HOUSE OF LORDS

Select Committee on Economic Affairs

2nd Report of Session 2009–10

Government Response to Report on Private Finance Projects and off-balance sheet debt

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The Economic Affairs Committee

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* Lord Currie did not take part in the inquiry leading to this report.

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Government Response to the First Report of the House of Lords Economic Affairs Select Committee, Session 2009–10

PRIVATE FINANCE PROJECTS AND OFF-BALANCE SHEET DEBT

The House of Lords Select Committee on Economic Affairs published its report "Private Finance Projects and Off-Balance Sheet Debt" on 17 March 2010. The Government response is printed below in the Appendix.

APPENDIX: GOVERNMENT RESPONSE TO THE FIRST REPORT OF THE LORDS ECONOMIC AFFAIRS SELECT COMMITTEE, SESSION 2009-10

159. Against a background of shortage of funds and doubts about conventional methods of procurement, it was clearly in the public interest for Governments to look for new, efficient and cost-effective ways to meet demand for new public infrastructure (paragraph 14).

160. The rapid growth of private finance projects over the past decade or so is striking and has played a significant role in the expansion and renewal of the nation's infrastructure (paragraph 21).

HM Treasury is focused on ensuring the value for money of investment in public services and public private partnerships (PPPs), including Private Finance Initiatives (PFI), are one way of doing this.

PFI has delivered a significant amount of investment across the public sector, in particular to meet key Government priorities such as the challenges of providing a modernised health service and fit for purpose schools. It remains a small but crucial part of Government's investment in UK infrastructure and is used to deliver some of the largest and most complex investments in health, education transport and waste, in partnership with the private sector.

161. Despite the scarcity of private finance, there are few advocates of a return to the old system of public procurement in those sectors where PFPs prevail. But PFP payments are contractual commitments and, as public spending is constrained, could have an adverse impact on the budgets available to public authorities for other, non-PFP, expenditure. They could, for example, exacerbate any budgetary pressures arising from unforeseen bunching of commitments and demands in a given financial year. The Government should monitor and control year by year the impact of PFP commitments on the budgets of Departments and public authorities with a view to ensuring that delivery of essential public services in future years is not unduly constrained or jeopardised by such commitments (paragraph 24).

PFI unitary charges include payments to cover the cost of capital expenditure, the services needed to run and repair that asset and supporting soft services. If a project is built using conventional procurement, these future costs for services are not automatically covered, monitored or disclosed. Reporting estimated payments under PFI contracts therefore provides a fuller picture of future commitments than would be possible under conventional procurement, and provides better information for the management of future budgets.

The Government publishes its estimates of the unitary charge payments to be made under all signed PFI contracts in the Pre-Budget Report and the Budget. These Departmental commitments of future revenue are monitored by Government, included in consideration of future budgets, and therefore taken into account by Departments in deciding how much PFI investment to undertake.

These annual payments under PFI unitary charges make up a very small proportion—just over 2 per cent—of total annual resource budgets. Consequently, they represent very little threat to the flexibility of the Government's budgets, and a small commitment of future revenue.

162. Even though the cost of debt in private finance projects will usually be higher than under traditional procurement, this factor alone does not rule out the use of private finance. The higher cost of debt reflects risks carried by the private sector and a margin for profit. And, apart from bearing risks that would otherwise fall to the public sector, private finance can offer other advantages over traditional procurement to offset the higher interest rates (paragraph 30).

173. Construction and maintenance risks are usually seen as suitable for transfer to the private sector; whereas activities over which the private contractor is seen as having little or no influence have not been transferred (paragraph 81).

We agree with the Committee's conclusion on risk transfer and the benefits of debt financing. Where risks are transferred within PPP projects, it is to create the correct disciplines and incentives on the private sector, which then drive value for money through more effective risk management. Risks should be allocated to the party best able to manage them. Not all risks can or should be transferred because the cost of inappropriate risk transfer would be too high.

A benefit of incorporating private debt finance into contracts is that the risk borne by lenders ensures that upfront due diligence takes place and that the contractor is suitably incentivised by their financing obligations to work through any problems and not walk away from their obligations.

A decision to use PFI is only made after a stringent assessment of whether it offers better value for money than the publicly financed alternatives.

163. The NAO is sceptical about optimism bias uplifts in the context of Public Sector Comparators and about applying optimism bias solely to estimates of public sector costs. The projected costs of private finance projects may also be subject to optimism, although not necessarily at the same level as in conventional public sector procurement, and in practice any overruns would normally be met by the private sector (paragraph 36).

164. The addition of optimism bias may in many cases have had the effect, even at reduced discount rates, of tilting the comparisons of net present value which public authorities have to make, in favour of PFP and against conventional procurement. We recommend that, in order to reach a fairer basis of comparison, where a percentage uplift for optimism bias is added to the estimated Net Present Value of Public Sector Comparators, an appropriate rate of uplift should also be added to estimates of the NPV of the cost to the client under PFP (paragraph 37).

The Government does not agree with the Committee's recommendation. The Government does not intrinsically favour any one approach to contracting and risk sharing over any other; the central objective is to secure value for money to the taxpayer.

The same level of Optimism Bias is initially applied to both a PFI project and the Public Sector Comparator (PSC). The level of optimism bias that is applied to the PFI alternative can then be reduced as a project progresses as PFI projects are typically subject to more rigorous design and diligence before contracts are entered into than conventional procurements. The clearly defined nature of a PFI contract mitigates the risks associated with the delivery and capital expenditure of a project as these risks are passed on the private sector partner, as the Committee has noted.

If there were evidence that these risks were also absent from the traditionally procured alternative approach departments should make appropriate adjustments to conventional procurement optimism bias. It is not appropriate to increase the level of optimism bias in PFI contracts simply to balance out a necessary higher level of optimism bias in conventionally procured projects. This would introduce a bias in favour of conventionally procured projects and distort the methodology set out in the Green Book and used for assessing the value for money of a procurement route for capital investments.

165. It is difficult to compare whole life costs because PFP costings include maintenance and other services over many years while costings of conventional procurement generally do not. We recommend that, in order to make possible proper comparisons between privately-financed and traditional procurement, the Government should collect on a whole-life basis cost data on some comparable traditionally-procured projects. Better data would help public authorities achieve good value for money, the main criterion of successful procurement (paragraph 40).

The Government agrees with the Committee's recommendation, and will encourage departments and the Office of Government Commerce to collect this data.

PFI has a proven track record for delivering on time and on budget and the performance regimes in PFI contracts generate robust data on performance, which can be absent in conventional procurement.

166. A Value for Money test based on imputed costs of a Public Sector Comparator (PSC) should be a useful tool in assessing the relative costs and merits of private finance and traditional procurement. But its value is limited by shortage of relevant data and by the selective inclusion of optimism bias. Even if these deficiencies were addressed, as we recommend above, public authorities should not rely solely on PSCs when choosing a procurement route (paragraph 44).

The Government agrees with the Committee's recommendation. HM Treasury's Value for Money Assessment Guidance provides a series of qualitative considerations that frame the approach to the quantitative value for money assessment that is based on comparison against a Public Sector Comparator, with the intention being that the quantitative assessment is used as a support tool for making an overall assessment. This guidance emphasises that the outputs from the quantitative and qualitative assessment should not be considered in isolation as a standalone case for, or against, PFI.

167. There may or may not be enough lenders in the market already to finance public infrastructure, even in a period of restricted credit such as we now face. It is too early to tell whether the Treasury Infrastructure Finance Unit (TIFU) will bridge the gap. The pros and cons of establishing a National Infrastructure Bank should be kept under review (paragraph 49).

The Government agrees with the Committee's recommendation. Government announced at PBR 2009 the establishment of Infrastructure UK, to work closely with infrastructure developers and funders to make recommendations to stimulate increased private sector investment in infrastructure, focusing on unlocking new sources of private capital and developing new funding models, building on the success of PFI/PPP. Government announced at Budget 2010 its intention to establish a Green Investment Bank, operating on a commercial basis and involving both publics and private sector capital.

168. There should be greater clarity about financial liabilities arising from PFPs. The Treasury's requirement that departments should run two sets of accounts, though an understandable response to the use of one accounting system within departments and another nationally, is far from ideal. Furthermore, national accounts solely on a UK GAAP basis give a misleading picture of overall liabilities by excluding most PFPs from figures of Public Sector Net Debt. We recommend that the Government should publish figures for total liabilities for privately-financed public sector procurement as a separate item alongside figures for Public Sector Net Debt. Brief statistical information should also be supplied as to the distribution of these liabilities across a series of separate categories that reflects differences in the extent of risk transfer away from the public sector (paragraph 59).

169. Inclusion of PFP liabilities in Departmental balance sheets, as now required, together with publication of aggregate figures of national PFP liabilities, as we now recommend, should provide a clearer picture of their economic significance. The motive widely imputed by witnesses to the Treasury for its perceived bias in favour of PFPs—their low profile in accounts—would also fall away (paragraph 60).

HM Treasury has noted the Committee's points and has already taken a number of steps in these areas to improve the availability of data on PFI projects.

Departments will publish their resource accounts on an IFRS basis in summer 2010, and these will reflect the PFI accounted for under IFRS. Whole of Government Accounts (WGA) will be published around Spring 2011 and will also reflect PFI on an IFRS basis. A reconciliation between National Accounts debt measures and WGA on an IFRS basis will be provided.

Detailed information relating to signed PFI projects and projects in procurement is already published and regularly updated on the HM Treasury website. This includes the balance sheet treatment of each of the projects for both resource and national accounts and future commitments arising from signed PFI contracts.

170. We recommend that, subject to the need to maintain control of public spending, the Government should take measures to remove institutional bias in favour of private financing of public procurement, so that public authorities can select it, or another procurement method, on a case-by-case basis according to value for money (paragraph 61).

The Government agrees with the Committee's point that no procurement method should benefit from an institutional bias.

The Government does not intrinsically favour any one approach to contracting and risk sharing over any other; the central objective is to secure value for money to the taxpayer.

HM Treasury has always been clear in guidance to Departments that value for money and not accounting treatment should be the key factor in decisions on contract structure.

The initial decision to approve an investment project should not take into consideration the delivery model or the procurement process. A decision to use PFI is only made after a stringent assessment of whether it offers better value for money than the traditionally procured alternative.

171. There is strong evidence that PFPs have a better record of on time and on budget delivery than traditionally procured projects, although it appears this gap is narrowing. Nonetheless, too many PFPs are delivered late, albeit contractors rather than public authorities are liable to the consequent financial penalties (paragraph 69).

172. Substantial price increases are undesirable late in the bidding process whatever procurement path is chosen. Despite the longer bidding process under PFPs—and the associated higher costs—the greater likelihood of projects being completed on time and on budget after the contracts have been signed can be a benefit worth some extra expense to the public sector at the initial stage (paragraph 75).

The Government welcomes the Committee's recognition of PFI's proven track record for delivering on time and on budget.

A recent NAO survey of operational PFI projects showed over 80% of projects are completed within 3 months of the contracted date. As the Committee note it the private sector that typically takes risk on and is liable for project delays under PFI.

The cost of negotiations can be greater under PFI but this is typically because it is used for relatively complex projects. Ensuring that complex projects are properly designed and developed takes time, regardless of the procurement type. The private sector also invests substantially during the procurement process to apply commercial expertise to a project and ensure that they fully understand the procuring authority's requirements.

174. We welcome the Government's action to secure for the public sector a substantial share of refinancing gains in PFPs. We recommend that the Government should continue to learn from experience in order to ensure that the public sector enjoys a fair share of benefits from improvements in financing arrangements (paragraph 85).

HM Treasury recognises the importance of ensuring that the public sector ensures a fair share of benefits from improvements in the financing arrangements of privately financed assets. Since April 2004 HMT's Standardisation of PFI Contracts has required a 50:50 sharing between the Authority and contractor of any re-financing gains. This was modified to 70:30 split (authority:contractor) to take account of changes in market conditions.

We agree that it is important for Government to continue to apply experience from lessons learned in order to improve the value for money of financing arrangement in public sector transactions.

175. The failure of the London Underground Metronet PFP gave private finance projects in general a bad name. Yet this project was exceptional because huge debt guarantees together with a typically narrow equity base limited risk transfer. We recommend that the state should not guarantee large amounts, and a high proportion, of debt as a means to

make highly geared PFPs happen. For such exceptionally large and complex projects alternative procurement approaches should be used (paragraph 101).

The Government notes the Committee's views on the Metronet project.

The Government announced at PBR 09 the establishment of Infrastructure UK, which will work closely with infrastructure developers and funders to make recommendations to stimulate increased private sector investment in infrastructure. The professional capabilities and experience within IUK will enable it to evaluate alternative options for the financing of complex procurement projects alongside departments.

176. Private finance has led to a much needed focus on maintenance of public infrastructure. Public authorities should however keep a watchful eye on the price paid for what is on balance a positive development. We also recommend that the Government should promote the bundling of construction and maintenance, and whole-life costing, in all public procurement, whether privately financed or not (paragraph 108).

The Government agrees with the Committee's recommendation, which is a matter for the OGC to consider.

177. Monitoring and managing private finance contracts has long been a weakness of the public sector, although there have been improvements in recent years. We recommend that public authorities should do more to maintain and improve commercial skills of staff dealing with private finance projects, with emphasis on long-term contract management as well as contract negotiation (paragraph 112).

The Government agrees with the Committee's recommendation, which recognizes the importance of effective contract management in ensuring long-term value for money from operational private finance projects.

HM Treasury and the Office of Government Commerce have provided a range of guidance to procuring Authorities on how best to manage contracts in operation. In addition, HMT has for a number of years funded the Operational Task Force, within Partnerships UK, which provides a free at the point of use service to public sector authorities with operational PFI projects.

179. Traditional procurement has also benefited from the lessons learnt from private finance projects. Risk management and due diligence appear to be better in the public sector as a result of PFPs. These benefits need to be included when assessing the total benefits of private finance (paragraph 122).

HM Treasury welcomes the Committee's conclusion that the use of PFI has helped improve commercial skills across Government.

The lessons learnt from PFI about how to engage effectively with the private sector will have long-term importance in improving the public sector's ability to secure value for money for taxpayers.

A number of beneficial aspects of PFI—performance related payments, genuine risk transfer and fixed price contracts—are already being adopted across

Government, improving its approach to achieving value for money in commercial deals. HM Treasury expects departments to take account of risk benefits in their future assessment of alternative contracting and financing options.

178. There is some concern that construction companies which can sell their stakes in PFPs shortly after a project is operational may build a lower quality asset than if they remained shareholders with responsibility for maintenance. Although due diligence and checks by buyers in the secondary market amongst other parties may meet this concern, we saw no empirical evidence in this area. We recommend that the NAO should undertake studies of the effects of secondary markets on standards of quality in PFPs (paragraph 117).

This is a recommendation for the NAO.

180. PFPs have led to some innovation although few witnesses described this as a key reason for using private finance. It is for public sector clients to request more innovation from contractors when negotiating private finance contracts, if that is what they are seeking (paragraph 126).

The use of output-based specifications in PFI allows contractors to determine the most efficient and effective service delivery method and, if appropriate and value for money, suggest innovative ways of meeting the specification. But as observed by a number of witnesses there are often tried and tested service delivery methods and innovation will not always be appropriate. Procuring authorities should design a procurement process that allows contractors to suggest and discuss with the authority innovative approaches in the early stages of the competition, but balance this with the need to ensure the procurement process is run as efficiently and effectively as possible so that bid costs remain manageable and procurement times do not become drawn out.

181. Public sector employees transferred to the private sector during the course of a PFP are protected by TUPE (Transfer of Undertakings (Protection of Employment)) regulations and employees recruited directly are protected by general employment law. Pay and conditions of the two categories of employees may well differ, at least at the outset. Where average labour costs subsequently fall, in a PFP transferred from the public sector, such cost savings may simply indicate that the pay and conditions of the employees previously in the public sector exceeded the market rate (paragraph 130).

The Government notes the Committee’s point.

In our 2006 publication, “PFI: strengthening long-term partnerships” HM Treasury made clear that value for money should not come at the expense of employee terms and conditions.

182. Inflexibility has been a feature of private finance contracts, although it has also been a key factor in forcing the public sector to plan ahead. But flexibility is negotiable, at least to some extent. Public authorities should determine how much flexibility they want, the means of achieving it in the

terms of the contract and what they are prepared to pay for it; then negotiate accordingly (paragraph 138).

The Government agrees with the Committee's recommendation. The standard PFI contractual guidance (Standardisation of PFI Contracts version 4) encourages authorities to plan ahead for their future flexibility requirements. An appropriate amount of flexibility should be designed and negotiated into the initial bid solution to cope with anticipated changes, and a well developed change mechanism put in place in the contract to cope with residual unanticipated changes to the service.

183. We recommend that the Government should explore the feasibility of importing into PFP contract terms selected features of regulatory review models for utilities (paragraph 139).

The Government notes the Committee's recommendation.

A strength of the regulated utility model is that it is tried and tested in the capital markets and can create strongly rated entities which attract capital.

However, the model offers a very different risk transfer proposition to PFP. It is particularly suited to mature infrastructure businesses that operate large networks, and which ultimately pass financing risk to consumers. The regulated utility model may be less suited to Greenfield projects where there are benefits in the risk transfer to the private sector than PFP achieves.

The regulated model may not therefore fit all aspects of PFP but HM Treasury will consider the potential applicability of aspects of it.

184. High bidding expenses risk reducing competition for private finance projects which, in turn, could increase costs to the taxpayer. The Government should examine possible mechanisms for encouraging competition, such as returning an element of bid costs (paragraph 145).

HM Treasury is currently undertaking a review of the competitive dialogue procedure in PFI procurements, including the impact on competition of bid costs, and will publish its findings shortly.

185. The projects most suitable for private finance are those where the requirements can be clearly specified at the outset and which are of a size that consortia of private sector companies can take on their balance sheets (paragraph 152).

The Government agrees with the Committee's conclusion.

In our 2006 publication, "PFI: strengthening long-term partnerships," HM Treasury set out the characteristics of successful PFI projects, which are likely to generate value for money, including the need for the public sector to be able to define its required service outputs to ensure effective, equitable and accountable delivery of public services in the long-term.

The balance sheets of contractors impose a natural ceiling on the size of project they can realistically take on. One of the strengths of the PFP model is that these costs are explicitly revealed as the banks (in all but a very few circumstances) bear the risk of contractor default and so have an incentive to manage this through due diligence on the contractor's financial health.

186. The private sector is clearly not best suited to bear all the risks in all forms of private finance project. Experience has shown, however, that bundling certain services with construction in PFPs has delivered benefits, including the transfer of risk from the public to the private sector. We believe there is scope to transfer more demand or output-related risks. For example, with a prison such risks could be partly transferred by rewarding contractors for lower re-offending rates. In education, more risk transfer might be possible in the provision of teaching services; independent schools already take on all such risks. There is similar scope for the transfer of demand and output related risks in relation to medical services (paragraph 157).

The Government notes the Committee's point on expanding the benefits of the inherent risk transfer in privately financed projects by incorporating and transferring risk in relation to additional services.

HM Treasury will consider options for such expansion with Departments on a case-by-case basis. For example Government has pilots planned for 2010 to test the use of social impact bonds in improving the value for money of public services. These pilots, by building on the success of the inherent risk transfer in PFI, aim to deliver outcomes (such as reductions in re-offending rates) by taking advantage of skills and expertise in the third and private sectors.

187. We recommend that the Government should examine what additional risks now borne by the public sector can sensibly be transferred to the private sector, acknowledge the lesson of experience that the risks of exceptionally complex, large projects are not suitable for transfer to the private sector, and produce comprehensive revised policy guidelines (paragraph 158).

HM Treasury's PFI value for money assessment includes a qualitative assessment that addresses considerations such as public accountability and desirability of transferring certain services from a public perspective. Subject to this it is then essential to ensure that the risks transferred to the private sector can be controlled and managed by them otherwise this would not be value for money. So careful consideration needs to be given to this in relation to the transfer of demand-related risks and outcome-based measures of performance.

We continue to support a mixed economy of procurement and contracting approaches, including different approaches to risk transfer, to deliver our infrastructure needs. There is a substantial pipeline for PFI in areas where the industry has a strong record. But there is also a wider infrastructure space where we need to apply the lessons and technology of PFI to deliver some of our biggest challenges: energy, regeneration, water and communications and Infrastructure UK will be taking forward these challenges.

HM Treasury

29 March 2010