



Pointmaker

AFTER PFI

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SUMMARY

- The Private Finance Initiative (PFI) has been one of the costliest experiments in public policy making ever attempted. It has led to £200 billion of public debt, the equivalent to £8,000 for every household in the country.
- Originally introduced by Norman Lamont in 1992, it was greatly expanded by New Labour under whom total debts incurred through PFI projects rose by ten times in ten years. A significant attraction of the PFI for New Labour was that major capital projects were treated as “off-balance sheet” expenditure.
- There is no substantial body of evidence overall that PFI projects have delivered better value for money for the taxpayer, nor that they have been more innovative or better designed.
- The failure of the PFI can be traced to:
 - the fact that public sector institutions are often poor clients
 - a flawed procurement and tendering process
 - the asymmetry of negotiating power between individual hospitals, schools or councils on the one hand and contractors on the other.
- There must be root and branch reform of infrastructure procurement and finance. If wisely used, private sector capital and expertise can have huge public value.
- The PFI must be replaced by a new approach to the use of the private sector in the procurement of public sector projects. The following reforms should be implemented:
 - all past and future liabilities should be placed on the government balance sheet as soon as possible
 - a new central unit should be set up across government to monitor all PFI style projects, to advise on best practice, to educate actual and potential public sector clients on contract management and to generate greater “shared client power.”
- With over £200 billion of new infrastructure needed over the next decade, a new model of public procurement of major infrastructure is badly needed – and if well-designed, will hugely stimulate economic growth.



1. INTRODUCTION: 20 YEARS OF PFI

2012 marks the 20th anniversary of the Private Finance Initiative (PFI). It has proven to be one of the boldest, and costliest, experiments in public policy ever conducted. It has resulted in more than £200 billion of public debt, the cost of which will hang over the British taxpayer for decades. It has created great private fortunes, and fundamentally reshaped the nature of our public services. It has generated huge public outrage, and it raises profound issues of fairness between this generation and the next.

Over its two decades, the PFI has become notorious for waste and extravagance. Who can forget the 65p light bulbs reportedly costing £22 each under PFI? The £302 school plug sockets? The £40 Christmas tree billed at £875 to the Treasury? The three locks and deadlocks, plus maintenance, for which the PFI contractor BAM tried to charge North Bromsgrove High School £2,246.25? Or the £963 cost to install an aerial in the consultants' common room at my own local hospital, the County Hospital in Hereford?

As well as these horror stories, there have also been large-scale PFI scandals. The facts are well known, since they have been exhaustively reviewed by the National Audit Office. They include the M25 road widening project, estimated to cost £1 billion too much; or the Air Tanker refuelling contract which the MOD commissioned, then tried to cancel, then fudged the discount rates on, and then finally implemented at a cost widely believed to be £1.5 billion too high.

Finally, there has been the effect of PFI on whole sectors of our economy and public services, notably the NHS. For example, the Princess Royal University Hospital in Bromley, opened in 2003, cost an estimated £118 million to build and equip. Taxpayers will pay a total of

£1.21 billion over the 35-year life of its contract, excluding support services. The usual ratio of lifetime costs to construction costs for a PFI project is three to four times; the ratio for Bromley Hospital is 10.25 times.

So, 20 years on, we need to ask of the PFI: What's gone wrong? How did we get here? Is there any future for private finance in our public services?

2. A BRIEF HISTORY OF PFI

In principle, there ought to be a clear case for using private sector capital and expertise to support the creation of public infrastructure. After all, the UK had a glorious tradition of doing so during the 19th century, with the creation of the great city centres of Manchester, Birmingham, Leeds and Liverpool, among others. More recently, the idea was first revisited in the late 1980s with private toll concessions to build the Skye, Dartford, and second Severn bridges. Private funding had also been used in Australia at that time to pay for motorways.

The PFI itself was introduced by Norman Lamont in his 1992 Autumn Statement. Essentially it combined a mortgage with a full repairing lease; that is, it provided long-term debt finance with a commitment to maintain the fabric of the infrastructure over the life of the contract. In time, soft services such as caretaking, cleaning and catering were bundled into PFI contracts. Though costly, the idea was that PFI would offer a better way to transfer substantial construction and maintenance risks from the taxpayer to the private sector, enabling better infrastructure to be built on time and on budget.

But try as it might, the Major Government could not make the PFI work effectively. The Government insisted on judging each deal on its merits, and the merits were sometimes very



thin indeed. A great deal of work was done in looking at how private finance and expertise could be brought into the public services. But there were deep concerns as to whether the PFI could be made cost-effective. A year before the 1997 general election only £6 billion of PFI projects had been signed off. Not one PFI hospital had been built.

For its part, the Labour Party was divided over the issue. Old Labourites denounced PFI in traditional terms as “creeping privatisation”. But – and this point is often forgotten, or conveniently ignored – the new Labour position was the exact opposite of that. New Labour thought that the PFI was a good thing; the problem was simply that the Tories had not gone ahead with it fast enough. In a speech in Parliament on 28 November 1995, Tony Blair rammed the point home repeatedly. His position was perfectly clear: “The PFI is right in principle. We have supported it, and in many ways we have been advocating it.” At that point, John Prescott helpfully chipped in with, “We initiated it.” And Blair was perfectly clear about one further point: “The PFI should not be manipulated to cook the books of public finance.” Gordon Brown agreed. As he put it at the time, the “PFI is a cynical distortion of the public accounts.”

As events quickly proved, these remarks were breathtakingly cynical. Over the next decade Labour would use PFI to manipulate the public accounts on a hitherto unimagined scale. Under Labour, PFI significantly changed and massively grew in size over that period. Indeed, John Prescott spoke truer than he knew. In many ways, Labour was in fact the real originator of the PFI in its current form.

This was made clear directly after the 1997 election. Labour had identified a clear need for new infrastructure, especially schools and hospitals, and Tony Blair was desperate to

bolster his chances to win a second term by showing that he could build them. That meant a huge ramp up in public spending, fast. At the Treasury, Gordon Brown and Ed Balls also wanted a “legacy”. But they were hampered by two inconvenient commitments: their promise to stick to Conservative spending plans for the first two years of the government, and by Gordon Brown’s Sustainable Investment Rule, which required them to keep government net debt below 40% of national income over the economic cycle.

For them the solution was PFI. PFI projects seemed to offer a way out of this dilemma, since their capital costs could be treated as off-balance sheet, and so never appear either within departmental budgets, or within the national debt overall. For spending departments under Labour this was a godsend, since it meant that they only needed to account for the unitary charges, and not the total capital commitment. So Gordon Brown commissioned a very hurried report; relaxed the rules; removed officials and independent experts who might inhibit the escalation of PFI; discouraged the use of alternative financing methods by government; set up a new joint venture vehicle, Partnerships UK; wooed the finance and construction industries; and ramped up the debt.

It spoke volumes about the new government that almost its first action was to fire Alastair Ross Goobey, the Chair of the Private Finance Panel – and it was “fired”, not “resigned” or “let go”, at his own insistence. Ross Goobey was responsible then and afterwards for the vast pool of combined BT, Post Office and Royal Mail pension funds, now called Hermes. A man of impeccable character and public service ethos, he went on to revolutionise British corporate governance as a leader in active shareholder ownership.

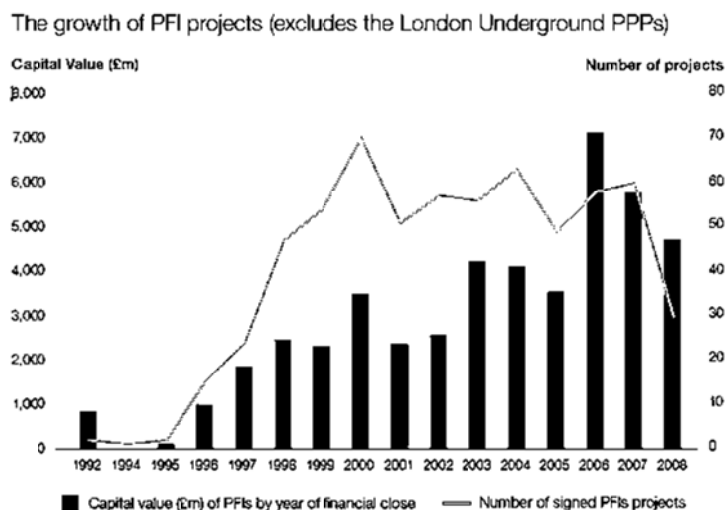


Over time, the push for PFI was aided by the introduction of PFI Credits, which distorted the capital budgets of spending departments and allowed them to evade responsibility for PFI spending by local authorities; by the use of high official project discount rates, which artificially privileged the PFI over other forms of procurement; and by the unwillingness of both the Blair and Brown Governments to conduct any overall analysis of the PFI's cost-effectiveness or gather the full data on primary and secondary transactions, which would have allowed proper transparency and public accountability.

The result of Labour's ramp-up was that PFI became "the only game in town". Total PFI debt rose by ten times in as many years. More than £67 billion of capital value in PFI projects have now been signed, with total repayments of £210 billion. In 2010 the BBC reported that 103 PFI hospital projects, with a capital value of £11.3 billion, will have a total lifetime cost of £65 billion alone.

Since the Coalition took office in 2010, the Treasury has implemented a wide range of measures to manage the PFI better. These include abolishing PFI Credits; strengthening the approval process of all projects; including

PFI liabilities in new unaudited Whole of Government Accounts to improve transparency; and a "deep dive" investigation of the PFI contract at the Queen's Hospital in Romford, the first time in 15 years that government has taken a long, hard forensic look at the workings and costs of a specific current PFI project. As a result it has issued new guidance on cost savings for existing projects, and promised a new Code of Conduct. The Cabinet Office is also looking closely at PFI, in its quest for efficiency savings, and the Ministry of Defence has announced that it is reopening three major contracts as part of its own renegotiation strategy. The Department for Education cancelled Building Schools for the Future, but has brought back various PFI projects at lower cost. The Department of Health has been vocal about PFI costs and their impact on hospitals. So far the Coalition has announced an expected £1.5 billion of savings from PFI contracts in England.



Source: HMT signed PFI projects database (http://www.hm-treasury.gov.uk/ppp_pfi_stats.htm)



More broadly, the Coalition has placed much emphasis on the need for more and better infrastructure, including a new source of pension fund investment. As regards PFI itself, a Treasury review closed in February 2012; its results, and a new policy, have yet to be announced.

3. COST AND VALUE FOR MONEY

Many PFI projects have become famous for eye-poppingly expensive individual items, as we have seen. But anecdote is not evidence. The real question is how costly the PFI is overall, and especially in comparison to use of conventional public finance at Treasury borrowing rates. For years, the answers to these questions have been shrouded in mystery, obfuscation or simple lack of direct comparability.

Private finance is always more expensive than public finance, since no private institution can generally borrow at lower cost than the government. But how much more expensive in fact is PFI? Three pieces of recent evidence give the answer. The first is a report by Infrastructure UK (a unit within the Treasury, replacing the now-defunct Partnerships UK), which set out the extra average costs in 2010. It estimated PFI costs as 2.00% to 3.75% over Gilts per year, significantly higher than government-supported private finance, or regulated utility finance. Only debt finance for private concessions offered a more expensive funding approach.

In 2011, the *Financial Times* did an independent analysis of the costs of PFI. This estimated that PFI projects have cost the taxpayer £20 billion more than if they were paid for through the Treasury – some 10% of the total cost. This was, it reported, “the equivalent of more than 40 sizeable new hospitals... In addition, lawyers, financial and

other consultants have earned a minimum of £2.8 billion and more likely well over £4 billion in fees over the past decade or so.”

Shortly afterwards, there was a report by the House of Commons Treasury Select Committee (on which the author sits). This found that PFI costs had widened from less than 1% over Gilts to more than 2.5% by 2010, and more the following year: “the cost of capital for a typical PFI project is currently over 8% – double the long-term government gilt rate of approximately 4%.”

Even so, PFI providers have argued that PFI offers taxpayers value for money, on the grounds that any extra financing costs are more than justified by the PFI’s record of innovation and on-time and on-budget delivery, by its whole-life cost, and by the level of risk absorbed by the private sector.

Again, the Treasury Select Committee has examined these claims. It found evidence that PFI had in fact hindered innovation in NHS building design, while the Royal Institute of British Architects testified that “the quality of the buildings delivered through PFI schemes remained poor in many cases.” A 2003 Audit Commission report into PFI schools found no difference in cost between PFI and non-PFI funded schools, but that PFI schools were of significantly worse quality. This was supported by research on hospitals in 2009 by the Buildings Research Establishment.

Claims about on time and on budget delivery were also found to be suspect. The Committee surveyed evidence that PFI budgets were typically 20% to 30% higher than non-PFI projects – making it far easier to “hit budget” – while public procurement overspend on a range of projects was just 4.1%. The NAO found that in a sample of PFI projects over 31% had



been completed late, while 35% had not been delivered for the contracted price. In their words, “using PFI is not a panacea for solving construction problems.” Meanwhile, there were significant and widely recognized problems of flexibility and transparency in PFI.

There are three clear conclusions to be drawn:

- PFI is a relatively expensive method of finance, which has become exorbitant since the credit crunch.
- Specific projects may be unexceptionable, but general claims to greater value for money, cost-effectiveness, on-time or on-budget delivery, greater innovation or design or build quality, cannot be sustained by the evidence.

- If the *Financial Times* analysis is correct – and it has barely been contested, let alone refuted – the cost of PFI has been far greater than the likely value of private sector expertise or risk transfer involved.

And there is one final point to be made, in response to the PFI ramp-up after 1997: whether it is on or off balance sheet, debt is debt. It always has to be paid back in the end, out of taxpayers' money.

4. PFI AND THE NHS

What has never been noted before is how PFI has had a specific bias towards Labour. This is not necessarily political in inspiration; it is intrinsic to the procurement method itself. We can see it especially at work in the NHS, which has been by some margin the largest user of PFI.

PFI projects signed since 1992

	Capital value		No. of contracts	
	£m	%	No.	%
Cabinet Office	12	0%	1	0%
Crown Prosecution Service	18	0%	1	0%
Business, Innovation and Skills	58	0%	2	0%
Communities and Local Government	2,117	4%	64	9%
Culture, Media and Sport	308	1%	16	2%
Education	7,758	15%	162	23%
Energy and Climate Change	4	0%	1	0%
Environment, Food and Rural Affairs	3,059	6%	24	3%
Transport	6,643	13%	56	8%
Work and Pensions	1,086	2%	4	1%
Health	11,887	22%	116	17%
Foreign and Commonwealth Office	91	0%	2	0%
GCHQ	331	1%	1	0%
HM Revenue and Customs	622	1%	8	1%
HM Treasury	141	0%	1	0%
Home Office	848	2%	25	4%
Ministry of Defence	9,064	17%	46	7%
Ministry of Justice	799	2%	23	3%
Northern Ireland Executive	1,786	3%	37	5%
Scottish Government	5,704	11%	84	12%
Welsh Assembly	544	1%	24	3%
Total	52,879	100%	698	100%



The reason lies in its cost. A 2007 NAO report found that PFI hospitals took on average over three years to commission, and significantly longer for bigger and more complex projects. The average tender cost for a successful PFI hospital bid was in the region of £12 million. The effect of these embedded costs, which are significantly higher than in comparator countries, is to push up the minimum cost-effective size for a PFI hospital project to £100+ million. This creates strong incentives for NHS trusts to bundle together different health facilities into enormous healthcare centres. These are generally located in inner cities around teaching hospitals, which are disproportionately full of Labour seats. Thus over and above its status as off-balance sheet debt, the Blair and Brown Governments had a specific reason to favour PFI, indeed to insist on it.

By contrast, a less expensive procurement method, or an array of different methods, could have been used to procure a broader mix of facilities across the population as a whole, in a more politically neutral way. The losers have been those living in suburban and rural communities.

This is not to argue against big hospitals as such, where the number of surgical and other procedures is a crucial determinant of health outcomes, but against the massive agglomerations of healthcare and out-patient facilities that we have seen under PFI. But this latter trend is likely to make a significant long-term difference to outcomes as well. In clinical terms the PFI imposes a huge burden on the NHS, and thus on the public generally, for three reasons.

The first is that PFI costs are fixed contractual obligations; they have to be paid by hospital trusts whatever else happens, and trusts have

had huge difficulty in negotiating them downwards. NHS costs have historically risen at well above the rate of inflation in the overall economy, and many PFI costs are themselves inflation-linked. So as the slowdown continues there is an increasing risk that clinical services will come under threat to pay the PFI bills. The consulting firm McKinsey & Co. was retained in 2011 by the NHS to look at this issue. It is quite telling that their brief was to assess not how to reduce PFI costs, but whether hospital trusts could pay for them.

The PFI's effect is thus to impose a huge squeeze on hospitals, as its guaranteed costs become a rigid part of tightening healthcare budgets. In the words of Professor John Appleby, chief economist at the King's Fund health think tank: "It is a bit like taking out a pretty big mortgage in the expectation that your real income is going to rise, but the NHS is facing a period where that is not going to happen."

The second challenge to the NHS exists within our major cities, which are often served by a mix of PFI and non-PFI hospitals. There is a clear risk that local healthcare decisions will prioritise the PFI hospital at the expense of the non-PFI one, not on clinical grounds, but in order to ensure that the PFI hospital is kept at high enough capacity to be able to pay the bills. More widely, PFI imposes huge incentives on hospitals to operate at higher capacity than they may have been designed for, increasing cash flow at the cost of long-term patient welfare.

The third has to do with the new healthcare facilities themselves. As we have seen, PFI cost pressures have pushed the NHS to assemble massive hospital projects so as to justify the enormous bidding costs. The result has been a Maginot line of huge hospitals, which greatly



distort local healthcare provision, especially affecting community hospitals and clinics. A case in point is the new Royal Liverpool and Broadgreen Hospital, which will consolidate five different facilities into one, and probably undermine the health economy around Liverpool.

It is little short of a tragedy that this has happened just at a time when healthcare is moving towards more flexible models, which combine specialist institutions with new technologies and joint commissioning to deliver health and social care much nearer the home.

This point was acknowledged last year by Lord Crisp, who was CEO of the NHS and Permanent Secretary at the Department of Health from 2000 to 2006. In an interview he said, in effect, that the NHS had too many large hospitals and needed to close hospitals in order to pay for adequate care for older people at home. To which one might respond "Why on earth didn't you do something about it?" After all, Lord Crisp ran the NHS at the time, and the facts about our ageing population and future PFI costs are well understood, indeed mathematically predictable many years in advance. It is a huge shame that Lord Crisp did not speak up, or take action, to curb these politically motivated developments at the time.

5. WHY PFI FAILED

The efficient procurement of public infrastructure should not be impossibly difficult in principle: as we have noted, at root a PFI project combines a repayment mortgage with a full repairing lease, each of which is routinely seen in the private sector. Procurement is done well in other countries, and it has been done very well at other times in British history. But PFI has been very far from a success. Why not?

(a) The main reason why any big procurement project fails is simple: a bad client.

In the case of PFI, public sector clients (hospital trusts, local authorities etc.) were often, in technical terms, bad clients. These were generally huge one-off projects agglomerating very different skills, services and expertise, from construction to IT to facilities management. They were laden with social, bureaucratic and political prestige, creating external interference and a demand for expensive "signature" buildings with unknown future costs. Often the clients were dominated by producer interests, over-specified the projects, changed the specification en route, lacked the necessary commercial or negotiation skills to manage the procurement, were naïve about using external professional advice, and did not adequately understand the risks involved, the likely future costs or the relevant financing models. The Departments themselves were often unable to support these clients with the relevant commercial and advisory skills. External advisory fees were driven up by complexity and client inexperience.

(b) In the case of PFI this problem was worsened by poor procurement design and tendering practice...

PFI procurements were far too long, inflexible and complex. They varied wildly in quality across different arms of government. They required fully funded bids capable of immediate acceptance, from huge bidding consortia. There was a final period of preferred bidder negotiation in which costs often rose dramatically. Many good potential bidders were deterred from bidding by the sheer expense, delay and complexity involved, reducing competition. In some cases the "winner's curse" led to contractor failure and loss of value to the taxpayer. The huge cost of



bidding also raised the minimum size of projects deemed to be economically viable, and encouraged gigantism, notably in huge new hospital facilities procured in the NHS. Surprisingly little account was taken of international best practice in design, of procurement or of facilities.

(c) ...by use of whole-life costing,

By far the greatest element of risk in a PFI project is construction risk. But historically PFI projects have been priced to reflect costs over the whole life of the building. The claim has been that this results in higher quality buildings, because the contractor will use materials and techniques in construction that lower future maintenance spend. PFI providers like it because it creates a guaranteed income stream over 30 years. However, as the Treasury Select Committee report showed, there is little aggregate evidence that this basic claim is true, and that PFI buildings are of higher quality or better design than their predecessors; and the effect of “whole life” costing seems to be to push up cost overall. The issue can in any case be addressed by other means, such as via sinking funds.

(d) ...by bundling soft services into the contracts,

PFI contracts include not merely construction and repairs, but also soft services provided to the client organisation such as cleaning, meals and administration of car parking. The effect of this bundling is to create a need for consortia, which can generate different incentives between the partners; to increase the complexity of the bidding process; and to build in layers of profit between any contractors and subcontractors. Result: lower competition and higher cost.

(e) ... by poor treatment of risk,

There was an official insistence with PFI across the public sector on offloading all risks –

however small or poorly understood or naturally suited to public self-insurance – onto the successful bidders, who then took out commercial insurance at high rates. The highly leveraged structure of PFI deals, with a large amount of debt sitting atop a small sliver of shareholder equity, also created an intrinsic need for expensive debt insurance, while reducing the incentives to co-operate between the contracting parties. These factors added significantly to cost and complexity.

(f) ... and by lack of choice.

The situation was also made worse by the lack of alternative financing methods. During the 2000s the PFI providers quickly picked up on the huge political desire to get infrastructure projects off the national balance sheet via PFI, which became “the only game in town”. Projects as diverse in operating cash flow and risk profile as roads, schools, hospitals, prisons, IT and aeroplanes were shoehorned into a single financing model. This further increased costs and complexity, and reduced accountability. It also inhibited innovation, and specifically the development of new and less expensive financing models, such as regulated asset base models.

(g) An official obsession with value for money did not prevent PFI from being poor value for money.

Value for money is of course important in public procurement. But financial models can easily be manipulated, especially in discounted cash flow calculations which are invariably hostage to small tweaks in key assumptions. Moreover, the twin requirements to deliver value for money and to use PFI create a general conflict, as we have noted, since PFI is an intrinsically expensive financing method. Useful signals from secondary market sales as to possible loss of taxpayer value have been inhibited by lack of information.



The result of this conflict is that officials have been forced to engage in tortuous and implausible value for money justifications for projects clearly undertaken on other grounds. For example, the business case for the new Royal Liverpool and Broadgreen Hospital PFI relies on at least eight tendentious assumptions about valuation to justify a 0.03% advantage for PFI over a conventional procurement. Moreover, the preoccupation with value for money has sometimes obscured a wider consideration of the net economic and social effects of a given PFI project. Finally, there has been little, if any, attempt historically within government to track the cost leakage vs. government borrowing from use of PFI overall.

(h) Insufficient thought has been given as to how PFI projects should be managed most cost-effectively across the public sector.

A PFI procurement is not just about the creation of a capital asset; it is also about the management of a set of commercial relationships. There is almost always a huge asymmetry of negotiating power between a single hospital trust or local authority and a commercial PFI provider. First, individual contracts matter less to providers, which will generally be managing many different ones. Secondly, PFI contracts themselves typically provide little if any insight into how the public moneys involved are actually spent. The result is that PFI clients do not know where to look for savings, PFI providers have little interest to help them, and there are few mechanisms in place to resolve disputes cheaply and amicably.

6. EIGHTEEN RECOMMENDATIONS

So what can we do? The key point is that PFI needs to be abolished, in name and in fact, and replaced by what we might call Private Finance 2. But what specific features should PF2 have? The following recommendations flow immediately from the analysis above.

1. PFI and PF2 liabilities should be placed fully on balance sheet; if not immediately, then on a short and clear schedule.

Care should be taken with PF2 to ensure that there are no residual incentives for any Government to engineer a project so that it is off-balance sheet for the National Accounts.

2. Departmental budgets should be adjusted as soon as practicable to reflect both current and future commitments incurred under the current PFI, and in due course for PF2.

The accounting treatment should give no net incentive to use PF2 over other procurement methods within Departmental capital or current spending.

3. Review Waste Infrastructure Credits.

Waste Infrastructure Credits are a form of PFI Credit. Since the Coalition has rightly abolished PFI Credits, HM Treasury should either explain the reasons for the continued use of Waste Credits, or abolish them too.

4. A comprehensive programme should be implemented across government to educate actual and potential public sector clients in infrastructure procurement and contract management.

This could involve: specific courses and seminars devoted to effective procurement; improvement of financial and commercial understanding of infrastructure within Departments and local government; and working with outside accrediting agencies to create new qualifications for financial officers in this area. There should be a special focus on improving bid teams and commissioning boards, and especially finance directors. The cost of this should be largely or wholly borne by the clients themselves; it will pay for itself many times over.



5. The design of PF2 should incorporate a specific review of global best practice in financing and procurement, and Departments should be required to show that PF2 projects reflect an assessment of global best practice.

There is great scope for inexpensive modular construction techniques in UK infrastructure procurement. Around the world, there are useful lessons for the UK from the use of private finance in Canada and of hospital design in Norway, to take only two examples.

6. A new central unit should be set up across government to procure and negotiate PF2 deals.

This should be staffed by professionals with relevant legal, financial and commercial experience, and operate alongside the public sector client in each case as one team. It should be involved in all projects over a threshold size. Existing PFI projects should be able to call the new unit in to assist with their negotiations; this will create negotiating leverage because of the unit's familiarity over time with other projects with the same contractor. This unit deliberately falls some way short of the Infrastructure Ministry model adopted in countries such as Australia, Israel and Canada, but it will need high-level political sponsorship, especially from the Treasury.

7. Value For Money financial models should not be used as single pass-fail tests for PF2. Departmental ministers should have a positive duty to satisfy themselves that a PFI or PF2 project sponsored by their Department offers value for money overall, using robust new criteria.

The National Audit Office should audit the assumptions behind existing value for money assessment methods, and publish its own analysis of them and proposals for change.

8. As part of the present PFI review HM Treasury should specifically assess (a) whether whole-life costing has actually reduced cost and improved build quality in aggregate, and (b) whether these goals could be met better by other means such as sinking funds.

9. The requirement to bundle "soft services" within infrastructure contracts should be abolished for PF2.

Bundling in soft services to PFI contracts increases their cost, complexity and inflexibility, and reduces competition. It needs to be handled far more selectively.

10. PF2 must include a variety of different financing options.

These could include government borrowing; mortgage and repairing lease; regulated asset base models; local asset-backed vehicles; and asset fund-type structures. Some of these can be combined: the point is to create choice and competition, and a better fit between financing options and project needs. There should be regular discussion with different categories of financial investors and advisers, in order to track their priorities and risk appetite. There should also be a mechanism by which unbudgeted productivity gains can be easily shared between client and contractor.

11. Data from existing PFI and new PF2 contracts should be published wherever commercially possible. PF2 contracts should also require greater transparency to the client as to different categories of operating costs.

There should be a default setting of maximal transparency on PF2 contracts. This will help to level the playing field between public sector client and private sector contractor. Open book contracting, in which costs are fully transparent between both sides, should be encouraged.



12. Progress on savings on current PFI projects should be regularly reported to Parliament.

HM Treasury published *Guidance on cost reductions to existing PFI projects* in 2011, with an expectation of cost savings of £1.5 billion over time. The Treasury should provide an update to Parliament in 2012 on savings achieved under this programme, and regularly thereafter.

13. The Treasury's new PFI Code of Conduct should be published as soon as possible.

In July 2011 the Treasury undertook to conclude a new voluntary Code of Conduct on operational savings with the PFI providers by the end of 2011. This should now be published.

14. Departments should step up efforts to create greater shared client power among their PFI projects.

At present far too many PFI hospitals and schools operate on an individual basis, rather than concerting negotiating leverage on a shared contractor. This creates huge asymmetries of information and power, to the detriment of taxpayers. The new central unit can be used to spread this information more widely and effectively.

15. The Treasury should benchmark the cost of any remaining PFI and future PF2 procurements both individually and in aggregate.

Officials should be required to explain periodically any differential between the actual aggregate cost of PF2 projects over a given period and the benchmark cost incurred if they were funded directly from government borrowing.

16. Secondary market PFI equity and debt sales should be transparent.

There has been much adverse comment at profits made on resale of PFI equity and debt. But debate and scrutiny have been hampered by lack of information, and by an orthodoxy that PFI

assets should be treated as purely private. But this is not correct: there is a public interest in PFI projects retaining or acquiring high quality investors who are committed to them; secondary market sales change relationships and shift accountability; and resale prices are a useful guide to mispricing in the original projects. There should therefore be mandatory transparency to government on sales of PFI equity and debt as to amount, duration and beneficial counterparty. Consideration should be given as to whether the government should have a right to block secondary market sales. The same principles should apply to PF2.

17. Assets should be tracked as well as liabilities.

Under both PFI and conventional procurement, the national accounts disclose the public debt incurred, but not the asset created. As a result, these projects are scored as adding to the national debt, without any offset for the value of the asset involved, and despite the fact that they may over time be *adding to*, not *subtracting from*, national net worth. This also creates a lack of clarity and increased uncertainty among investors, who cannot be sure of the extent to which debt is financing consumption or investment. The solution is that PF2 assets should be periodically revalued, and the projects' net worth calculated. This would provide greater transparency and confidence for the financial markets, strengthening the UK's ability to fund infrastructure investment without undermining its AAA credit.

18. Continued work should be done to create a National Balance Sheet, however imperfect initial versions may be.

The Office of Budget Responsibility has already done valuable work on Whole of Government Accounts. This should be extended over time to a National Balance Sheet, although inevitably it will be very incomplete and inexact in its early stages.



7. CONCLUDING REMARKS

To conclude: PFI must be abolished. But PF2, if well designed, will enable more infrastructure to be created for a given cost, boosting economic growth. With an estimated £200 billion of new infrastructure needed over the next decade, there is a huge opportunity here for the UK.



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DEDICATION

To the memory of Alastair Ross Goobey

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