot over the last few months, so I think the banks would say they are concerned about any change that causes the costs to them of long-term funding and of investing in long-term assets—

Q166 Stephen Barclay: If they have to hold more capital for these long-term loans, they're going to have to put their prices up.

Andy Rose: It goes back, I'm afraid, to my prior answer. I understand that point, that if holding these loans increases the cost to them, that will mean that will be a risk that they will pass on, but it brings in so many different constituent parties to whether that is the appropriate thing to do or not, that I absolutely accept the point that if there is a regime that increases the cost to them, they would attempt to pass it on. I don't feel well enough versed to give a view on Basel III and the implications.

Q167 Stephen Barclay: To me, you see, if we look at paragraph 27, the NAO is warning on the value for

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money for subsequent projects. In its paragraph 23, which is on page 10, it's saying, "The usual cost advantage lay in a range of 5% to 10%" some of which, when they audited it, showed smaller savings. Yet the annual contract charges are going up by 16% to 17%. We have touched on this tension in some of the earlier questions, but if there's regulatory hurdles in terms of the access to this market for the insurers, which is why they're losing this competition you just referred to, and also the banks' costs through Basel III are going up, then the viability of PFI surely comes under more pressure?

Andy Rose: I will go back to Mr Morse's comment earlier about the recommendations the NAO makes about transferred risk across the criteria; I think we welcome that. I think as part of the review we're doing, we will certainly take those recommendations on board, and we are looking at this, but as I say, there are other areas in the market—global banking regulation—that may have an impact, and that would ultimately drive into the value position of the overall PFI valuation, because the finance is one component of that evaluation.

Q168 Stephen Barclay: We heard with these major projects, because of the urgency and the macro-economic climate, individual assessments were not called in, because there was seen to be an overarching policy priority. In terms of PFI projects that haven't closed as of today, will you be reassessing those?

Andrew Hudson: That's a continuing exercise of the Treasury, whether through the Project Review Group or through the Treasury spending teams doing their work on the value for money of a project, and of the Department doing its work on value for money, because in the end, responsibility rests with the Accounting Officer, to satisfy himself or herself that a project is still value for money.

Q169 Stephen Barclay: Sure, but, Mr Hudson, we've heard in reply to Mr Johnson's questions, about the role of the Treasury as the green-light body on this, and the role moving forward in terms of having some sort of central control—it just seems strange. What I am trying to understand is what has changed. We have a clear reason why individual assessments were not done in this report, because we were told there wasn't time. There was a policy objective that overrode that need. What I'm saying is: is that policy urgency in terms of time still a constraint, and if so, when is it going to be lifted? Or if not, why is it that individual assessments are not being called?

Andrew Hudson: Those deals that have closed—

Q170 Stephen Barclay: The ones that haven't closed, I'm talking about.

Andrew Hudson: They will be going through a scrutiny process at the moment, which will take account of current market conditions.

Q171 Stephen Barclay: Presumably some of those won't go ahead.

Andrew Hudson: If they're good value for money, they will go ahead; if not, they won't. As Charles

Lloyd says, through the period that we've been talking about, some were sent back for further work.

Q172 Stephen Barclay: It's just that on the reports I've seen today, and we take the Air Tanker one, there was a pressing defence need for it to go ahead, so a different valuation discount was applied. The waste one was a regulatory and legal requirement, not to mention a political requirement, driving that, and therefore value for money figures, dare I say it, surprisingly were made to fit in order for that to go ahead. It's very difficult to see which PFI deals have been turned down.

Q173 Ian Swales: What proportion are turned down for good? They disappear because they're not good value for money? What proportion?

Andrew Hudson: I think the best evidence that I'm aware of is that, of the 35 that went ahead, six, I think, were sent back to be looked at again and were then able to renegotiate or redo the deals such that it did turn out to be one that the Project Review Group felt able to support.

Q174 Stephen Barclay: They went ahead with TIFU to renegotiate on them—

Ian Swales: What changed on those six? What changed?

Stephen Barclay: It didn't go to the comparison and then say "We're going to fund it in a different way". What happened was it just went back, but it still went ahead as a PFI deal.

Charles Lloyd: Some go ahead as PFI deals; some don't go ahead at all. Andrew Hudson is exactly right that of the deals that came to us we sent six back, for a range of reasons. I think it's important to remember that most of these deals come to us at a fairly late stage in their evolution. They've been thought about a lot by the authority, they've put a team together, a business case and so on. Many of the deals never get to that point, and we don't see the deals, obviously, which don't get to us. They don't get to us because they are not value for money, because they are not affordable, so we don't have data on that set of transactions.

Andy Rose: There are two other recent developments. One is, in the Spending Review it was announced that funding would not be available for certain PFI schemes, and also there is a change in the PFI credit regime, whereas now Departments have to look at their spending in the round, they are not having the allocation of funding for PFI credit. I think there have been profound changes in making sure there is a level playing field when these Departments look at their particular PFI budget.

Chair: I'd like to just draw us to a close. Richard, then Ed wanted a quick one and then that's it.

Q175 Mr Bacon: Three quick questions; if perhaps you could give quick answers, because I know the Chair does want to finish this. There's an intriguing sentence in paragraph 3.8 of the NAO's report, which talks about how once in operation, many of the risks that you have during the construction phase fall away, "Making possible an approach that coordinates the

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right to refinance by a number of public authorities.” Is that saying, or have you thought about, the possibility of, once they are all in operation, bundling up a whole load of different projects together, which would also make it more attractive to a long-term institutional investor like an insurance company, offering something larger to a larger investor? Perhaps even through one entity that ends up having the legal right to receive the annual unitary charge payments, and then passes them on? Has that been considered yet?

Andy Rose: The answer is yes.

Q176 Mr Bacon: And once you’ve done that, of course, then you could securitise it, which is my note.

Andy Rose: Obviously yes, but I think it’s important to understand that these PFI deals individually are relationships between private sector borrowers and their banks, where it (the public sector) has a very important stake because it’s paying the bill. Very often the shareholding in each of these individual deals is different and complex, and therefore I think the ability for Government to mandate a portfolio refinancing is actually very difficult.

Q177 Mr Bacon: I wasn’t talking about mandating.

Andy Rose: What I think we can do, and to take the advice and recommendation of the NAO, is be more proactive, and that’s part of the work we’re—

Q178 Mr Bacon: And you could steer large bundles together to meet large bundles of potential institutional investors. That would then recycle and enable the banks to free up a whole load of capital.

Andy Rose: And sell the portfolio of loans on. Absolutely. That is a dialogue we intend to have. Driving the private sector on how to refinance and when, in its relationships with its banks, creates enormous complexities, but the aspiration I absolutely accept and we will be more proactive.

Q179 Mr Bacon: Second quick question, which I’m sure Mr Hudson knows the answer to. The last time I asked this question, the answer was about £5 billion, I think. What is the total value of the annual unitary charge payments that are being made in the current year, for all projects?

Andrew Hudson: It is estimated at £8.555 billion in 2010–11.

Q180 Mr Bacon: If you roll that forward by however many years you would need to for each of the contracts, however long it runs for, what’s the total value in cash terms and in net present value terms?

Andrew Hudson: This is the exchange you had with my predecessor.

Q181 Mr Bacon: It is, yes. Actually it was Mr Kingman. We had a long correspondence about it.

Andrew Hudson: Mr Kingman and Mr Pocklington.

Q182 Mr Bacon: He started talking about foreign exchange, for no obvious reason.

Andrew Hudson: If you simply add up the cash, then, as Mr Lloyd says, you get to £210 billion.

Q183 Mr Bacon: Because it’s my constituents and my colleagues’ constituents who have to pay the cash, at the end of it.

Andrew Hudson: Indeed.

Q184 Chair: Is this for all PFI contracts?

Q185 Mr Bacon: It’s £210 billion. It was £190 billion, so it’s gone up £20 billion.

Andrew Hudson: Yes, but I think we explained in the note that we sent to you after that exchange that we thought that the meaningful figure was the present value.

Q186 Mr Bacon: This was where Mr Kingman got into foreign exchange. But the present value figure is?

Andrew Hudson: The present value figure is £117 billion.

Q187 Mr Bacon: So that has gone up from £91 billion?

Andrew Hudson: Yes.

Q188 Mr Bacon: So the net present value figure has gone up by more than the cash figure, quite considerably so. £17 billion and £9 billion is £26 billion more than last time I asked the question. Finally, the Green Investment Bank, which you’ve mentioned a couple of times. I must say, perhaps this is disloyal to my party, but when I heard that you were going to launch a Green Investment Bank, my first thought was, “Oh my goodness, how long will it be before an NAO report is delivered to us about how horribly it’s gone wrong?” Which of the eight common causes of project failure did they fail to take any notice of? Who is going to have oversight of it in the Treasury, and will it stay the same person, and why won’t it go wrong?

Andrew Hudson: It won’t go wrong because we will learn the lessons from the common causes of failure that you refer to, and other inquiries by the Committee and the NAO.

Q189 Chair: But you won’t be asking for it?

Andrew Hudson: Within the Treasury, colleagues in Infrastructure UK, with the market expertise that someone like Andy Rose brings to bear, will have a role to play. Also other colleagues working on relevant sectors will be involved, but we will make sure we learn lessons from—

Q190 Mr Bacon: There will be hires in from the private sector to run it, will there?

Andrew Hudson: We certainly want to use the relevant expertise.

Q191 Chair: Ed, very quickly.

Ed Humpherson: A point of clarification to Mr Barclay’s questions. There are different regulatory requirements for the assets that can be held by insurance companies and pension funds. They are set by a European Union directive called Solvency II, and those institutions tell us that that does affect the attractiveness of PFI assets for them to hold.

26 October 2010 Andrew Hudson, Charles Lloyd and Andy Rose

Q192 Chair: It does?

Ed Humpherson: It does indeed affect; it does act as an impediment.

Chair: Right. Well, thank you very much indeed, and can I just commend you for the way that you've given

evidence this morning. I think it's been really very helpful: very thorough, straight and to the point, and honest. Thank you very much indeed; it's been a really good evidence session.

Written Evidence HM Treasury

QUESTIONS RAISED BY IAN SWALES MP

Q138. *"In March this year, a new hospital was announced for the area between Stockton and Hartlepool, costing £460 million. The Trust was told it would be funded directly by the Department of Health. Does that make any sense to you?"*

Q139. *"Why would a £460 million hospital suddenly be funded by the Treasury, as opposed to PFI, which I understood was the normal way of doing these things?"*

Response

1. These questions refer to North Tees and Hartlepool NHS Foundation Trust's plans to develop a single site hospital at Wynyard Park, to replace both the existing University Hospital of North Tees and the University Hospital of Hartlepool.

2. NHS foundation trusts have access to private sector and public sector financing for capital projects, such as hospital schemes. There is no normal way of financing such schemes. Private Finance Initiatives are only approved if the trust is able to demonstrate there is a clear value for money case compared with a publicly procured alternative.

3. North Tees and Hartlepool NHS Foundation Trust's outline business case for the scheme contained a projected capital cost of £464 million with 93% of this value to be funded through Public Dividend Capital, and the remainder through an equity contribution from the developer.

4. Government approval for this scheme was initially granted in March 2010. It was therefore considered as part of the cross-Government review of spending decisions between 1 January and the general election. When considered alongside similar schemes at a similar stage of development, other schemes were considered to be more urgent, and so Government approval for the North Tees and Hartlepool NHS Foundation Trust's scheme was cancelled.

5. We understand that the trust is currently reappraising the available options for this scheme, including the possible use of the Private Finance Initiative (PFI). The trust has not yet submitted an updated business case to the Government for approval.

RESPONSE TO PAC QUESTION—STEPHEN BARCLAY MP AND RICHARD BACON MP

Question

The question concerns the accountability, and on how it is regulated, of passing PFI contracts to third parties. Would there be checks on the third party as to whether they are suitable to take on the PFI contract and are there any safeguards should circumstances change for the worst? Lastly, what would happen if the third party held on to the money?

Response

The Treasury's *"Standardisation of PFI contracts—Version 4"* (SoPC4)¹ provides detailed guidance to Authorities when writing a PFI contract.

Section 18 (pp 124–127) of SoPC4 contains guidance on change of ownership clauses in a PFI contract, indicating where it may be appropriate to restrict ownership in a PFI contract to address the specific concerns of an Authority. For example, in the interest of national security in a defence project, or where an authority wishes to prevent tobacco companies holding shares in a school. The provisions within this section allow an Authority to ensure that there are adequate restrictions on the organisations that are able to hold shares in a PFI company.

Section 21 (pp 145–146) provides for Contractor Defaults which lead to termination of the PFI Contract if not remedied. One of the defaults is failure to comply with the change of ownership provisions. If there is a transfer of shares in the Contractor to an unsuitable third party and that unsuitable shareholder fails to transfer its shares to a suitable third party the Authority has the right to terminate the PFI Contract.

¹ http://www.hm-treasury.gov.uk/d/pfi_socpc4pu101_210307.pdf?bcsi_scan_F8D0BFE83951C3DA=0&bcsi_scan_filename=pfi_socpc4pu101_210307.pdf

BREAKDOWN OF EUROPEAN INVESTMENT BANK LENDING TO UK AND COMPARABLE MEMBER STATES

1. On 26 October 2010, at a hearing on the financing of PFI projects during the credit crises and the Treasury response, the Public Accounts Committee requested a note, (Stephen Barclay Q57) on the relative share of EIB funding the UK receives relative to other European countries with a similar shareholding (but with particular reference to Spain and Italy).

2. Finance contracts signed by the EIB in the countries holding the five largest shares of EIB capital, expressed as a total amount and as a share of total EIB lending in the EU, are set out in table 1.

Table 1.

	2010*		2009	
	<i>Loan amount (€m)</i>	<i>% of EU lending</i>	<i>Loan amount (€m)</i>	<i>% of EU lending</i>
UK	4,687	10.0	5,411	7.7
France	3,791	8.1	6,290	8.9
Germany	5,690	12.1	9,802	13.9
Italy	4,404	9.4	9,687	13.7
Spain	7,967	17.0	10,494	14.9

Source: European Investment Bank, Annual Reports and EIB website.

** statistics for 2010 include all finance contracts signed up to 10 November 2010, as published on the EIB website*

3. The Committee should be aware that France, Germany, Italy and the UK all have the same capital holding of €37.6 billion. Spain has a capital holding of €22.6 billion.

4. The share of lending going to the UK should be considered in the context of:

- UK projects traditionally having access to and securing funding from capital markets;
- local authorities ability to obtain competitive financing from the Public Works Loan Board and
- Limited UK access to the EIB's convergence objective, given the relatively limited number of convergence regions in the UK

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