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TREASURY COMMITTEE

Sixth Report

THE PRIVATE FINANCE INITIATIVE

Together with the Proceedings of the Committee,
Minutes of Evidence and Appendices

*Ordered by The House of Commons to be printed
1 April 1996*

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Sixth Report

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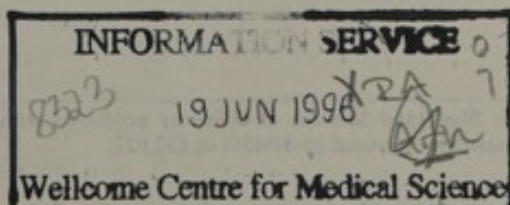
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The Treasury Committee is appointed under Standing Order No 130 to examine the expenditure, administration and policy of the Treasury, the Board of Customs and Excise and the Board of Inland Revenue.

The Committee consists of a maximum of 11 members, of whom the quorum is three. Unless the House otherwise orders, all members nominated to the Committee continue to be members of it for the remainder of the Parliament.

The Committee has power:

- (a) to send for persons, papers and records, to sit notwithstanding any adjournment of the House, to adjourn from place to place, and to report from time to time;
- (b) to appoint specialist advisers either to supply information which is not readily available or to elucidate matters of complexity within the Committee's order of reference;
- (c) to communicate to any other committee appointed under the same Standing Order (or to the Committee of Public Accounts or the Deregulation Committee) its evidence and any other documents relating to matters of common interest;
- (d) to meet concurrently with any other such committee for the purposes of deliberating, taking evidence, or considering draft reports.

The Committee has power to appoint one sub-committee and to report from time to time the minutes of evidence taken before it. The sub-committee has power to send for persons, papers and records, to sit notwithstanding any adjournment of the House, and to adjourn from place to place. It has a quorum of three.

13 July 1992

The following were nominated as members of the Treasury and Civil Service Committee: (now the Treasury Committee):

Ms Diane Abbott	Mr John Garrett
Sir Thomas Arnold	Mr Barry Legg
Mr A J Beith	Mr Giles Radice
Mr Nicholas Budgen	Mr Brian Sedgemore
Mrs Judith Chaplin (decd 19.2.93)	Mr John Watts
Mr Quentin Davies	

Mr John Watts was elected Chairman on 15 July 1992.

Sir Thomas Arnold was elected Chairman in the place of Mr John Watts on 19 October 1994.

The following changes in the membership of the Committee have been made.

Monday 29 March 1993:	Mr Nigel Forman appointed.
Monday 13 December 1993:	Mr John Garrett discharged. Mr Mike O'Brien appointed.
Monday 31 October 1994:	Mr John Watts discharged. Mr Matthew Carrington appointed.
Wednesday 28 November 1994:	Mr A J Beith discharged. Mr Malcolm Bruce appointed.
Monday 27 November 1995	Mr Mike O'Brien discharged. Mr Clive Betts appointed.
Monday 15 January 1996	Mr Giles Radice discharged. Mr Stephen Timms appointed.

THE PRIVATE FINANCE INITIATIVE

TABLE OF CONTENTS

	<i>Paragraph</i>	<i>Page</i>
INTRODUCTION: Additional or Substitutional	1-10	v
PREVIOUS PRIVATE FINANCE SCHEMES	11-15	vii
THE STRUCTURE OF THE PFI	16-20	viii
TURNING CAPITAL INTO CURRENT SPENDING	21-25	ix
PUBLIC EXPENDITURE CONTROL	26-29	x
VALUE FOR MONEY	30-44	xii
The analysis of value for money	32-35	xiii
The bidding process	36-44	xiv
THE TRANSFER OF RISK	45-50	xvii
THE PFI IN HEALTH	51-56	xix
ACCOUNTABILITY	57-62	xxi
CONCLUSION	63	xxii
PROCEEDINGS OF THE COMMITTEE RELATING TO THE REPORT		xxiii
LIST OF WITNESSES		xxx
LIST OF MEMORANDA INCLUDED IN THE MINUTES OF EVIDENCE		xxxi
LIST OF APPENDICES TO THE MINUTES OF EVIDENCE		xxxii
LIST OF MEMORANDA REPORTED TO THE HOUSE BUT NOT PRINTED		xxxiii
MINUTES OF EVIDENCE		1
APPENDICES		116

THE PRIVATE FINANCE INITIATIVE

The Committee on the Private Finance Initiative (PFI) was established in 1992 to examine the possibilities for the private sector to finance and deliver public services. The Committee's report, published in 1993, set out a number of principles for the PFI and recommended that the Government should establish a PFI Unit to coordinate the initiative.

TABLE OF CONTENTS

INTRODUCTION	1
THE PRIVATE FINANCE INITIATIVE	2
THE STRUCTURE OF THE PFI	3
THE PRIVATE FINANCE INITIATIVE UNIT	4
THE PRIVATE FINANCE INITIATIVE UNIT'S FUNCTIONS	5
THE PRIVATE FINANCE INITIATIVE UNIT'S MEMBERSHIP	6
THE PRIVATE FINANCE INITIATIVE UNIT'S SECRETARY	7
THE PRIVATE FINANCE INITIATIVE UNIT'S OFFICE	8
THE PRIVATE FINANCE INITIATIVE UNIT'S WORKING PROCEDURES	9
THE PRIVATE FINANCE INITIATIVE UNIT'S REPORTING	10
THE PRIVATE FINANCE INITIATIVE UNIT'S ACCOUNTS	11
THE PRIVATE FINANCE INITIATIVE UNIT'S ASSETS	12
THE PRIVATE FINANCE INITIATIVE UNIT'S LIABILITIES	13
THE PRIVATE FINANCE INITIATIVE UNIT'S EQUITY	14
THE PRIVATE FINANCE INITIATIVE UNIT'S INCOME	15
THE PRIVATE FINANCE INITIATIVE UNIT'S EXPENDITURE	16
THE PRIVATE FINANCE INITIATIVE UNIT'S PROFITS	17
THE PRIVATE FINANCE INITIATIVE UNIT'S TAXATION	18
THE PRIVATE FINANCE INITIATIVE UNIT'S RISK	19
THE PRIVATE FINANCE INITIATIVE UNIT'S REPUTATION	20
THE PRIVATE FINANCE INITIATIVE UNIT'S ACCOUNTING	21
THE PRIVATE FINANCE INITIATIVE UNIT'S COMPLAINTS	22
THE PRIVATE FINANCE INITIATIVE UNIT'S REVIEW	23
THE PRIVATE FINANCE INITIATIVE UNIT'S CONCLUSION	24
THE PRIVATE FINANCE INITIATIVE UNIT'S APPENDICES	25
THE PRIVATE FINANCE INITIATIVE UNIT'S REFERENCES	26
THE PRIVATE FINANCE INITIATIVE UNIT'S INDEX	27

SIXTH REPORT

THE PRIVATE FINANCE INITIATIVE

The Treasury Committee has agreed to the following Report:

INTRODUCTION: ADDITIONAL OR SUBSTITUTIONAL?

1. In our Report on the 1995 Budget, we took a good deal of evidence on the Private Finance Initiative (PFI). Then, we did not comment in detail on the PFI, but promised to report shortly on it in a separate Report. We did, however, isolate a few of our concerns. "Does it in fact provide better value for money for the taxpayer? Is the expenditure additional or substitutional? What would happen if a private sector contractor went bankrupt and was unable to fulfil the contract? How can Parliament and the public be kept informed of developments without weakening the power of Government to obtain the best deal? What clarification should take place of the particular rules and application of commercial confidentiality? What types of project qualify under the PFI, what types do not and where is the dividing line between the two? What approach is adopted towards risk transfer? What are the revenue consequences of PFI?"¹ In this Report, we address some of these issues.

2. We have taken a consistent interest in the Government's plans to import private finance into publicly-sponsored capital projects, and have regularly commented on the PFI since its introduction in the 1992 Autumn Statement and our Report thereon.² In February 1993, we took an isolated session of evidence from the Treasury on the subject.³ In 1994, reporting on the November 1993 Budget, we suggested that public sector financial involvement was an important element in allowing such projects to proceed, and asked for more clarity in the spending plans relating to private finance.⁴ In 1995, reporting on the November 1994 Budget, we noted that the scheme had failed to attract significant private interest, and expressed concern that it was unclear whether the PFI was intended to supplement or replace public expenditure.⁵ It was a recognition, while taking evidence on the 1995 Budget, that our concerns had not altered which led us to decide to undertake a short inquiry into the Initiative.

3. Our principal concern was to establish whether the PFI was intended to replace or to supplement public capital spending. On the introduction of the Initiative, and in the 1993 Red Book, it appeared quite plain to us that the expenditure raised in this way would be an additional source of funding for investment in capital projects.⁶ By the 1994 Budget, however, we were expressing doubts as to whether the PFI was still additional, or whether a projected rise in private finance projects was being used to enable cuts to be made in orthodox public capital expenditure.⁷

4. Since then, it has become increasingly apparent that the sums of money projected under the PFI are in practice replacing orthodox public capital spending and allowing cuts in expenditure to be made. In the 1995 Red Book, for instance, cuts in expenditure in the transport budget, from nearly £6 billion in 1994-95 to £4.18 billion in 1996-97 are matched by projected rises in capital spending under the PFI to £1.12 billion in 1996-97.⁸ Our perception has been reinforced by the observations of several ministers and officials, notably the Chancellor, who has said that "The growing importance of private finance has helped us to find significant savings for the taxpayer."⁹

¹ Third Report, The 1995 Budget, Session 1995-96, HC79, para.85.

² First Report, The 1992 Autumn Statement and the Conduct of Economic Policy, Session 1992-93, HC 201.

³ Session 1992-93, HC 508-i.

⁴ Second Report, The 1993 Budget, Session 1993-94, HC 87, para.89.

⁵ Third Report, The 1994 Budget, Session 1994-95, HC 79, para.41.

⁶ Autumn Statement 1992, para.2.116; FSB 1994-95, para.5.23.

⁷ Third Report, Session 1994-95, para.39.

⁸ FSB, 1996-97, Tables 6.6 and 6.5.

⁹ Official Report, 29 November 1994, col.1085

5. The Health Secretary, who as Financial Secretary was responsible for the PFI, told us "it is additional money which in the Health Service is allowing us to substitute what were previously publicly funded capital programmes for quite publicly funded revenue programmes."¹⁰ A Treasury official said that "in the early days of PFI it was pretty clear to me that the projects that were going forward were additional in some sense. When something is established, it is much harder to say whether it is additional because it is very speculative to know what would have happened if it had not been there."¹¹ The Financial Secretary said that "it is additional at the time it occurs because clearly you are seeing private funding coming in to help the Government procure services...the additionality is the arrival of the private project with its capital to enable that particular project to take place... in the current spending round... there has been a deletion against previous capital plans of certain sums which the Government have planned to spend because the Private Finance Initiative can be seen to provide an alternative way of procuring those services."¹² Witnesses stressed that the value-for-money gains obtained through the PFI had, in fact, led to an ability to increase expenditure in other areas; in other words, the PFI, although substitutional in the sense that it allowed orthodox expenditure to be cut, is additional in the sense that it effectively permits additional spending.¹³

6. If the Government is increasingly prepared to view PFI expenditure as substitutional, and to cut orthodox public expenditure, it is largely in anticipation of a rise in PFI spending rather than in response to it. In our previous Reports which have commented on the Government's PFI projections, we have expressed scepticism as to their rapid rise. PFI spending, which has slowly risen from £300 million in 1993-94 to an estimated outturn of £600 million in 1995-96, is projected to treble in 1996-97 to £1.9 billion, and to continue to rise to £2.6 billion in 1997-98.¹⁴ Some of this money is now agreed, but the Government's projections are, at the very least, optimistic. If there is a serious shortfall in the PFI projections, it will be difficult to provide money from public capital budgets to fill the gap.

7. In our view, the Private Finance Initiative is now being treated by the Government as substitutional. It is enabling the Government to cut capital budgets in future plans. We are concerned that, if the PFI projections are met or exceeded and overall capital budgets not diminished, they may still not have an equivalent effect. In this Report, we address concerns that the PFI makes the long-term planning of infrastructure more difficult. It is arguable that the PFI hands over a considerable number of capital projects to bodies whose main concern is the profitability of the facility. If the need for a facility, and its probable profitability, do not coincide, the Government will need to take steps to ensure that services continue to be planned and provided. It would be unacceptable if the Government's planning for the future provision of roads or hospitals began to be driven by the shorter-term perspectives of private bidders. **The Committee would welcome therefore the Treasury's views as to whether the prioritisation of projects should be the responsibility of Government and Parliament, or those seeking to provide projects on a commercial basis.**

8. There is potential for value-for-money gains to be made through the PFI, although we think that the sources of these gains are not quite clear. Moreover, we think that, for confidence in the policy to be gained by bidders, Parliament and the public, it needs to be made more transparent, and the savings to be made through the greater efficiency of the private sector openly demonstrated. One of our witnesses thought that "the cost of doing that [refurbishing and renewing the social infrastructure] is beyond the public sector's appetite for raising cash with which to do it. So as a society I believe we have to seek to tap other sources of finance."¹⁵ The PFI could become a useful and effective way in which to increase investment.

¹⁰ Q5.

¹¹ Q370.

¹² Q434.

¹³ See, eg, Q7 and Q379.

¹⁴ FSNR 1996-97, Table 6.4.

¹⁵ Q194.

9. Despite these comments and reservations we continue to see PFI as an imaginative and very laudable initiative to attract private capital into areas into which it has not before previously been drawn, and, simultaneously, and by virtue of the same mechanism, to introduce into investment appraisal and project management in the public sector more effective techniques and disciplines.

10. In the course of our inquiry we took oral evidence from the Secretary of State for Health, the Financial Secretary to the Treasury, the Transport Minister and independent experts. Memoranda were submitted by a wide range of interested parties. We are grateful to all those who gave evidence, to Professor David Heald, our specialist adviser on this inquiry, and, not least, to the team of shorthand writers who produced expert transcripts within hours of the evidence being taken.

PREVIOUS PRIVATE FINANCE SCHEMES

11. The Government has, for some considerable time, been actively attempting to harness private finance to fund investments by public sector bodies. The first major scheme stemmed from the recommendations of a committee, set up by the Treasury under the chairmanship of Sir William Ryrie, which produced a report in 1981. The Ryrie rules established two main principles for the use of private funds in capital projects. The first was that privately funded solutions must be tested against publicly funded alternatives and shown to be more cost-effective. The second was that, unless Ministers decided otherwise in particular cases, privately funded projects should not be additional to public expenditure provision, and provision for public expenditure would be reduced by the amount of private funding obtained.

12. The Ryrie rules engendered a number of major projects, notably a third crossing of the Thames at Dartford and a second Severn crossing. The Government now considers, however, that the Ryrie rules were too restrictive, and gave public bodies no incentive to seek out private finance. The rules were relaxed in 1989 so that private funding would no longer have to be substitutional; the Treasury would no longer require cuts in public capital expenditure to match privately funded projects.

13. Transport had, from an early date, been a primary area in which private finance was exploited. The major expansion of the later 1980s into the field of private funding was the Transport Green Paper, "New Roads by New Means",¹⁶ which proposed means of leasing and charging for roads. Though it has been suggested that this project failed to attract the private sector, since the publication of the Green Paper coincided with a major boost to the public sector roads programme,¹⁷ the Transport Green Paper formed the basis for a wider programme of private sector funding. This was what, on its launch in 1992, was termed the Private Finance Initiative which, in the course of our evidence, was described by the present Health Secretary, a former Financial Secretary to the Treasury, as "a fundamental change in the way Government managed and secured its sponsored capital investment programmes."¹⁸

14. The PFI, in several respects, loosened the restrictive provisions of the Ryrie rules. As noted, the requirement that private funding would have to be substitutional had already been relaxed, and in the introduction to this Report, we have already mentioned the various perceptions expressed by Government witnesses to the question of whether the PFI is now additional to or substitutional for public sector capital spending. Moreover, the other requirement of the Ryrie rules, that privately funded projects always be tested against a public sector comparator, no longer applies. In some cases, for instance where a project involves no

¹⁶ "New Roads by New Means." A Consultation paper. Department of Transport, Cm.698, May 1989.

¹⁷ Private Sector Involvement in Road Infrastructure: the UK Experience, Dr David Starkie, January 1995, p.3.

¹⁸ Q2.

public money or which would not have gone ahead other than as a PFI project, no public sector comparator is required, and value for money is established through competition.¹⁹

15. It was expected, on the creation of the PFI, that the less restrictive and more permissive framework of the Initiative would create an atmosphere in which public bodies would find an incentive to put a project out to tender, and private bodies would find an incentive to invest in publicly-sponsored projects. In the words of the Health Secretary, the PFI was designed to remedy a situation where "the public sector was missing both extra access to capital and extra access to good management that could come through a proper partnership with the private sector."²⁰ Although we have expressed doubts here, and on other occasions, about whether the private sector capital will emerge to the extent which the Government projects, we do think that the PFI is a more effective tool than previous Government attempts to attract investment from private bodies.

THE STRUCTURE OF THE PFI

16. At the launch of the PFI in 1992, three types of PFI project were identified. In the first, the costs of the project are funded entirely by private money, and recovered by means of direct charges to the end user. The public sector here acts as an enabler rather than a supplier of funds at any point. An example of such a project might be a road funded by direct tolls on the user. In the second, the private sector funds the project, and recoups the costs by selling the services the facility provides mainly or entirely to the public sector, as in the case of privately financed prisons. In the third, the capital cost of the project is divided between public and private funds, with overall responsibility for the project resting with the private sector. This type is most appropriate for projects where the social benefit is thought to be greater than the revenue it could generate, such as a road designed to lessen congestion. In the second and third types, the overall effect is to shift capital expenditure into current expenditure, via payments for services. We examine this point below.

17. The PFI is not seen by the Government as an initiative with limited and specific application. It has stated that all public sector bodies should consider PFI options when business strategies and efficiency plans are being drawn up, when the refurbishment or acquisition of a capital asset is foreseen or being considered, and when the future of a public body is under consideration. To encourage wider participation in PFI projects and to stimulate new ideas for the application of the PFI, and a wider understanding of the Initiative in both public and private bodies, a Private Finance Panel was established in 1993 under the chairmanship of Sir Alastair Morton and subsequently of Sir Christopher Bland.

18. Before deciding to embark on a PFI project, rather than one funded by the conventional means of public capital expenditure, two requirements must be satisfied. The first is that value for money must be demonstrated for any expenditure by the public sector. Apart from free-standing projects which do not create a monopoly, where no significant public expenditure is envisaged, PFI projects must be subjected to a value for money test. An economic appraisal is followed by a comparison with a conventionally procured alternative. If the PFI project is shown to represent greater value for money than the public sector comparator - and the Government's "starting point is a clear presumption that the PFI approach will generally be better than a traditional procurement"²¹ - the PFI bidders enter into a competition. We examine the value for money principle in paragraphs 30-44 below.

19. The second requirement of the PFI is that the private sector must assume risk. The Government's view is that the transfer of risk should be allocated to whoever is best able to manage it, and that the transfer of risk is a significant incentive to perform well for a private service provider. In cases, such as free-standing projects, where no value-for-money test is deemed necessary, the transfer of risk is the principal requirement. The risks the Government

¹⁹ *Private Opportunity, Public Benefit*, Private Finance Panel, November 1995, pp.19-20. (Hereafter referred to as the POPB).

²⁰ Q51.

²¹ POPB, p.18.

isolates as being of general importance for the majority of PFI projects are design and construction risk; commissioning and operating risks; demand risks; residual value risk; technology/obsolescence risk; regulatory risks; and project financing risk.²² We consider what risks may be transferred, and whether the transfer of risk will be genuine, or whether, in practice, the public sector retains much of the risk, in paragraphs 45-50 below.

20. Once these requirements have been satisfied, procurement may take place through a competition between bidders, which itself, the Government considers, will act as an important incentive to ensure value for money. The contract itself, in which experience is, thus far, limited, may be of longer duration than other contracts. If the capital asset is expected to last longer than the life of the contract, then the ownership of the asset may be transferred, after the end of the contract, either to the public sector, or to a new private supplier.

TURNING CAPITAL INTO CURRENT SPENDING

21. A key feature of the PFI is that "the public sector does not contract to buy assets: it contracts to buy services."²³ The effect of this on public sector capital expenditure is shown in the Red Book; over the planning period 1995-96 to 1998-99 public sector capital expenditure will fall by £2.5 billion.²⁴ As a proportion of GDP, net capital spending will fall from 1.75 per cent in 1995-96 to 0.75 per cent in 2000-01.²⁵ This is expected to be offset by capital investment under PFI which is forecast to increase significantly from its currently modest levels to reach £2.8 billion in the financial year 1998-99.²⁶ The achievement of this aim will depend largely on the success of PFI in three departments - Transport, Scotland and Health - which together are expected to make up more than 70 per cent of expected capital spending under PFI over the period 1995-96 to 1998-99.²⁷

22. The Red Book goes on to explain future plans for PFI: "By the end of 1998-99, Departments expect to have agreed PFI contracts involving capital expenditure worth some £14 billion. This figure could well be exceeded: the Private Finance Panel have identified over 1,000 potential projects worth £25 billion for the Government to consider. Capital expenditure under PFI commitments is expected to run at about £2 billion or more a year over the next three years... *Total expenditure on the services purchased under these contracts will be much greater still.*"²⁸ The final sentence of this section of the Red Book illustrates one of the most important aspects of PFI, so far as the public finances are concerned; that the commitment by the public sector to purchase services from the private sector will be significant. In this way, the PFI replaces capital expenditure in the near future for the purchase of an asset with a stream of revenue expenditure stretching further ahead, often over several decades ahead. This raises a series of concerns, the main one being the ability to control public expenditure. This is dealt with in detail in later paragraphs.

23. In evidence to the Committee, the Treasury was keen to point out that the difference in the spending implications between conventional and PFI procurement may be more apparent than real. We were told "that whenever the Government creates an asset, whether it is by some traditional method of procurement, it is *de facto* entering into a stream of obligations because it will usually want to keep that asset working. ... When you move into PFI that *de facto* commitment become a legal commitment to the PFI supplier, so there is that change, an important change, but one has to measure it by what would have happened under a traditional procurement and it is not totally novel in that sense."²⁹ This analysis is however only partial. As the Treasury also admitted in evidence, the upfront capital costs of traditional

²² POPB, p.13.

²³ FSBP 1996-97, para. 6.21.

²⁴ FSBP, 1996-97, Table 6.4.

²⁵ FSBP, 1996-97, Table 1.1.

²⁶ FSBP, 1996-97, Table 6.4.

²⁷ FSBP 1996-97, Table 6.5.

²⁸ FSBP 1996-97, para.6.22 [added italics].

²⁹ Q380.

projects are in part substituted by longer term revenue commitments.³⁰ In this sense, the PFI turns capital into current expenditure, and may increase the extent of the legal commitment to revenue expenditure even when the need for this facility may have ceased to exist.

24. A particular concern has been raised in relation to the interaction of plans to introduce resource accounting (and eventually budgeting) techniques to the public sector with PFI projects. In a recent article in *The Times*, Sir Peter Kemp warned "the Treasury will have to make sure that ministers, always on the lookout for the political equivalent of the fast buck, know the risks involved and are not seduced by energetic merchant banks fighting for their big up-front fees. In the wrong hands, the combination of resource accounting and PFI could be a witches' brew, leading to borrowing off balance sheet and paying dividends out of capital or unrealised gains. That sort of behaviour has sent many a private company into bankruptcy."³¹ The particular concern relates to the treatment of capital expenditure under resource accounting. Based on the system of accruals accounting, the new treatment of capital expenditure is explained in the Government's White Paper. "If expenditure is capital expenditure (ie it is for an asset which lasts for several years) then it is not all recorded as operating cost in the year in which the asset is acquired or built, but instead is spread out over the useful life of the asset in the form of an annual depreciation charge."³² The concern is that large spending programmes can be entered into which will not show up as capital outflows but which will post increasingly large bills to future public expenditure.

25. A further concern is that by turning capital into current expenditure, the PFI partially undermines the need for the introduction of resource accounting. The Government clearly places great stock on the PFI as a means of providing services. Recent Treasury guidance states "The emphasis of PFI is away from funding; towards involvement in the design, build and operation of a capital asset by a service provider",³³ while, in his 1994 Budget speech, the Chancellor asserted "Privatisation and private finance are rapidly becoming the chosen method for raising the quality of public services in the majority of countries in every continent in the world. They started in this country."³⁴ The Red Book shows that by 1998-99 more than 12 per cent of "publicly sponsored" capital investment will be derived from the PFI.³⁵ Since PFI entails the purchase of services (current expenditure) rather than assets (capital expenditure), the increasing use of PFI will diminish one of the assumed benefits of introducing resource accounting, since the public sector will own fewer capital items to which it can apply accruals accounting techniques.

PUBLIC EXPENDITURE CONTROL

26. The control of public expenditure is a keystone of Government economic policy. The Chancellor confirmed in his budget speech that the Chief Secretary and he "are both convinced that the share of national income taken by the state in public expenditure must be reduced to below 40 per cent if we are to remain competitive in today's world."³⁶ One of the main concerns that has arisen with the development of the PFI is the potential loss of control over public expenditure. On the face of it, PFI projects, to the extent to which they allow the reduction of public capital expenditure, should enhance the control of public expenditure. The Chancellor made this very point in his 1994 Budget speech, when he announced "The growing importance of private finance has helped us to find significant savings for the taxpayer in the transport programme."³⁷ There has, however, been considerable concern about the implications of PFI for future public expenditure control, as

³⁰ QQ382-3.

³¹ Sir Peter Kemp "Plans to bust Britain", *The Times*, 14 September 1995.

³² *Better Accounting for the Taxpayer's Money: The Government's Proposals: Resource Accounting and Budgeting in Government*, July 1995, Cm 2929, Diagram 2.

³³ POPB, para.2.6.

³⁴ *Official Report*, 29 November 1994, col.1084.

³⁵ FSR 1996-97, Table 6.4.

³⁶ *Official Report*, 28 November 1995, col.1057.

³⁷ *Official Report*, 29 November 1994, col.1085.

a result of the revenue expenditure implications of PFI commitments entered into by a diversity of organisations.

27. The particular concern is that by turning capital into current expenditure the costs of investment are passed to future years. Our specialist adviser summarised this view when he commented "There are substantial dangers that recourse to private finance will be used as a means of undertaking hidden public borrowing and expenditure. ... Without a significant transfer of risk to the private sector, schemes for private finance look like an attempt to circumvent budgetary controls on public expenditure, whether by creative accounting around definitions or by retiming the scoring of expenditure."³⁸ A further concern is that there is no central control over the commitments being entered into by a diversity of organisations. In evidence during our inquiry into the 1995 Budget, the Treasury commented "this [PFI] is a decentralised initiative, for example, health authorities round the country are entering into contracts, and I do not think we can produce information on individual schemes. That would be the responsibility of individual departments and authorities."³⁹

28. Part of the difficulty of monitoring the level of future commitments is that PFI contracts are negotiated by bodies removed from both the Treasury and, in some cases, the departments to which they are responsible. In evidence the Treasury told us "So far as the Private Finance Unit in the Treasury is concerned, it does not have a role. It is even more remote than, say, the NHS Executive from trusts in relation to the monitoring of obligations that are entered into or are anticipated as being entered into by trusts. ... it is very much the responsibility of departments and they are the ones that are informed as to the arrangements that they are entering into for monitoring those commitments, and some of these are as small as a few hundred thousand pounds."⁴⁰ Indeed, the Government's proposals for resource accounting show the diffuse nature of purchasing organisations,⁴¹ and also makes clear that several types of organisation capable of entering into PFI contracts will not have their accounts consolidated with that of the parent department. Evidence from the Treasury made it clear that even where initiatives are in place to collect information about PFI projects these are, at present, of a voluntary nature. "Health have for ... roughly a year to 18 months now had a system established on a subcontracted basis to a consultancy to actually monitor commitments. ... the way in which that database works is that it is very much market-driven, in that trusts are encouraged to register, but I am not aware that they are actually required to or there is a means to require them."⁴² This implies that information concerning PFI projects - if it is to be consolidated centrally by departments and globally by the Treasury - will need to be collected by some special process which is not yet in place.

29. The rather haphazard system of monitoring PFI commitments was further revealed in the course of our oral evidence. The Treasury told us that, with regard to systems of monitoring, "There are none in place to monitor forward commitments in a systematised way of any sort across government departments, whether it is my pension, a defence project or the PFI. The PFI has brought a focus on to this. We are responding to it and putting those in place."⁴³ The failure to establish monitoring systems for PFI commitments was explained rather lamely by the Treasury. "The simple answer to that is that we were concerned to put the effort initially into getting this initiative established and working."⁴⁴ Sir Christopher Bland expressed his concern at the risks posed to public expenditure control by this lack of control of PFI commitments.⁴⁵ He noted that "the Treasury do not centrally total those forward commitments for every government department, and it is the case that not all government departments themselves total those forward commitments. ... if you ask some

³⁸ Appendix 17, p.53.

³⁹ *Op.cit.*, Q128.

⁴⁰ Q395.

⁴¹ *Better Accounting for the Taxpayer's Money: The Government's Proposals: Resource Accounting and Budgeting in Government*, July 1995, Cm 2929, Diagram 3.

⁴² QQ391-2 (Italics added).

⁴³ Q384.

⁴⁴ Q390.

⁴⁵ Q107.

departments 'What are the revenue implications of the PFI contracts they have signed in the year, say, 2005?', they would not readily be able to give you an answer, and if you asked the Treasury 'What is the sum total of the PFI commitments in the year 2005?' they would not readily be able to give you a total, but the information is there and it needs to be codified, organised, and assembled fairly speedily in our view."⁴⁶ We share this concern that a major Government policy can be introduced with the potential to involve significant amounts of public expenditure without previously establishing a system of effectively recording and monitoring the liabilities being entered into. Furthermore, it is possible that this lack of information could frustrate a linked strand of policy - the reduction of public spending, and future Chancellors might find their policy options limited as a result of today's lack of control. **We would therefore welcome details from the Treasury of the system they will put in place to monitor PFI commitments.**

VALUE FOR MONEY

30. According to the Treasury, the main benefit of PFI for the public sector is: "more and better projects and better services. These services should also cost less than if provided by traditional public sector means because the private sector achieves efficiencies in delivery by better design and management."⁴⁷ Improvement in value for money is obtained under PFI through "better allocation of risk; better incentives to perform; close integration of service needs with design and construction; a clearer focus of responsibilities of public and private sectors which more clearly reflects the strengths of each; a continuing commercial incentive for efficiency throughout the design, asset creation and operation of the project; and more potential for efficiencies."⁴⁸ In the following section we review various aspects of how value for money is measured and obtained.

31. The Treasury is clearly convinced of the significant value for money gains available under PFI. In its recent guidance it states "The starting point is a clear presumption that the PFI approach will generally be better than a traditional procurement; the better management inherent in a PFI project will give better value for money. As a matter of Government policy, public bodies should always consider private finance options unless it is clear that transfer of project control and risk to the private sector is not feasible."⁴⁹ This statement is interesting, for if the benefits of PFI are so apparent, it is difficult to explain the slow progress of the Initiative so far or why there is a need for a "clear presumption" in favour of PFI as a means of procurement. Our specialist adviser drew attention to the shift in belief at the Treasury in the usefulness of private finance; in 1993, a former official recalled "The Treasury's objective then [in 1983]... was to stop such schemes. The notorious Ryrie rules were a tease — the conditions they set for private financial projects were not intended to be met in practice."⁵⁰ The Treasury blamed inertia in departments for the slow progress of PFI. "Sitting where I sit one gets the sense that there are plenty of people in departments who are busy trying to find ways to let the traditional way win rather than the new way because doing things in a new way is risky and they would much prefer to stick with tried and tested methods."⁵¹ The Treasury, however, believes that this inertia in departments will be overcome. As we have noted above, Table 6.4 of the 1996-97 Red Book shows that capital expenditure under the PFI in 1993-94 and 1994-95 was £0.3 billion per year. In 1995-96 this is expected to double to £0.6 billion, leaping to £1.9 billion in 1996-97 and totalling £2.8 billion in 1998-99.⁵²

⁴⁶ QQ109-110.

⁴⁷ POPB, para.1.8.

⁴⁸ POPB, para.1.9.

⁴⁹ POPB, para.3.30.

⁵⁰ Appendix 17, p.47.

⁵¹ Q411.

⁵² FSB 1996-97, p.120, Table 6.4.

The analysis of value for money

32. Treasury guidance on PFI states "A critical question in deciding whether to go ahead with a PFI option is identifying **best** value for money. Competition is the best guarantor of value for money. As a result of the competitive process, the best PFI options should emerge. These may involve comparison with a conventionally procured alternative - the public sector comparator."⁵³ There are, however, a series of situations when it is deemed inappropriate or unnecessary to use a public sector comparator.⁵⁴ Perhaps the most subjective of these is the view that if the project is suitable to go ahead as a publicly financed project, but public funds are not (or not likely to be) available in a similar timescale to the PFI project, then no public sector comparator is needed. In such a circumstance it is difficult to see the justification for describing the project as best value for money, but rather that it is the best available value for money. Comments made by the Chief Secretary to the Treasury in the course of our 1995 Budget inquiry are illuminating in this respect. He commented "We do not start from saying that there is a set amount of public provision and that PFI is on top of that. When I came into the Department in July I said that the approach I wanted to capital spend was to tell departments that they had to justify their capital spend, that we were doing what was called in old-fashioned jargon zero budgeting, and they should assume that they had no capital and then they should come back and say why they needed what they needed, why if they did need it they needed conventional public capital provision to do it and why they could not do it by PFI or in some other way."⁵⁵ In this context for capital spending, there is a danger that PFI projects will become "best value" by default, to the overall long-term detriment to the public finances.

33. Although the testing of value for money can be approached as a systematic and impartial science, our evidence has shown that a series of subjective judgements will impinge upon the testing process. This subjectivity is reflected in some of the Treasury guidance. "Private sector bidders are exposed to the financial consequences of their bids, in a way that officials are not in respect of the public sector comparator. This will tend to make the assessment of comparators unduly optimistic about the public sector solution."⁵⁶ "The construction of a public sector comparator is not straightforward. It will typically be based on a set of hypothetical contracts to design, build and manage a public sector facility, based on recent experience of actual costs. Allowance must be made for the likelihood that out turns are usually higher than initial estimates."⁵⁷ This guidance seems to be encouraging subjective judgements in favour of PFI projects. However, there is no *a priori* reason why public procurement should not run to time and cost. Indeed, many of the assumed benefits of PFI would appear to be available to better managed and controlled conventional procurement. Furthermore, there is an element of subjectivity involved in assessing and placing a cash value on the external benefits of different project options. In evidence to the Committee, Sir Christopher Bland acknowledged the difficulties in attaching cash values to external costs and benefits in project appraisal.⁵⁸

34. A related point is that the public sector has access to cheaper capital than private sector investors. The assumptions made regarding the relative costs of capital are vital to the assessment of projects to net present values. It makes intuitive sense that the cheaper capital available to the public sector should make this route of procurement best value where the project involves a large capital element. Indeed, in some cases it is conceivable that the same contractors would be performing the work. As Dr Glaister pointed out in evidence to the Committee, private options (which may require a premium of 6-9 percentage points above the gilt rate) will prove better value for money "If, and only if, they achieve lower construction costs, more efficient maintenance in the long run. ... It is accepted, I think, that the cost of borrowing will be higher but one is offsetting that against these perceived efficiency gains.

⁵³ POPB, para.3.35 [added emphasis].

⁵⁴ *Ibid.*, paras.3.36-3.43.

⁵⁵ Third Report, Session 1995-96, Q510.

⁵⁶ POBP, para.3.42.

⁵⁷ POPB, para.3.39.

⁵⁸ QQ159:161.

... That is the trade-off."⁵⁹ The question arises of exactly how the value for money benefits of PFI are obtained. This is one of the difficulties in moving from the theoretical to the actual, to see how the perceived benefits manifest themselves in real projects. For instance, the Treasury guidance notes that, with regard to the supply of Northern Line trains, "it is suggested that the train service contract is in excess of 20 per cent better value for the public sector compared to the purchase alternative over 20 years."⁶⁰ It is difficult to determine, however, exactly how this expected saving has been achieved. Evidence from Dr. Glaister helped to elucidate the types of areas where savings are most likely to be derived. "In the case of buses, part of the cost saving came about because the private sector used its labour more flexibly than had the public sector,"⁶¹ while, in construction, it is likely that the same firms will be building the assets, so the benefits will derive from design requiring low maintenance.⁶² There is no obvious reason why the benefits of better design could not be obtained under traditional procurement, so the more "flexible use of labour" may well be one of the key areas where PFI projects obtain savings. **The Committee would welcome further information from the Treasury on how the benefits of PFI projects accrue, for instance giving guidance on the relative importance of different areas of cost saving.**

35. The subjectivity of some aspects of the evaluation process, together with the difficulty in determining exactly how benefits are obtained under PFI puts those responsible for determining value for money in a pivotal position in deciding the future of projects under PFI. The question of who is ultimately responsible in determining whether best value for money is achieved, has been raised throughout our inquiry. The Treasury have made it clear that they have no interest in policing individual decisions. "We in the Treasury and Mr. Hogg's Executive Unit provide help, advice and guidance, but the responsibility - and we have made this very clear indeed - is the responsibility of the accounting officer of that department accountable to the Public Accounts Committee."⁶³ The comments of our specialist adviser are pertinent in this regard. "Ministers and civil servants assert that there will be efficiency gains because of the inherent greater efficiency of the private sector, and that these efficiency gains will more than offset higher financing costs. Measurement is held not to be required because it is taken as a prior assumption that there will be efficiency gains; the question of whether these will be sufficient to offset higher financing costs is thus never directly addressed. ... The two key issues at this juncture are: whether claims of efficiency gains can be substantiated in independently conducted post-audits of projects; and the provision of firm evidence about the costs of capital relevant to various kinds of PFI project."⁶⁴

The bidding process

36. Competition is regarded as a vital element of the PFI process to ensure that the public sector obtains the best possible value in the purchase of the services it requires. The Treasury told us "so long as there is a level playing field, there is a competitive process, there is therefore the mechanism in place to ensure value for money."⁶⁵ Competition is obtained through a process of bidding for PFI contracts. However, some of the most strident criticisms we received of PFI related to this bidding process.

37. The first concern is that bids are requested for projects that are either unsuitable for PFI, by virtue of their size or nature, or for projects that are unlikely to proceed. This causes frustrations for both the public and the private sector. Government policy appears to encourage departments to set up bidding for projects. As the Treasury guidance notes "In November 1993 the Parliamentary Under-Secretary of State for Health, Tom Sackville, announced that NHS bodies would not be given access to public funds for capital projects

⁵⁹ Q272.

⁶⁰ POPB, para.4.64.

⁶¹ Q247.

⁶² Q253.

⁶³ Q412.

⁶⁴ Appendix 17, p.166.

⁶⁵ Q399.

before they have rigorously explored PFI options and shown them to be impracticable. ... In November 1994 the Chancellor generalised the NHS approach by announcing that in future the Treasury would not approve any capital projects unless private finance options had been explored."⁶⁶

38. This requirement for private finance testing has been criticised by the private sector. In its memorandum to the Committee, SJ Berwin & Co, a firm of solicitors that has advised both private sector consortia bidding for PFI projects, and public sector clients developing such projects, commented "We constantly receive complaints from clients and prospective clients that they are forced to explore private finance options for projects that are plainly not financeable by the private sector. A larger minimum value threshold should be established for PFI. Some public bodies pursuing PFI are wasting their own time and resources and those of the private sector with ill-thought out schemes. ... Public bodies need to be clear what it is they wish to achieve before launching a bidding competition."⁶⁷ These sentiments were echoed by Wimpey Construction Investments Ltd. who commented "The public sector should be very confident that a project will proceed before it is put out to bid."⁶⁸ W S Atkins Ltd., a leading engineering consultancy, also expressed its concerns. "In the particular case of Healthcare projects, we are concerned that so many of these have already been launched by NHS Trusts whose covenant cannot be relied on in view of their constitution and funding arrangements. We believe it is essential that the Department of Health should immediately confirm its commitment to provide the support necessary for these projects to be funded in order to end the uncertainty surrounding them."⁶⁹ It is clear that both public and private sector parties involved in PFI are concerned that meaningless bidding processes will be initiated which benefit no-one. The view that bidding processes are sometimes paper exercises may explain the inertia in some departments towards PFI referred to by the Treasury.⁷⁰ In oral evidence, both Mr Hogg, Chief Executive of the Private Finance Panel, and its Head, Sir Christopher Bland, felt that certain projects are unsuitable for PFI treatment,⁷¹ and it must surely benefit all involved to identify at the earliest possible stage which projects will not prove amenable to PFI treatment. **We would welcome further comment from the Treasury on this important area. We ask the Treasury to review whether it remains appropriate that private finance options must always be explored or whether unsuitable projects could be identified and excluded much earlier in the process.**

39. A further difficulty that has been raised in respect of bidding is the degree of specification that is required by the public sector body letting the PFI contract. Here the evidence is more diverse. The Treasury view was expressed as "The traditional public sector way of doing this sort of business ... is to put a specification out in tremendous detail to the private sector to do whatever it is, build a road, build a hospital, put it out to maybe five firms and get back five bids. You will get back five very similar bids because the specification was so rigid there is hardly any room for manoeuvre, so the decision at that point is very simple, 'Which is the cheapest?' By comparison, when the PFI bid comes back the specification that will have been sent out will be much more open, will specify the outputs it has sought and left it to the private sector to come back with solutions to that, solutions which will usually have a number of variant bids in them with different degrees of risk transfer, so that instead of a simple, 'The cheapest must be best solution,' you have then got a number of bids with a combination of price and risk transfer to deliver the output and you compare it with the traditional way of doing things where hopefully you have identified and costed the risk of that solution *ex ante*."⁷² This need for flexibility in the bidding criteria has been stressed by BMI Healthcare (an independent healthcare company which has been involved in PFI projects). In its memorandum, it commented "historically the bidding process has been complicated at an unnecessarily early stage when superfluous operational details are

⁶⁶ POPB, para.2.7.

⁶⁷ Appendix 3, p.120.

⁶⁸ Appendix 6, p.129.

⁶⁹ Appendix 11, p.140.

⁷⁰ Q411.

⁷¹ QQ120-2.

⁷² Q411.

added ... Bidding procedures should be updated to reflect the experience and expertise of total hospital/healthcare facilities management in a bidding partnership. These revised procedures should provide a tiered bidding process where considerations of detailed costings on minor operational matters are not considered at the outset. This would provide a simpler, cost-effective bidding procedure."⁷³

40. While the Committee recognises and accepts that flexible project specifications can increase innovation, and that there is a need to protect intellectual property rights resulting from bids for such projects, we are concerned that open ended specifications may make quantitative comparisons of bids more difficult and increase the cost of tendering. **There is clearly a trade-off between greater flexibility of specification to encourage innovation and new approaches and the greater objectivity and precision that is possible in tender evaluation when specifications have been more standardised.** We would not, on balance, wish procedures to be adopted that vitiated the opportunity for new thinking which we see as one of the major attractions of the PFI. We therefore feel there may be a need for a higher level of scrutiny of such bidding processes, to ensure openness and protect against the danger of corruption. We would welcome comment from the Treasury on how it perceives this problem and what measures it can propose to deal with it.

41. Other evidence has, however, expressed considerable concern over the lack of specification provided by the public sector purchaser in the bidding process. In its memorandum, Coopers & Lybrand highlighted these concerns. "A particular problem area is the incidence of non-compliant bids which could be minimised with better defined specifications and more clearly identified evaluation criteria."⁷⁴ A slightly differing view was presented by the WS Atkins consultancy which noted that the degree of specification required in the bidding process varied widely between departments, with Transport requiring most detail and Health least. Its concern was for consistency between departments. WS Atkins commented "We believe it is essential that a common approach is adopted to the degree of detailed project development required to enable Preferred Supplier status to be achieved, such as would keep bidder's costs to a manageable level yet provide the Client Organisation with an adequate degree of certainty that Financial Close can be achieved."⁷⁵ Given the decentralised nature of the PFI and the vast range of projects that are expected to receive PFI investment, it is difficult to see how central control of bidding specification can be achieved. **We would welcome comment from the Treasury on the level of specification it expects to be required by the promoting body.** Clearly it is important that the various public bodies involved in letting PFI contracts remain sensitive to the representations of the private sector bidders, otherwise the warnings voiced by Wimpey Construction Investments Ltd., that "the PFI process simply seizes up within the next 2 -3 years because of lack of resources,"⁷⁶ could materialise.

42. With regard to roads, the Automobile Association (AA) commented "One disadvantage in the DBFO approach is that the cost of bidding is a significant deterrent and on-cost for even the largest firms. One rule of thumb is that while 'design and build' bidding is three times the cost of conventional road contract bidding, the cost of DBFO bidding is five times the cost. These costs eventually have to be recovered from successful projects."⁷⁷ This highlights the risks to value for money benefits expected from PFI unless the concerns of the industry receive attention.

43. The difficulties with bidding imply that the PFI will not achieve its expected level of investment unless the concerns of the private sector are addressed. This has two worrying prospects for proponents of PFI: that companies will simply fail to put in bids; or that, in order to cover the risks of costly failed bids, the private sector will increase its prices so that the expected value for money gains of PFI projects fail to materialise. The Construction

⁷³ Appendix 12, p.145.

⁷⁴ Evidence, p.35.

⁷⁵ Appendix 11, p.26.

⁷⁶ Appendix 6, p.15.

⁷⁷ Appendix 14, para.35.

Industry Employers Council warned that "Putting together a PFI bid is an extremely expensive exercise, and this is viewed by the industry as a real barrier to entry into this vital new market."⁷⁸ WS Atkins echoed these sentiments and asserted that "We believe that the future success of the PFI is dependent on the Government being prepared to compensate Bidders for their costs incurred after appointment as Preferred Supplier in the event that a decision is taken not to proceed with the Project."⁷⁹ Two particular suggestions emerged from Wimpey Construction Investments Ltd. "Wherever possible standard documentation should be used to minimise the legal costs in negotiation. In particular, NHS trusts should be discouraged from re-inventing the wheel for each project. [and] The public sector should, when setting PFI bid procedures, attempt to identify the expensive elements of the bid cost eg. full design, obtaining of firm financing commitments, and attempt to delay them until the number of bidders has been reduced."⁸⁰ These views were echoed by the Construction Industry Employers Council.⁸¹ **We would welcome specific comment from the Treasury on how it proposes to address the concerns raised in this paragraph.**

44. A broader policy concern is that the introduction of PFI has impinged upon the ability of departments strategically to plan their capital investment programmes. The evidence above shows that concerns about the suitability of projects and the costs of bidding are encouraging the private sector to become increasingly careful about which schemes it will bid for and invest in. Sir Christopher Bland admitted that PFI "is plainly particularly well suited in the former [i.e. projects which generate revenue], where either real or shadow streams of revenue can be identified."⁸² This raises the possibility that those projects which raise identifiable revenue will attract PFI bids and will proceed, while other projects — which a department may regard as important — may be delayed. In this way the mechanism of funding, rather than a coherent plan, may determine which capital assets are created. Clearly, those capital assets which are most in demand are likely to be those which will yield streams of revenue (either real or shadow) and, it could be argued, in this way the most worthwhile projects will automatically be those which attract finance and become reality. Our specialist adviser drew attention to the fact that the Skye Bridge received the blessing of the Highland Regional Council only after the Scottish Affairs minister, Lord James Douglas-Hamilton, said that there was no possibility of a toll-free bridge for at least 20 years.⁸³ This not only calls into question whether "best value for money" was obtained but also highlights the concern that the decision to proceed with projects is determined by the funding mechanism rather than an evaluation of desirability.

THE TRANSFER OF RISK

45. A vital element of the cost efficiency of PFI projects is that "risk should be allocated to whoever is best able to manage it. Although there may also be policy reasons to encourage risk transfer, the aim is to achieve optimum risk allocation, not transfer for its own sake."⁸⁴ The optimum allocation of risk will be the most cost effective solution, as the party that can manage the risk at the lowest cost will be responsible for it. Evidence presented to the Committee suggests that in PFI projects to date the optimum transfer of risk has not always been achieved, to the detriment of value for money. This has implications for the individual PFI project concerned — as it may not represent best value for money — and for the policy as a whole — as firms may feel obliged to increase their bids for other projects to compensate for their total risk.

46. In its memorandum to the Committee, Coopers & Lybrand explained the problems of sub-optimal risk allocation. "As risk is transferred to the private sector, value for money

⁷⁸ Appendix 15, para.11.

⁷⁹ Appendix 11, p.141.

⁸⁰ Appendix 6, p.129.

⁸¹ Appendix 15.

⁸² Q131.

⁸³ Appendix 17, p.163.

⁸⁴ POPB, para.3.6.

risers so long as the private sector is taking on risks with which it is familiar and which it is better able to manage than its public sector counterparts. However, the rise does not go on indefinitely. There comes a point where the private sector may be asked to take on risks which it cannot control, and which it may be less able to handle than the public sector. Although such levels of risk may be accepted, they will be priced at a level which represents poor value for money for the public sector."⁸⁵ In its memorandum, Wimpey Construction Investments Ltd. felt that sub-optimal PFI deals have been let. "The public sector clients letting PFI schemes seem to be driven by the wish to score maximum points for risk transfer on each individual scheme, frequently forcing the private sector to take risks which are not within their control. They are not taking a long term view of what is reasonable in order to ensure the long term success of the programme."⁸⁶ This reflects the view of other construction concerns.⁸⁷ **We would welcome the Treasury's view on whether sub-optimal deals, in terms of risk allocation have been let, and the extent to which the achievement of value for money has been impeded as a result.**

47. A rather opposite concern is that, in some instances, aspects of risk transfer are apparent rather than real. This is particularly true where the PFI deal involves the creation of a "vital" part of public infrastructure. Dr. Glaister drew attention to this difficulty in risk transfer of how assets are treated at the end of a contract. "I think you can see as you come to the end of a contract there are things which the two parties can do and there will be a bit of negotiation and game playing to shape up, as it were, to negotiate and that will have to happen at the end of the period. For instance, if London Transport wishes to exercise its right to walk away from those trains at the end of the 20 years, which I believe in principle it does have, it will start making threats towards the end of the contract to start buying replacement trains from other people and cascading them down and that kind of thing and indeed start executing that threat as the time gets closer. I do recognise the problem you identify and I think it has also been raised in the context of hospital buildings, which are very specialist, where the terminal value of the building at the end of the contract is very low unless it is used as a hospital so who is going to take it on and on what terms?"⁸⁸ This evidence suggests that, although in theory the terminal risk for disposal of the asset can be transferred to the private sector, where PFI is used to procure infrastructure there is an implicit guaranteed market for the asset at the end of the contract.

48. The Minister for Transport was, however, convinced that this element of risk transfer was genuine. He told the Committee "If the offer which was made was considered by London Underground to be good value for money for them, if that was cheaper than a new procurement or procuring secondhand rolling stock from somebody else, there would essentially be a competitive market. By then perhaps the rolling stock leasing companies that are supplying rolling stock for heavy rail might also be trying to move into the Underground market. We are hoping generally to create a competitive market for rolling stock. I do not think that the contractor is really in a monopoly supplier position even at the end of the contract. He could be if the management had not started to review its options and negotiate early enough and found that they either had to run them with these trains or not have the trains at all but I do not envisage that happening either."⁸⁹ It remains to be seen whether "a competitive market for rolling stock" will exist at the end of PFI contracts, but there is an element of doubt over how real risk transfer can be in the instance where large capital assets are in situ.

49. The question of the extent to which the public sector effectively underwrites programmes during construction and operation has also been raised. Again, where PFI is used to construct vital infrastructure it defies belief that, in the event of a private sector failure, the public sector would not involve itself in the project, either through direct investment or by re-letting the contract. Indeed, the private sector is most likely to become

⁸⁵ Evidence, p.32.

⁸⁶ Appendix 6, p.128.

⁸⁷ See Appendices 11 and 15.

⁸⁸ Q261.

⁸⁹ Q348.

involved in PFI projects where there is commercial demand for the asset provided and the opportunity to raise real or shadow revenues. Using market demand as a criterion, these are the projects which are most necessary and so the public sector would need to meet this demand that the private sector had initially failed to satisfy. In evidence to the Committee, the Transport minister told us that if a contractor went into liquidation "we would have to appoint another company to take over the contract. ... If it is 20 years down the line then the main responsibility would be for the management and maintenance of the road itself rather than for any major element of construction."⁹⁰ There will be no guarantee, however, about the cost at which the contract can be re-let and the expected value for money benefits of the project may be lost. Therefore, although the public sector may have initially transferred risks, it may be forced to reassume them in the future, at an unknowable cost.

50. Although the Committee welcomes the possibility of the provision of assets through PFI, and recognises that there is potential for value for money benefits from the scheme, we remain concerned that in some key areas of bidding and risk transfer there are impediments to the realisation of these gains. We feel that the Treasury must address the concerns of both private sector contractors and public sector customers if the PFI is to result in the increases in investment predicted for it. While we share the Financial Secretary's view that, so far as the level of PFI expenditure is concerned, "it is better to travel in hope than not to travel at all,"⁹¹ we conclude that this hope may not be fulfilled.

THE PFI IN HEALTH

51. In order to improve our understanding of the difficulties and challenges posed by PFI, we decided to take evidence on some specific projects in the health sector. We accordingly took oral evidence from Mr Green, the Chief Executive of the Royal Hospitals NHS Trust, and from Mr Whitney and Mr Linacre of the Central Sheffield University Hospitals NHS Trust. Both Trusts have PFI proposals for major capital works which are both in the bidding and evaluation process. We also questioned the Secretary of State for Health on the issues raised by the operation of PFI by these Trusts.

52. The evidence taken from the Trusts and the Secretary of State illustrates several of our concerns with PFI. The slow progress of the policy is well illustrated by the health sector. Although there are many projects in the pipeline the effects of the policy in terms of extra resources provided appear so far to be marginal.⁹² The concern is that capital spending in health will be cut on the basis of expected PFI investment that has yet to materialise. The PFI in health has also been criticised in evidence to the Committee for failing to provide clear project objectives to bidders.⁹³ This issue appears to arise in relation to the Royal Hospitals NHS Trust's plans to develop Whitechapel Hospital; bids were invited on the basis of a project involving a 750 bed hospital - and bidding has been conducted on this basis - but the Chief Executive of the Trust admitted that consideration is now being given to a larger hospital.⁹⁴ It must surely be desirable that a Trust is clear at the outset about the nature of the project it is embarking upon both for the purposes of public consultation where this is a statutory requirement and for the subsequent benefit of bidders and those seeking to manage the project.

53. A further criticism of PFI is that in some circumstances it has delayed rather than encouraged investment, by creating a need for testing and uncertainty over the level of public funding. The evidence from the Central Sheffield University Hospitals NHS Trust confirmed this. "The money that was available in the region's capital programme as at October 1993, whilst it might still be available in principle, and hopefully in practice, is not immediately available until we have gone through the process of testing the public option against the

⁹⁰ QQ291-3.

⁹¹ Q441.

⁹² QQ633-642.

⁹³ Evidence, pp 34-5 and Appendices 6 and 11.

⁹⁴ Q496.

private financing."⁹⁵ The difficulty arising from the lifespan of projects and effective risk transfer was also apparent in relation to this Trust. The initial contract for this project is expected to be for 25 years, and there is concern that in future the Trust may find itself committed to purchasing services which are obsolete.⁹⁶ The Trust expects to be able to negotiate terms to avoid this problem, but it is not clear how this risk will be shared between the Trust and the contractor.⁹⁷

54. The evidence taken from the Trusts also reveals some concern about the suitability of PFI for health projects. The Secretary of State for Health told us "I entirely agree with the proposition that there are some aspects where it may prove the PFI is not a sensible way of dealing with capital expenditure I do not agree with the proposition that the health service is in some sense not an ideal application for PFI."⁹⁸ A concern is that those aspects of investment which have a lucrative return will attract investment and that the need to link different aspects of projects to ensure this return might be detrimental. The Central Sheffield University Hospitals NHS Trust told us "in discussions with the potential PFI partners it became clear that the reality of any coherent viable bid seemed that it would have to be linked to a substantial facilities management type arrangement."⁹⁹ This raises the concern that the ability of the Trust to plan effectively the provision of its services could be lost¹⁰⁰ as decisions will be determined by the method of funding rather than an objective assessment of need.

55. There are a number of further difficulties specific to the health service. One arises as a result of the Department of Health's view — which we support — that clinical services should not be provided under the PFI. The Secretary of State, in evidence, said, "Within the context of the PFI it is not our policy to seek to transfer the delivery of either clinical or clinical support services into the private sector"¹⁰¹ and that if the viability of a "PFI project depends upon the privatisation of clinical or clinical support services that does not have the consent of local clinicians then it would not get departmental backing."¹⁰² However, the Central Sheffield University Hospitals NHS Trust told us that PFI was forcing it to introduce a false split between 'clinical' and 'non-clinical' services¹⁰³ which, hitherto, had been successfully provided together, in some cases by the same people. The Chief Executive of the Trust said, "The domestic housekeeper is a key part of the clinical team. How do you engage that service from a non-NHS employer, if you like, whilst making sure they remain as a core part of the clinical team? When you talk to patients on the ward the housekeeper is a key part of that team."¹⁰⁴ We are concerned that PFI should not introduce inappropriate and arbitrary demarcations in hospital management.

56. It should be noted that both projects on which we took evidence are in a relatively early stage and whilst we have drawn attention to difficulties with the projects, we do not take a view on the ultimate outcome or success. It is beyond this Committee's order of reference to pass judgement on particular PFI projects and we do not seek to prejudice either scheme. We are concerned however lest the difficulties apparent in these two schemes manifest themselves in other projects and that effective provision of services may be jeopardised as a result.

⁹⁵ Q554.

⁹⁶ Q566.

⁹⁷ Q567.

⁹⁸ Q653.

⁹⁹ Q570.

¹⁰⁰ Q573-4.

¹⁰¹ Q49.

¹⁰² Q594.

¹⁰³ Q582.

¹⁰⁴ Q581.

ACCOUNTABILITY

57. The spending of public money is accounted for by the Government to Parliament. The scrutiny of public expenditure is rightly considered by the House of Commons and the Government to be among the most important tasks of Parliament. Similarly, it is among the most important responsibilities of Government to provide Parliament with transparent and full details of its expenditure. Through the mechanisms of the National Audit Office (NAO), the Public Accounts Committee (PAC), and the other committees of the House, the Government's spending is examined in detail.

58. As commented on above, many PFI projects will involve the expenditure of public money through leasing payments. It is to be expected that this expenditure will be accounted for, and the House appraised of both general levels of spending, and the spending on individual projects. It has been suggested to us, however, that making details available would be subject to the constraints of commercial confidentiality. The Transport minister told us that, though there would be no difficulty in reporting the general level of leasing payments, it would not be sensible to break it down by project for reasons of commercial confidentiality.¹⁰⁵ He was careful to assure us that "there is no bar on the NAO or PAC from looking at individual contracts."¹⁰⁶ The Treasury's Director, Financial Regulation and Industry, confirmed that the commercial details would "certainly be available for the National Audit Office to look at and to satisfy itself that the accounting officer has entered into a transaction that represents value for money for the taxpayer."¹⁰⁷ However, other Government witnesses appeared to suggest that even the PAC might be somewhat constrained. Giving evidence in connection with the 1995 Budget, Mr Douglas Hogg told us that the PAC "can presumably see all the documentation but presumably will itself have to be sensitive to what it discloses."¹⁰⁸

59. The Government argues that the details of contracts should not be made publicly available. It sees a danger that detailed public accountability could have an adverse effect on the value for money PFI represents. The Government believes that competitions may produce unnecessarily high bids if the levels of payments and the details of contracts are disclosed.¹⁰⁹ In these circumstances, it may be that a relatively high degree of trust is placed in the accounting officer of the department concerned to ensure that value for money is achieved, and, if necessary, to oppose the wishes of ministers.

60. We welcome the Government's willingness to continue to supply the House with details of contracts. We note, however, signs that pressure may be brought to bear not to disclose such information in the interests of commercial confidentiality. We do not think that the House would or should sacrifice its rights to see any details of Government spending it sees fit. We stress that the Government's duty to account for its spending to the House is not conditional upon the House's willingness not to disclose such information; if the House refused to give such assurances, it would be improper for the Government to withhold details it regarded as commercially confidential, and unlikely that the House would accept that, in such cases, the accounting officer's satisfaction that value for money had been achieved was sufficient.

61. We welcome the indication that we were given by the Comptroller and Auditor General that the National Audit Office is planning to carry out a series of value for money examinations into the PFI.¹¹⁰ These examinations, while not considering the merits of the PFI, will examine the ways in which individual departments had ensured good value for money through negotiation, the effective working of contracts, the transfer of risk, and the effectiveness of open competition in ensuring value for money.

¹⁰⁵ Q345.

¹⁰⁶ Q346.

¹⁰⁷ Q427.

¹⁰⁸ Third Report, Session 1995-96, Q165.

¹⁰⁹ *Ibid.*

¹¹⁰ Appendix 9, p.132.

62. We accept that there is a serious issue here, and that the Government's concerns that the involvement of private sector companies do bring potential problems of commercial confidentiality are valid. The argument that was put to us, that the widespread dissemination of the details of contracts could affect the ability of the Government to ensure the best value for money, may in fact be a sound one. But if the House and its relevant organs are to be convinced of the need not to disclose details, the particular circumstances in which commercial confidentiality will apply will need to be drawn up with stringent care, in advance, and, wherever possible, not applied on an *ad hoc* basis.

CONCLUSION

63. While we welcome the PFI in principle, we are concerned about a number of issues which cannot be resolved until PFI projects are more widespread and more developed. We expect to return to these issues from time to time in future years. First, we would like the Government to publish aggregate figures of the proportion of PFI projects which are financed via charges to the user, such as road tolls, and those financed by leasing costs and charges on future public expenditure. Secondly, we ask the Treasury to review whether it remains appropriate that private finance options must always be explored or whether unsuitable projects could be identified and excluded much earlier in the process. Thirdly, we expect the Treasury to demonstrate with reference to particular examples and total figures, that higher financing costs have been more than offset by efficiency gains. Fourthly, when PFI projects are being financed and paid for, we look forward to seeing how transparent and full accounting will be maintained, now and after the introduction of resource accounting, including a clear statement of the future revenue commitments implicit in PFI projects, reflecting their impact on the public finances. Finally, we expect, when examining the economy in future years, to analyse whether there is any difference from a macro-economic perspective between funding large capital projects via the PSBR and PFI spending, underwritten by taxation. **We recommend, in the furtherance of public and parliamentary accountability, that the Private Finance Panel produce an annual report which brings together details of projects undertaken by individual departments, as well as the number and details of projects where a public sector solution was finally preferred to a PFI project.**

PROCEEDINGS OF THE COMMITTEE RELATING TO THE REPORT

WEDNESDAY 14 FEBRUARY 1996

Members present:

Sir Thomas Arnold, in the Chair

Ms Diane Abbott
Mr Clive Betts
Mr Malcolm Bruce
Mr Matthew Carrington

Mr Quentin Davies
Mr Barry Legg
Mr Brian Sedgemore
Mr Stephen Timms

Draft Report (The Private Finance Initiative) proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 6 read and agreed to.

Paragraph 7 read, amended, and agreed to.

Paragraph 8 read and agreed to.

A paragraph - (*Mr Quentin Davies*) - brought up, read the first and second time, amended, and inserted.

Paragraphs 9 to 19 (now paragraphs 10 to 20) read and agreed to.

Another paragraph - (*Mr Brian Sedgemore*) - brought up and read, as follows:

"19A. We are, however, concerned that Private Finance Initiatives might conceal hidden political agendas, lead to the distortion of services and fail to provide value for money. For example, we have grave doubts about the proposal of the Secretary of State, the Rt Hon Stephen Dorrell MP, to encourage the Royal Hospitals Trust to advertise for a construction firm to build a new hospital on the site of the Royal London Hospital and in the process close St Bartholomew's Hospital at a cost of £230 million for new build and an unknown cost for the construction company to run the hospital for the next 25 years. We are particularly concerned:

- (i) that a construction company and those skilled in concrete mixing and welding are not the best people to run an NHS hospital for the next 25 years;
- (ii) that the NHS and the Royal Hospitals Trust lack the technical expertise and financial acumen to enter into such a large contract in a new field. In other parts of the world where this has been tried the experiment has come to grief.
- (iii) that the future of the NHS should not be guided by the needs of a private company to secure financial profits;
- (iv) that inevitably a contract granted to a private company to run a hospital for 25 years will impinge on medical matters and if such schemes were widespread would inevitably lead to the privatisation of the National Health Service;
- (v) that there is little difference between a construction company running a major NHS hospital for 25 years and a private nursing home where the owner of the home provides the premises and the money is provided by local authorities and central government;

- (vi) that in the light of the overrun on the expenditure on the Chelsea Westminster Hospital such schemes in the NHS are clearly premature and could lead to disaster for patients;
- (vii) that there is a concern which has been expressed by hospital consultants that political considerations may be driving such PFIs rather than considerations of value for money and patient care.

We believe that in the NHS there is a need to examine the dangers inherent in 1-7 above before the Government and its agents rush ahead with PFIs on the basis of their perception of the need for political speed rather than on the need to pursue the interests of patients in need of medical services."

Motion made, and Question proposed, That the paragraph be read a second time.

Ordered, That the Debate be now adjourned. - (Mr Barry Legg.)

Debate to be resumed on Monday 1 April at Four o'clock.

MONDAY 1 APRIL 1996

Members present:

Sir Thomas Arnold, in the Chair

Ms Diane Abbott	Mr Quentin Davies
Mr Clive Betts	Mr Nigel Forman
Mr Malcolm Bruce	Mr Barry Legg
Mr Nicholas Budgen	Mr Brian Sedgemore
Mr Matthew Carrington	Mr Stephen Timms

The Committee deliberated.

Consideration of the Chairman's draft Report resumed.

New paragraph proposed by Mr Brian Sedgemore.

Question again proposed, That the paragraph be read a second time.

Question put.

The Committee divided.

Ayes: 3

Noes: 6

Ms Diane Abbott	Mr Malcolm Bruce
Mr Clive Betts	Mr Nicholas Budgen
Mr Brian Sedgemore	Mr Matthew Carrington
	Mr Quentin Davies
	Mr Nigel Forman
	Mr Barry Legg

Another paragraph — (Mr Brian Sedgemore) — brought up and read, as follows:

"On the basis of the unsatisfactory evidence given to us by Mr Gerry Green, the Chief Executive of the Royal Hospitals Trust, we believe that before any final decisions are taken on the scale of rebuilding at the Whitechapel and the plan to close St Bartholomew's Hospital, a new Outline Business Case for the PFI should be prepared by the Trust and put out to public consultation. Such consultation should take account

of the expert views of the York Economic Health Consortium as well as those set out in the CASPE report which query the need to close St Bartholomew's Hospital."

Question put, That the paragraph be read a second time.

The Committee divided.

Ayes: 5

Noes: 5

Ms Diane Abbott	Mr Nicholas Budgen
Mr Clive Betts	Mr Matthew Carrington
Mr Malcolm Bruce	Mr Quentin Davies
Mr Brian Sedgemore	Mr Nigel Forman
Mr Stephen Timms	Mr Barry Legg

Whereupon the Chairman declared himself with the Noes.

Paragraphs 20 and 21 (now paragraphs 21 and 22) read and agreed to.

Paragraph 22 (now paragraph 23) read, amended, and agreed to.

Paragraphs 23 to 32 (now paragraphs 24 to 33) read and agreed to.

Paragraph 33 read, as follows:

"A related point is that the public sector has access to cheaper capital than private sector investors. The assumptions made regarding the relative costs of capital are vital to the assessment of projects to net present values. It makes intuitive sense that the cheaper capital available to the public sector should make this route of procurement best value where the project involves a large capital element. Indeed, in some cases it is conceivable that the same contractors would be performing the work. As Dr Glaister pointed out in evidence to the Committee, private options (which may require a premium of 6-9 per cent above the gilt rate) will prove better value for money "If, and only if, they achieve lower construction costs, more efficient maintenance in the long run. ... It is accepted, I think, that the cost of borrowing will be higher but one is offsetting that against these perceived efficiency gains. ... That is the trade-off."¹¹¹ The question arises of exactly how the value for money benefits of PFI are obtained. This is one of the difficulties in moving from the theoretical to the actual, to see how the perceived benefits manifest themselves in real projects. For instance, the Treasury guidance notes that, with regard to the supply of Northern Line trains, "it is suggested that the train service contract is in excess of 20 per cent better value for the public sector compared to the purchase alternative over 20 years."¹¹² It is difficult to determine, however, exactly how this expected saving has been achieved. Evidence from Dr. Glaister helped to elucidate the types of areas where savings are most likely to be derived. "In the case of buses, part of the cost saving came about because the private sector used its labour more flexibly than had the public sector,"¹¹³ while, in construction, it is likely that the same firms will be building the assets, so the benefits will derive from design requiring low maintenance.¹¹⁴ There is no obvious reason why the benefits of better design could not be obtained under traditional procurement, so the more "flexible use of labour" may well be one of the key areas where PFI projects obtain savings. **The Committee would welcome further information from the Treasury on how the benefits of PFI projects accrue, for instance giving guidance on the relative importance of different areas of cost saving.**"

¹¹¹ Q272.

¹¹² POPB, para.4.64.

¹¹³ Q247.

¹¹⁴ Q253.

Amendment proposed, in line 28, at the end, to add "and clarifying the extent to which cost savings are likely to result from reductions in wages and poorer conditions of employment." — (*Mr Clive Betts.*)

Question put, That the Amendment be made.

The Committee divided.

Ayes: 5

Noes: 5

Ms Diane Abbott

Mr Nicholas Budgen

Mr Clive Betts

Mr Matthew Carrington

Mr Malcolm Bruce

Mr Quentin Davies

Mr Brian Sedgemore

Mr Nigel Forman

Mr Stephen Timms

Mr Barry Legg

Whereupon the Chairman declared himself with the Noes.

Paragraph 33 (now paragraph 34) agreed to.

Paragraph 34 (now paragraph 35) read, amended, and agreed to.

Paragraphs 35 and 36 (now paragraphs 36 and 37) read and agreed to.

Paragraph 37 (now paragraph 38) read, amended, and agreed to.

Paragraphs 38 (now paragraph 39) read and agreed to.

A paragraph — (*Mr Betts*) — brought up and read, as follows:

"While the Committee recognises and accepts that flexible project specifications can increase innovation, and that there is a need to protect intellectual property rights resulting from bids for such projects, we are concerned that open ended specifications may make quantitative comparisons of bids more difficult. We therefore feel there may be a need for a higher level of scrutiny of such bidding processes, to ensure openness and protect against the danger of corruption. **We would welcome comment from the Treasury on how it perceives this problem and what measures it can propose to deal with it.**"

An Amendment made.

Another Amendment proposed, in line 5, after the words last inserted, to insert the words

"There is clearly a trade-off between greater flexibility of specification to encourage innovation and new approaches and the greater objectivity and precision that is possible in tender evaluation when specifications have been more standardised. We would not, on balance, wish procedures to be adopted that vitiated the opportunity for new thinking which we see as one of the major attractions of the PFI." — (*Mr Quentin Davies.*)

Amendment proposed to the Amendment, in line 3, to leave out from "standardised" to the end. — (*Ms Diane Abbott.*)

Question put, That the Amendment to the Amendment be made.

The Committee divided.

Ayes: 5

Ms Diane Abbott
Mr Clive Betts
Mr Malcolm Bruce
Mr Brian Sedgemore
Mr Stephen Timms

Noes: 5

Mr Nicholas Budgen
Mr Matthew Carrington
Mr Quentin Davies
Mr Nigel Forman
Mr Barry Legg

Whereupon the Chairman declared himself with the Noes.

Amendment made.

Another Amendment proposed, in line 6, to leave out "danger of corruption" and insert "dangers of subjective judgement." — (*Mr Nigel Forman.*)

Question put, That the Amendment be made.

The Committee divided.

Ayes: 2

Mr Quentin Davies
Mr Nigel Forman

Noes: 5

Ms Diane Abbott
Mr Clive Betts
Mr Malcolm Bruce
Mr Brian Sedgemore
Mr Stephen Timms

Paragraph, as amended, inserted.

Paragraphs 39 to 49 (now paragraphs 41 to 51) read and agreed to.

A paragraph — (*The Chairman*) — brought up, read the first and second time, and inserted.

Another paragraph — (*The Chairman*) — brought up, read the first and second time, amended, and inserted.

Other paragraphs — (*The Chairman*) — brought up, read the first and second time, and inserted.

Another paragraph — (*Mr Clive Betts*) — brought up, read the first and second time, amended, and inserted.

Another paragraph — (*Mr Clive Betts*) — brought up and read, as follows:

"The second difficulty arises from the need to transfer the ongoing management of new hospital facilities built under the PFI to the private sector where, as in the case of the Royal Hallamshire hospital in Sheffield, the new facility becomes part of an existing hospital. In order to achieve constancy of management arrangements this will mean transferring the management of the existing hospital together with 1000 jobs to the private sector, producing great uncertainty for those involved and potential industrial relations problems. (Q579)."

Question put, That the paragraph be read a second time.

The Committee divided.

Ayes: 4

Ms Diane Abbott
Mr Clive Betts
Mr Brian Sedgemore
Mr Stephen Timms

Noes: 5

Mr Nicholas Budgen
Mr Matthew Carrington
Mr Quentin Davies
Mr Nigel Forman
Mr Barry Legg

Another paragraph — (*Mr Clive Betts*) — brought up and read, as follows:

"The third difficulty is created by the lack of available alternative capital finance and the acceptance by the Central Sheffield University Hospitals NHS Trust that the PFI was to be used for clinical support services such as diagnostic imaging, sterile services and pathology laboratories, as the only way of replacing and renewing worn out equipment. Hospitals under a PFI regime are being left with no alternative but to use that system or continue with outdated equipment. (Q554)."

Question put, That the paragraph be read a second time.

The Committee divided.

Ayes: 4

Ms Diane Abbott
Mr Clive Betts
Mr Brian Sedgemore
Mr Stephen Timms

Noes: 5

Mr Nicholas Budgen
Mr Matthew Carrington
Mr Quentin Davies
Mr Nigel Forman
Mr Barry Legg

Another paragraph — (*Ms Diane Abbott*) — brought up and read, as follows:

"Finally, since virtually the whole cost of NHS hospitals will ultimately be paid for out of taxation, PFI has the effect merely of postponing payment rather than introducing new funding to the health service. The PFI does not introduce benefits in major hospital projects which could not be secured by other means, but it does create problems which ought to be avoided and, in particular, it cannot be implemented in a manner which sustains the distinction between clinical and non-clinical services. We are therefore not persuaded that PFI is appropriate for major hospital construction projects."

Question put, That the paragraph be read a second time.

The Committee divided.

Ayes: 5

Ms Diane Abbott
Mr Clive Betts
Mr Malcolm Bruce
Mr Brian Sedgemore
Mr Stephen Timms

Noes: 5

Mr Nicholas Budgen
Mr Matthew Carrington
Mr Quentin Davies
Mr Nigel Forman
Mr Barry Legg

Whereupon the Chairman declared himself with the Noes.

Another Paragraph — (*The Chairman*) — brought up, read the first and second time, and inserted.

Paragraphs 49 to 54 (now paragraphs 57 to 62) read and agreed to.

Paragraph 55 (now paragraph 63) read, as follows:

"Though, as we said at the outset, we do not oppose the PFI in principle, we are concerned about a number of issues which cannot be resolved until PFI projects are more widespread and more developed. We expect to return to these issues from time to time in future years. First, we would like the Government to publish aggregate figures of the proportion of PFI projects which are financed via charges to the user, such as road tolls, and those financed by leasing costs and charges on future public expenditure. Secondly, we expect the Treasury to demonstrate with reference to particular examples and total figures, that higher financing costs have been more than offset by efficiency gains. Thirdly, when PFI projects are being financed and paid for, we look forward to seeing how transparent and full accounting will be maintained, now and after the introduction of resource accounting. Finally, we expect, when examining the economy in future years, to analyse whether there is any difference from a macro-economic perspective between funding large capital projects via the PSBR and PFI spending, underwritten by taxation. **We recommend, in the furtherance of public and parliamentary accountability, that the Private Finance Panel produce an annual report which brings together details of projects undertaken by individual departments, as well as the number and details of projects where a public sector solution was finally preferred to a PFI project.**"

Amendment proposed, in line 1, to leave out "Though, as we said at the outset, we do not oppose" and insert "While we welcome". — (*Mr Nigel Forman.*)

Question put, That the Amendment be made.

The Committee divided.

Ayes: 6

Noes: 4

Mr Malcolm Bruce
Mr Nicholas Budgen
Mr Matthew Carrington
Mr Quentin Davies
Mr Nigel Forman
Mr Barry Legg

Ms Diane Abbott
Mr Clive Betts
Mr Brian Sedgemore
Mr Stephen Timms

Other Amendments made.

Paragraph, as amended, agreed to.

Resolved, That the Report, as amended, be the Sixth Report of the Committee to the House.
— (*The Chairman.*)

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order No. 116 (Select Committees (reports)) be applied to the Report.

Ordered, That the Appendices to the Minutes of Evidence taken before the Committee be reported to the House. — (*The Chairman.*)

Several Memoranda were ordered to be reported to the House.

LIST OF WITNESSES

	<i>Page</i>
<i>Tuesday 16 January 1996</i>	
DEPARTMENT OF HEALTH	
The Rt Hon Stephen Dorrell MP and Mr Andrew Neill	3
<i>Wednesday 17 January 1996</i>	
PRIVATE FINANCE PANEL	
Sir Christopher Bland and Mr Douglas Hogg	17
COOPERS & LYBRAND	
Mr Stanley Webster and Mr Andrew Jordan	35
<i>Monday 22 January 1996</i>	
LONDON SCHOOL OF ECONOMICS	
Dr Stephen Glaister	44
DEPARTMENT OF TRANSPORT	
Mr John Watts MP, Mr Henry Derwent and Mr David Gray	55
<i>Wednesday 24 January</i>	
HM TREASURY	
Mr Andrew Likierman, Mr Steve Robson and Mr Douglas Hogg	66
Mr Michael Jack MP and Mr Steve Robson	76
<i>Monday 4 March</i>	
THE ROYAL HOSPITALS NHS TRUST	
Mr Gerry Green	87
THE CENTRAL SHEFFIELD UNIVERSITY HOSPITALS NHS TRUST	
Mr David Whitney and Mr Chris Linacre	95
DEPARTMENT OF HEALTH	
The Rt Hon Stephen Dorrell MP and Mr Andrew Neill	103

LIST OF MEMORANDA INCLUDED IN THE MINUTES OF EVIDENCE

	<i>Page</i>
1. Memorandum submitted by the Department of Health	2
2. Memorandum submitted by Coopers & Lybrand	28
3. Memorandum submitted by the Department of Transport	53
4. Letter from the Central Sheffield University Hospitals NHS Trust ..	94
5. Supplementary Memorandum submitted by the Department of Health ..	100

LIST OF APPENDICES TO THE MINUTES OF EVIDENCE

	<i>Page</i>
1. Letter from the Audit Commission	116
2. Memorandum submitted by Sir Alastair Morton	116
3. Memorandum submitted by Mr Mark Johnson, Solicitor, Infrastructure Group, SJ Berwin & Co	119
4. Memorandum submitted by the British Medical Association	120
5. Memorandum submitted by Barclays Trust	125
6. Memorandum submitted by Wimpey Construction Investments Ltd	127
7. Memorandum submitted by Ryder Defence	130
8. Letter to the Chairman from Mr Barry Francis, Beechcroft Stanleys, Solicitors	131
9. Memorandum submitted by the Comptroller and Auditor General, National Audit Office	132
10. Memorandum submitted by Hambros Bank	133
11. Memorandum submitted by W S Atkins Ltd	139
12. Memorandum submitted by BMI Healthcare	143
13. Memorandum submitted by the Finance and Leasing Association	146
14. Memorandum submitted by the Automobile Association	150
15. Memorandum submitted by the Construction Industry Employers Council	155
16. Memorandum submitted by the Freight Transport Association	159
17. Memorandum submitted by Professor David Heald, Specialist Adviser to the Committee	160
18. Memorandum submitted by HM Treasury	171
19. Memorandum submitted by Ms Diane Dawson, Corpus Christi College, Cambridge	171
20. Supplementary Memorandum submitted by the Department of Transport	175
21. Supplementary Memorandum submitted by the Department of Health	177
22. Supplementary Memorandum submitted by BMI Healthcare	178
23. Supplementary Memorandum submitted by the Department of Health	179

LIST OF MEMORANDA REPORTED TO THE HOUSE BUT NOT PRINTED

Copies of the Memoranda listed below are deposited in the Library of the House and the Record Office of the House of Lords. Requests for inspection by the public should be addressed to the Record Office, House of Lords, London SW1 (tel. 0171-219 3074). Hours of inspection are from 9.30 am to 5.00 pm on Mondays to Fridays.

1. Paper by Mr David Starkie.
2. Letter from Sir Peter Kemp.
3. Submission from the Building Employers Confederation on the Private Finance Initiative to the Department of the Environment.
4. Note of meeting between the Government and the Construction Industry on Private Finance Initiative.
5. Press Release from Private Finance Panel.
6. Memorandum from Clifford Chance.
7. Letter to Mr Stephen Timms MP from the British Road Federation.
8. Appendices to Memorandum submitted by the Automobile Association.
9. Fact Sheets from the Royal Hospitals NHS Trust.
10. Memorandum from Politics International.
11. Letter from Mr Peter Puplett.
12. Supplementary Memorandum from HM Treasury.

MINUTES OF EVIDENCE

TAKEN BEFORE THE TREASURY COMMITTEE

TUESDAY 16 JANUARY 1996

Members present:

Sir Thomas Arnold, in the Chair

Ms Diane Abbott

Mr Clive Betts

Mr Malcolm Bruce

Mr Nicholas Budgen

Mr Matthew Carrington

Mr Quentin Davies

Mr Nigel Forman

Mr Stephen Timms

Memorandum submitted by the Department of Health

This memorandum provides a brief commentary on the issues which the Committee has indicated it wishes to examine in this inquiry, as they relate to the Private Finance Initiative in the National Health Service.

1. TECHNIQUES OF INVESTMENT APPRAISAL

Techniques of investment appraisal are documented in the NHS Executive's Capital Investment Manual issued to all NHS Trusts and Health Authorities in June 1994 under HSG(94)31. This draws on the Treasury guidance "Economic Appraisal in Central Government" (HMSO, 1991) and supersedes earlier Department of Health guidance on NHS investment appraisal.

2. SCHEMES FOR WHICH PFI IS SUITABLE

NHS projects undertaken under the PFI will generally be limited to the design, construction and operation of building and support services. In the overwhelming majority of cases, the Trust itself will continue to be the direct employer of clinical staff. The Secretary of State made clear in a recent speech to the Royal College of Physicians (Annex A) [not printed] that the PFI is concerned with the provision of modern and efficient facilities for the delivery of healthcare; it does not seek to extend private sector responsibility into the clinical area.

Within this context, the private sector is expected to be capable of providing, and managing the risks involved in, a wide range of facilities for the NHS. Exploration of private finance options is now a standard part of the process of appraising the options for capital investment within the NHS. Guidance on the process to be followed was set out in "Private Finance and Capital Investment Projects, HSG(95)15, issued to all NHS Trusts and Health Authorities. As testing of schemes under the PFI proceeds, a database will be built up of information about projects and the outcome of the PFI process. Over time this database, will enable us to see whether there prove to be common characteristics of projects that do and do not prove suitable for a PFI approach.

3. EFFICACY OF PFI

HSG(95)15 indicates some areas where a private partner could improve a capital project for the NHS. A PFI approach should make it possible to reduce the risk to the NHS of:

- construction costs overrunning;
- losses through completion delay;
- costs of latent defects;
- losses through unavailability of any aspect of facilities;
- escalating maintenance and repair costs;
- failure to meet energy efficiency targets;
- failure to meet facilities management cost targets;
- income generation schemes failing to meet net income targets;

*16 January 1996]**[Continued*

- costs of new investment to maintain performance of income generation schemes,
- facilities failing to meet pre-set performance targets.

HSG(95)15 also indicates ways in which a PFI approach may improve the cost effectiveness for the NHS of a capital project, for example through

- economies of scale from enlarged schemes where capital assets are shared;
- increases in operational efficiency through using existing private sector expertise;
- new sources of income generation from outside the NHS;
- short leases, after which other users can re-use assets;
- scope for companies to recover costs of facilities through user charges where applicable (eg restaurants and car parks).

4. THE PRIVATE FINANCE PANEL AND ITS ILLUSTRATIVE LIST OF PROJECTS

The list of projects issued by the independent Private Finance Panel at the end of November includes a number of NHS projects, although the Panel made clear that the list was illustrative rather than comprehensive. NHS projects listed by the Panel as "priority B" are generally at an earlier stage of development than those in list A; the NHS Executive gives priority to all projects which merit investment.

5. HOW VALUE FOR MONEY IS MEASURED

The Business Case Guide within the NHS Executive's Capital Investment Manual explains how value for money is to be assessed.

6. MONITORING PROCEDURES

The Capital Investment Manual gives guidance on how the NHS should organise, manage and monitor capital projects. NHS Trusts, and Health Authorities and GPs, will monitor the achievement of the objectives of capital projects. Under the PFI, the delivery of the capital solution is the responsibility of the PFI partner. Trusts are also responsible for post project evaluation after schemes have been built.

7. BIDDING PROCEDURES

HSG(95) 15 gives guidance on procurement procedures. Advertising in the Supplement to the Official Journal of the EC is required in some cases. Small scale projects falling below the thresholds over which EC rules apply will not require an OJEC advertisement. Generally a competitive process will be followed in all cases, but the costs incurred in competitive tendering should be proportionate to the likely gains to be made. Limited exercises may be appropriate for small scale projects.

8. OVERALL IMPACT ON INVESTMENT LEVELS

So far 45 PFI projects have been approved by the NHS Executive, with a total capital value over £160m. By the end of next year it is expected that projects worth over £1 billion will have come forward for assessment and approval. Annual capital sums spent under the PFI are expected to increase in future years. Figures are given in Table 6.5 of the "Financial Statement and Budget Report 1996-97".

9. REVENUE IMPLICATIONS

Before any capital scheme with significant expenditure consequences for the NHS is approved, a business case is produced to demonstrate the cost-effectiveness of the proposal and assess the public spending implications. Approval for PFI schemes is only given if the business case demonstrates that a PFI approach increases the cost-effectiveness of the scheme for the NHS; that any expenditure implications are affordable to NHS purchasers; and that risks are to be appropriately shared. The aggregate effects of major schemes will be monitored as they come forward for approval.

January 1996

Examination of Witnesses

THE RT HON STEPHEN DORRELL, a Member of the House, Secretary of State for Health, MR ANDREW NEILL, (Grade 3 equivalent) Head of Private Finance Unit, examined.

Chairman

1. Thank you very much for joining us. I wonder if you could just introduce Mr Neill for us, please?

(Mr Dorrell) Thank you for the invitation to come along. Andrew Neill joined us on 2nd January as a secondee from a merchant bank. He is working at Grade 3 level in the Department of Health as the lead official on the implementation of the Private Finance Initiative.

2. Thank you. The PFI was launched in 1992 and as Financial Secretary you were responsible for this initiative in its formative years. I wonder if you could tell the Committee how you feel the initiative has evolved since its launch and with what particular implications for the provision of health care?

(Mr Dorrell) I think it has evolved in a manner that was, frankly, both predictable and predicted at the time that it was launched because I think the important point to realise is that what we were engaged upon from 1992 onwards was a fundamental change in the way Government managed and secured its sponsored capital investment programmes and it required a change of approach in terms of the provision of the range of services by both the public and the private sector. I remember well that as Financial Secretary there was a choice presented in a meeting between two different approaches. The first approach was for the Treasury to set out clearly precisely what all the detailed rules were going to be in different sectors of Government that were necessary to make the PFI work and the alternative was to say, No, we will set out some general principles but then pick up real projects and seek to make them work and draw the conclusions in terms of what the shape of the deals needed to look like from the deals that were done rather than trying to decide in advance what they needed to look like. I did not have much difficulty in choosing the second of those two approaches because I am quite certain that if we sought to set out all the detailed rules from the Treasury from the beginning the project would have been still born. What we did was to opt for a deal-based approach and what we are now seeing is some of those big deals coming to fruition in the Health Service. In the Health Service, as in other parts of Government, it was obviously easier to get the smaller deals off the ground quickly, but what we are now seeing is that that deal-based approach is starting to produce some very major hospital building projects that will deliver, as far as the Health Service is concerned, freer access to capital, firstly, and, secondly, better quality management, I believe, of the range of risks that we are seeking to put into the private sector. That is not the risks associated with the management of clinical services but the risks associated with the design, operation

and building of the facilities within which clinical services are delivered.

3. I think I am right in saying that there are some £670 million estimated for health PFI capital spending over the years 1996/97 and 1998/99. You have referred to the design and build of hospitals. Are there any other projects that would fall under this?

(Mr Dorrell) Obviously the balance of the PFI funded programme is going to broadly reflect the balance of the big capital programme certainly of the NHS and that is overwhelmingly about the provision of health care facilities and, in terms of numbers, about the provision of hospital facilities. There are other projects engaged in it, but in terms of the big numbers, they are attached primarily to hospital building programmes, building and regeneration, refurbishment programmes.

4. I have only one other question at the moment and it really goes back to the development of the PFI. How does the PFI influence now other Government policies to increase the involvement of the private sector in the provision of public services, for example privatisation and contracting out? In other words, what criteria are you using to decide which of these policies, which of these methods, is most appropriate in any particular circumstance?

(Mr Dorrell) The issue does not often come to a head as a choice of that nature because the case where the PFI is the option that we are required now under our own guidance to examine first is where there is a major investment project, a specific refurbishment, replacement or new build project and in those circumstances the PFI is the preferred first choice model. If that cannot deliver good value then we look into the public sector, but if the private sector can deliver a good value solution to a major building development project then the PFI is the preferred method both because it delivers a new source of capital and because by definition before we do it we satisfy ourselves that it passes a good value test. That is one set of circumstances. In terms of introducing a more competitive approach to the delivery of peripheral services within the Health Service, that is obviously continuing business that arises in a routine sense in cases where there are not big capital developments in view. So the answer to your question is that where there is a big capital project in view the PFI is the way we do it. Where it is the routine delivery of support services then we look at the conventional competitive approach.

Ms Abbott

5. The PFI was launched in 1992 and obviously you were then Financial Secretary. In December of that year departmental guidelines were published

[Ms Abbott Contd]

and the guidelines said: "Spending as a result of this initiative ... will be additional to public provision and will make new resources available." I was surprised to note in his Budget speech the Chancellor said: "This money"—he is talking about the PFI now—"is replacing old-style public sector capital spending ...". So what is it, Mr Dorrell, is it additional money or is it substitution?

(Mr Dorrell) The answer is that it is additional money which in the Health Service is allowing us to substitute what were previously publicly funded capital programmes for publicly funded revenue programmes.

6. Mr Dorrell, I know we do not all have your intellectual subtlety but I think you are playing with words. Is PFI money additional to money which we have spent anyway or substituting for part of the money we would have spent anyway?

(Mr Dorrell) I do not regard myself as doing anything other than applying a common sense proposition that would be understood in every pub in the land and that is that if we can finance hospital building projects by using private money that leaves me with more taxpayers' money to buy more health care. That is what I am doing.

7. Mr Dorrell, I obviously did not make my question clear. If HM Government was planning to spend X in capital expenditure in the Health Service, does the growth of PFI mean we will be spending X+Y or does it mean we will be spending X anyway but part of it will be PFI money? Does that make my question clear?

(Mr Dorrell) Yes, and it allows me to illustrate the principle I have just expounded in relation to the 1995 PES settlement. What we announced in the 1995 PES settlement for health was an increase in public resources available to the NHS of 0.6 per cent in real terms, but the availability of private capital to support the capital building programme of the Health Service allowed us to shift the balance of the public spending programme in health off capital onto current. It is a matter of public record.

8. So it is not really additional money, it is substituting?

(Mr Dorrell) That is the conclusion that I understand you want to draw, but I think it is impossible to square it with the facts.

9. Can you explain to the Committee the extent to which the PFI resulted in a cut in public capital spending in health in 1995?

(Mr Dorrell) I have already said that what happened in 1995 was that the developing maturity of the PFI has allowed us in the Health Service to access alternative sources of capital for the development of the Health Service and that has allowed us to spend a larger share of the public spending budget on health on the development of patient services.

10. What estimates have you made of the future savings in public capital spending as a result of PFI projects?

(Mr Dorrell) The Chairman quoted figures that showed the extent to which the capital programme of the Health Service is progressively, over the three years of the PES programme, expected to rely on private sources of capital rather than public sources of capital and the figure he quoted was, I think, the correct one of £670 million over three years rising in a wedge over the three-year period. That reflects new money coming into the Health Service from the private sector allowing us to spend more public money on developing patient care.

11. But if the PFI were to become the predominant source of capital expenditure for new hospitals, would the NHS then by degrees become solely a purchasing organisation?

(Mr Dorrell) No, it would not because we have made it clear that the PFI is not about the privatisation of clinical services; it is about privatising some of the capital investment programmes of the Health Service in order that the private sector partnership with the Health Service can deliver the context in which healthcare is delivered and the NHS trust can continue to be the main employer of clinicians, delivering a free NHS clinical service against NHS contracts to NHS purchasers.

12. When you say "clinicians", what would you include in that because at one end of the spectrum there is the surgeon and at the other end of the spectrum there is the lady who meets you on reception when you go into accident and emergency. When you say "clinicians", do you include in that administrative staff as well?

(Mr Dorrell) Well, no, I do not include them. There are, if I may put the question, as it were, in a more difficult sense to me, I think that the administrative staff are quite clearly non-clinical. There are some grey areas of clinical support staff, pathology staff and so forth where we have made it clear that we expect trusts to continue to look for clinical support or support from the affected community, clinical community, if they are going to change the nature of that element of the service. We are not about a large-scale transfer of clinical or clinical support services to the private sector, though the guidelines to the Health Service have for many years allowed reorganisation both in clinical and, more importantly, in clinical support services where local agreement can be reached and that continues to be the case.

Mr Betts

13. Mr Dorrell, I will ask you first of all about monitoring of the financial effects of the schemes under the PFI. As I understand it, while the different departments of government are doing accrual accounting now as well as cash-based accounting, there is a difference between traditional government funding and the PFI schemes in that the impact of the cash on the former will be up-front in the first year, but the impact of the PFI schemes on the Government's cash is over a number of years. How do you in your Department go about

16 January 1996] THE RT HON STEPHEN DORRELL, MP AND MR ANDREW NEILL

[Continued]

[Mr Betts Contd]

monitoring the impact of switching between traditional funding and the PFI within the budget of your Department?

(Mr Dorrell) The answer is it is very easy within the budget of the Health Service because since the NHS reforms were introduced, every provider unit, every trust in the Health Service pays a capital charge which reflects the amount of capital which is employed within the trust and that, broadly speaking, reflects the cost of capital which the private sector has to meet as well. That allows the trust to make a comparison between buying the service from the private sector and investing and doing the thing directly itself, including meeting the cost of capital which would be employed.

14. So that trusts are operating on an accruals-based system?

(Mr Dorrell) It is not so much accruals, although they are, but the more important point is that capital is not a free good to the trust and, therefore, it has to pay a capital charge whether it is using public or private sector capital.

15. Nevertheless, as far as your Department is concerned, overall you still have to account on a cash basis then to the Treasury for your total expenditure and that must be affected by the decisions of individual trusts about whether they go for a PFI scheme or for a traditionally-based scheme for a particular project?

(Mr Dorrell) It is perfectly true that at the global level the extent to which we start to use large quantities of private capital will affect the presentation of the figures, although it has been made clear that this is obviously a subject that would be discussed between the Treasury and the Department of Health in the setting of year-by-year spending levels.

16. In order for you to do that presumably, therefore, you would need to know what is going on in the individual trusts in your Department so that you can take a global view of the accumulation of their individual actions?

(Mr Dorrell) Well, we have to know that anyway because in setting the public spending totals that are allocated to health authorities, we take a figure exclusive of capital charges, public capital charges, and then we add the public capital charge on top, so we have to know how much trusts already pay in terms of their capital charges and we shall certainly be following the implementation of the PFI in order to reach an assessment of how much private capital is being employed and paid for by NHS trusts.

17. Therefore, you will have forecasts both of the likely reduction in your capital spend in future years and also forecasts of the total increases in revenue commitments that are likely to come from those actions which will affect the budgets in your Department?

(Mr Dorrell) That is true, although there is an important point to add on to this which is not to regard extra money that might be allocated to the

Department of Health in future years to meet the cost of employing private capital as extra public expenditure in total, because it is not. What is happening then is that the trusts are employing private capital to substitute for the public capital which the Treasury pays for directly through interest charges to the gilts market and so the net public expenditure figure is not affected, although there certainly is an element clearly in the discussion between the Treasury and the Department of Health about the level that is allocated to the Department.

18. It is helpful to know that they are substitute schemes and that, therefore, there is a change in the impact on the expenditure. Could you tell us then what the impact on the revenue budget for the next three years in your Department's finance of the PFI schemes will be?

(Mr Dorrell) I cannot tell you precisely because we do not yet know what the level of service that is actually being purchased by health authorities from new PFI schemes is going to be. The important point of course is that the effect on the Department's revenue budget will not be felt until the trusts actually start buying a service from the private sector partner. That timing will be different from the timing of the private sector partner's own capital spend.

19. You have not got a forecast then which you can provide against it?

(Mr Dorrell) Well, you do not need to be a rocket scientist to work out with a major hospital building programme that is going to spend over three years £670 million that the amount of actual service being bought by trusts in the first year will be, I would guess, virtually nil, in the second year comparatively small and that the total numbers will be very small in that three-year period.

20. So you have not got a forecast?

(Mr Dorrell) I will certainly send the Committee an estimate, but I can tell the Committee that it will be small in the first three years because the trusts will not be buying a service until there is a service to be bought and the investment is being completed.¹

21. I want to ask you about the dual-policy implications of these particular projects. Could you give the Committee an assurance that, as a result of funding through PFI rather than more traditional methods, there will not be any policy changes in the way that hospitals operate?

(Mr Dorrell) It depends what you mean by "no policy changes". If you mean by that the commitment of the Health Service to delivering high quality healthcare to the patient available on the basis of clinical need, largely free, all those usual standards of the Health Service, then that is a commitment that the Government has restated many times. It is not true actually to say that it is unaffected by the PFI. I strongly believe the PFI allows us to deliver that commitment better than the traditional systems did. If you are asking me to lay

¹ See Appendix 21.

[Mr Betts Contd]

down a commitment that no policy change of any description can be contemplated in the context of the PFI scheme, that would obviously be absurd.

22. But there will be no impact on clinical or medical services?

(Mr Dorrell) Yes, of course there will be an impact. The impact will be that the context in which those services are delivered will be better.

23. But there will be no sense in which the medical or clinical judgment of people working in hospitals will be in any way overridden by people providing the facilities in a way which suits them rather than suits the needs of the clinicians within the hospitals?

(Mr Dorrell) The key principle here is that the service that is delivered by the private sector partner is delivered under agreed contract to an NHS trust and the NHS trust must be satisfied before it signs the contract that the terms on which the service is provided reflects the central commitments of the Health Service, one of which of course is that the decisions made about the treatment of patients are for clinicians, subject to the management routines of the Health Service, and that principle will be safeguarded.

24. How then does the PFI cope with the situation where you are entering into a contract to provide a service over a 20 to 30-year period maybe and yet very clearly, as the Government keeps saying, because of the changes in medical practice in recent years, the demand for beds in certain specialties has declined or people stay in beds for shorter periods of time and yet you can be contracting to a provider service on the basis of current medical evidence? How do you cope with those sort of changes to policy? Presumably you do not change the policy because you have entered into a PFI agreement.

(Mr Dorrell) Of course not. Clearly the contracts that are signed with PFI partners have to be contracts that allow the Health Service trust to continue to do its job and that is to use the resources in a way that reflects clinical need.

25. But will you build anything into the contracts to compensate the private operator, for example, if beds are not used to the same extent in the future and those beds are no longer needed?

(Mr Dorrell) I am not sure about compensating the operator. It will be one of the terms of the contract against which the operator quotes that it will be for trust management to decide on the level of commitment of particular resources to particular need to ensure that the trust, which is responsible for the totality of the service delivered to the health authority or to the fundholder, preserves its essential management freedoms.

26. If all this monitoring is now going on of these contracts, could you give us an estimate of what is now being spent within your Department in total on the administration, monitoring and comparative work between traditional methods of funding and PFI alternatives?

(Mr Dorrell) I do not think we can give you a number, although we can certainly send that to the Committee. Mr Neill might like to tell the Committee the size of his section.

(Mr Neill) We have got six secondees and one part-time secondee from the private sector helping to explain to both the private sector how the public sector operates and the public sector how negotiations with the private sector should operate. We believe that will largely reduce the cost of advisers at a trust level because it is effectively a free resource at the centre. We then have a unit which is manned with full-time civil servants who are linked into the Private Finance Unit and they are having a role to play in the approvals process of these projects.

27. But the figure can be provided for total costs?

(Mr Dorrell) I am sure we can provide a figure in terms of total money cost, yes, which we will split between those that are advisers to the implementation of the private finance process and those that are engaged in project appraisal which obviously would have to go on anyway.¹

28. In terms of policy, you mean you have accepted it as being a reduction in the availability of up-front capital financing and a shift of the costs downstream within the Red Book accounts. Is it not true, therefore, that certain projects and whether they go ahead—and that is a matter of policy for Government—now depends on whether you can get a private finance scheme which is considered to be appropriate, so effectively you have transferred the decision about whether a project goes ahead within the terms of the money available to private finance?

(Mr Dorrell) You described the position as being such that we have shifted the costs downstream and that is explicitly what I said we had not done because I said that the net effect on in-year public expenditure is nil or, indeed, it reduces rather than increases public expenditure because the total of public expenditure includes the cost of servicing public sector debt through the interest charge and the important point is that when we pay for the access to private capital, which we certainly will do under the PFI, we are substituting a profit element to the private sector, that is the PFI cost of capital, and that is a substitute for the public sector cost of capital which is the interest charge the Treasury pays direct but which it does not charge to Departments. That is why I say that the PFI is not what Mr Betts said it was, that is to say a shift of the financing costs downstream of the Health Service. What it does do, of course, is to alter cash flow because the capital is invested by the private sector rather than the public sector. Having said that, I have now lost your question.

29. Is it not now true that whether certain projects go ahead will be based on whether the private sector can come up with a scheme which you can approve?

¹ See Appendix 21.

16 January 1996] THE RT HON STEPHEN DORRELL, MP AND MR ANDREW NEILL

[Continued]

[Mr Betts Contd]

(Mr Dorrell) No, that is not true. What we have said is that the process will in future be such that when a project is being generated by a trust the first thing it will clearly have to look at is whether the project in outline would improve the quality of service, the value for money, which the trust is delivering to its patients compared with the status quo. If it passes that test then what the trust will do is to look for private sector partners against a public sector datum point and if the private sector can deliver a project or something which responds to a project definition which offers better value than the public sector datum point then the PFI would be adopted. If the private sector cannot improve on the value for money of the public sector option then the project falls to be assessed against the conventional public sector capital rules and that is what will continue to happen.

30. Even though that would increase the spending in the first year?

(Mr Dorrell) In that case the public sector option would deliver the lower total project cost seen through the revenue account.

Mr Carrington

31. Where a project, for instance a hospital, is desired and needed and justified in clinical terms but there is not the public capital available to pay for it then clearly the hospital would be considered for the PFI in any case in those circumstances, presumably?

(Mr Dorrell) It is rather the other way round in that once an idea has been identified as being worth pursuing because it would improve on the status quo then the first option is, having defined what the project would cost on a public sector model, to look and see whether there is a PFI option which would offer better value.

32. Yes, but if there was not the public money available, if there was not the capital allocation available from the Treasury, that presumably would then mean that a PFI project was sitting there as an alternative way of financing it, but if the PFI did not meet the hurdles that you have set up in terms of its cost the project would then not go ahead. Would that be right?

(Mr Dorrell) If it does not meet a value for money test it would not go ahead. The value for money test has to demonstrate that the purchase of the service by the trust from the private sector partner would improve the value for money of the service which the trust delivers to its purchasers compared with a realistically available alternative.

33. Which is saying that if the hurdle that it has got to cross for a project to be accepted is not met then the project would not go ahead?

(Mr Dorrell) If it does not pass the test of delivering good value compared with any realistically available alternative then it clearly would not go ahead, no.

34. So you could get situations where, for instance, a hospital that was needed for clinical purposes was not built because the PFI test did not meet the public sector benchmarks and the public sector money was not available?

(Mr Dorrell) Public sector budgets will continue to be needed to be set, as they have been since the beginning of the Health Service, against an assessment of the need for public capital within the Health Service to meet the objectives of the service. That continues to be the case. What we have done through the PFI is to create a procedure which I believe will hugely relieve the pressure on public capital because I actually think, both in principle and when you start to look at the substance of the ideas that are coming forward now on specific hospital sites, that we can demonstrate the private sector is actually offering more efficient better value solutions to the NHS problems than the old public systems did, but it does not alter the fact that if the demand for public capital is assessed on a value for money basis then there will continue to be a demand and we shall continue to need to provide public capital to meet it.

35. The value for money basis then is not just a numbers calculation, it is not just an analytical calculation, but also there are subjective elements in that calculation which produce the amount of money?

(Mr Dorrell) Well, any value for money calculation includes some subjective elements, although in order to discipline them, I suppose most of us most of the time try to attach some kind of number to it so that it is not justified purely on the basis of "That is my judgment".

36. Some are easier to do though. Obviously there are subjective elements, like the discounted interest rate, in the net present value calculations, but there are also subjective elements as to the clinical needs of the hospital, for instance, which are much more difficult to quantify, but presumably the clinical assessments of the hospital are part of the value for money calculation?

(Mr Dorrell) In most figures, if you look far enough into their provenance, you will find somewhere there is a judgment. I am being reminded that each of the bids has to meet a defined quality standard, that being the standard set as the original datum point for deciding that the project was worth considering anyway.

37. When a private sector participant provides financing for, say, a hospital, and the NHS then contracts or the trust then contracts with the private sector provider to provide the service to the hospital, that contract is for a fixed term presumably. What percentage of the project then, for your own calculations, do you assume will be the residual value at the end of your fixed contract?

(Mr Dorrell) The answer is that it is not an assumption; it is one of the elements of the competition typically, and that when we put the contracts out—and it is not incidentally for a total hospital

[Mr Carrington Contd]

service, but for the service we are talking about—we invite the potential partner or potential partners to compete down the price of that service and clearly the larger the element of residual capital risk they are prepared to bear, the lower the service cost is likely to be, other things being equal.

38. That is fine where the project is financing something which has an alternative use outside the NHS, and I can imagine that with some hospital services, for instance, that is perfectly applicable in that they either have a use outside medical services altogether or they have their use in the private sector. Some, on the other hand, do not and it is quite clear that some do not. If one was, say, building a hospital facility in an inner-city area, for instance, it is hard perhaps to see that as being a private hospital, in which case as to the residual value risk, therefore, the person who is providing the hospital is taking a view on the residual value that you will renew the contract out of the NHS.

(Mr Dorrell) That is right.

39. Now, they are going to take a very hard-nosed view on that presumably, but do you give any understandings or undertakings that you will do that, that you will renew the contract at any stage in the future?

(Mr Dorrell) No. The essential point must be that the trust preserves its freedom as a purchaser to walk away at the end of the contract, but you are quite right to say that the provider of the service will assess how much residual value risk he is prepared to take as a function both of the potential alternative uses of the facility and of the likelihood of the Health Service renewing the contract and although you may say that service providers will take a hard-nosed view of the likelihood of renewal, if I take a more hard-nosed view than he does, he gets the contract, other things being equal, so there is a discipline on the degree of hard-nosedness.

40. Clearly competition has a big role to play in this, as it does in everything else, but, on the other hand, when it comes to the contract negotiation with the NHS, the provider will tend to try and put conditions into the contract which limit the freedom in the NHS to provide alternative facilities in competition itself again with the facilities being provided in the private sector. What I am trying to get at, going back to my example of an inner-city hospital, is, say, there was an inner-city hospital being provided under the PFI, at the end of, say, the ten or 20 year-contract that the NHS has entered into the terms of renewal of the contract provided by the private sector were uncompetitive, would there be any conditions in the contract which had originally been signed to prevent the NHS commissioning an identical facility down the road from the first one, in other words, putting the first one out of business by having one built next door to it?

(Mr Dorrell) The essential answer to that question must be no, but I think it might be helpful to

the Committee if Mr Neill spoke about the specifics of the contracts that are currently being drawn up.

(Mr Neill) The contracts will vary from case to case depending on the specific demographics and competitive position and the location of the hospital and indeed in some inner-city areas or urban areas you may find that there are indeed alternative potential uses for the land if the NHS does not want the hospital at the end of the period. In certain rural areas there may be less alternative uses, but a greater certainty that the hospital trust will want to renew at the end, so the degree of residual value risk will vary from case to case, but while there may be some form of negotiated ideas about what you would do at the end of the first period, the ability to walk away before you have paid in full for the total cost of the facility, plus interest, plus everything else, is a fundamental part of assessing whether or not there has been any risk transfer.

41. I understand that and clearly if it was leased in the private sector, that would indeed also be the case, but the Inland Revenue, if you lease in the private sector, would also put a constraint on the size of the residual value before they decided it was an operating lease as opposed to a financing lease which presumably is much more subjective in your case rather than having a definite percentage on whatever the residual value is.

(Mr Neill) Well, the package of risks which we are seeking to transfer or share with the private sector covers a much wider range of risk than simply the value of the property at the end of 20 or 25 or longer years in the first lease period and we are looking to try and emphasise that there are plenty of operating risks which are also being transferred in discussion with accountants.

(Mr Dorrell) I am confident that as the programme develops, and, as Mr Neill quite rightly says, there is a very broad range of risks associated with managing one of these facilities and the residual value risk is only one of them, but I am quite sure that as the market develops, the competitive pressure will act as a constraint or act as a downward pressure on the extent to which residual value risk is a pressure driving upward the amount of residual value left in the asset at the end of the first period of the contract because that is actually one of the things that people will get better at assessing in the context of the continuing market.

42. One of the criticisms that was made of the PFI is that the Government can always borrow money cheaper than the private sector and, therefore, that the benefit of the PFI, apart from certain cashflow benefits to the public sector, but the benefit essentially of the PFI is that in exchange for a rather higher cost of financing, the public sector gains more efficient management of the project. Are you convinced that it would be impossible to provide efficient management within the NHS to compete with the efficiency of management you would get under the PFI?

16 January 1996] THE RT HON STEPHEN DORRELL, MP AND MR ANDREW NEILL

[Continued]

[Mr Carrington Contd]

(Mr Dorrell) First of all, I am applying an objective test case by case and I am not deciding it as a matter of principle, but, secondly, I observe that it is the overwhelming lesson of history that if you give people the profit incentive and allow them the relative freedom of the private sector management that the savings they are able to generate offset the high cost of capital and it is one of the ironies of the traditional Ryle or Treasury perspective on this issue that, taken to its logical conclusion, it is actually an argument for nationalising everything because the Treasury can deliver lower-cost capital than anyone else and if you can deliver the same management efficiency based on that lower capital, then it is an argument for nationalising everything. The lesson of experience suggests that that theory does not work.

Mr Bruce

43. I wonder if I can explore a little bit more the efficiency point. If the assumption is that the PFI creates a pressure for greater efficiency and that is the pay off to the public sector, does it not also potentially create a tension between perhaps a private sector project manager who wants something that is simple and transferable and the clinicians and the Health Service managers who want specialist delivery of service? Does it not create a tension of specification?

(Mr Dorrell) Of course there are choices to be made in every project as it is conceived and designed and built and complex and specialist solutions tend to be more expensive and higher risk than simple straightforward solutions. They are not made any less risky by doing them in the public sector. The only thing that changes is that the taxpayer bears the risk rather than the private sector operator.

44. Perhaps I am not explaining myself. A good few years ago I was on the Scottish Select Committee and we looked at the cost of building hospitals particularly in Scotland which seemed to be out of control, so I am not uninterested in the argument that this approach might reduce costs. I think it was Nicky Fairbairn who said, "What is the difference between a Holiday Inn and a hospital apart from one is ten times the price!" The counter to that was that the clinicians all have very specialist needs that they wish to have built into the hospital. I am not saying it is constructive or destructive, but is there not a tension in this between, if you like, the financial manager saying, "If we keep it simple, keep it flexible, then this is a better deal," and the clinicians saying, "If it is too simple and too flexible we cannot deliver the standards of care we want?"

(Mr Dorrell) My answer is yes, that is a tension, but it is a tension that is there in every hospital building project and if the effect of introducing a private sector discipline into the management of the super-specialist, super-risky approach is to encourage people to take a slightly less risky but slightly surer approach to solving a problem then on some occasions that may well be a very benign outcome. As I said in the speech I made on the

subject to the Royal College of Physicians, which I think I sent to the Committee, I am all in favour of innovation. We must ensure that there is a proper incentive to find new ways forward, but let us put the real premium on success rather than innovation for its own sake.

45. Are there any examples yet available to demonstrate one way or the other whether we have achieved that?

(Mr Dorrell) The best specific example of all these ideas in practice is the Wycombe and Amersham Trust announcement that we made on Budget Day. That is two major rebuilding operations going on in those two hospitals. Both the schemes which the private sector came forward with under the Private Finance Initiative are actually more radical solutions, not less radical, than the ones that were originally proposed by the public sector managers, but because they have freer access to capital they are able to adopt a more radical solution to the layout of the site and the quality of the building with the result that the total scheme is both lower in cost and preferred by the clinicians because they regard it as better value from a clinical point of view. The trust, I am told, is called the South Bucks Trust and the two hospitals are Amersham and High Wycombe.

46. Is that an indication of occasionally where short-term pressure to keep costs down costs money in the long run and that is not a constraint the private sector is faced with?

(Mr Dorrell) That is precisely right. One of the objectives of the PFI is to escape from that excessively constrained approach to capital which has been the experience of the Health Service ever since 1947 and to look for the long-term best value solution rather than the solution which offers the lowest short-term capital cost.

47. Can we get any more detailed information on that particular project?

(Mr Dorrell) We will send you as much detail as we can within the rules of commercial confidentiality of the South Bucks scheme because it is a good scheme.¹

48. That was a problem we had. We understand the commercial confidentiality point, but it does mean sometimes it is many years afterwards before you know whether or not it was what it was claimed to be.

(Mr Dorrell) I think we can send the Committee enough detail to demonstrate the principle that Mr Bruce is quite rightly picking up, which is that by releasing the investment programme from the constraints of keeping the short-term capital cost as low as possible what we are able to do is to offer a solution that is better for the clinicians, delivers better full-life cost and a better service for patients. It is a better solution, albeit one that in the short-term absorbs more capital.

¹ See Appendix 21.

[Mr Bruce Contd]

49. In the memorandum that you sent to the Committee, on page five or six under the heading "Trusts to Continue to Employ Clinicians" you have said in the first paragraph: "... the Trust itself will continue to be the direct employer of clinical staff. It is no part of the Government's policy to transfer the delivery of NHS clinical services into the private sector." In the third paragraph you say: "It is true that some Trusts have explored local arrangements for private sector provision of some clinical and clinical support services. This is a matter for local determination ..." Is there not a certain conflict there? Let me put this in context. I have a very specific close interest in the proposals for the Stonehaven hospital which I know is under the Scottish Office and not your Department. Nevertheless, that involves the entire project, including the clinical aspect, being put out to competitive tender. Either it is policy or it is not policy. If you are saying, "It is not Government policy but if the trusts want to do it they can," then if a lot of trusts want to do it you will finish up with a quite different Health Service from where we are at the moment.

(Mr Dorrell) I sought to address this issue earlier on. Within the context of the PFI it is not our policy to seek to transfer the delivery of either clinical or clinical support services into the private sector. However, it has been for many years the practice within the Health Service that where a local management and local clinical fraternity agreed that a particular service might be better delivered on a different model they are free to do that. I do not wish to withdraw that freedom. I think it would be perverse to withdraw that freedom, but there is no reason to imagine that NHS managers and clinicians are going to be any more radical about the pursuit of that principle in the future than they have been in the past. It is very much the exception rather than the rule in the NHS and that is how I expect it to remain. In terms of policy, the intention is that that issue will be completely unaffected. I am not withdrawing from it but neither am I pushing it forward through the PFI. What the PFI is about is bringing the private sector into the delivery of non-clinical services.

50. This business about support of the local clinicians you are saying is locally determined, but it is possible to see a situation where a trust or a board may say, "We want to privatise," or, "We want to put out to tender this entire project," and the local GPs may say, "Well, we are not very keen about that, we want to use the local hospital," and the board or the trust might say, "Frankly, that is the only way we are prepared to go forward."

(Mr Dorrell) I have made it clear that a PFI scheme that relied on us privatising clinical services without the support of the local clinicians would not get my support.

Mr Budgen

51. Mr Dorrell, I remember when you were at the Treasury you were one of the first ministers publicly advocating the Private Finance Initiative

and I remember you came here and we had a discussion about it. Since you were advocating from a supervisory role of the Treasury the general principles, have you found any modification of your general views on coming to your present duties?

(Mr Dorrell) I think the short answer to that is no. Indeed, my views when I was a Treasury Minister were rather coloured by my earlier experience in the Department of Health where I had been the junior minister responsible for what was then called unconventional finance, rather quaintly I always thought as it was what the rest of the world called conventional finance. The principle had always previously been that in theory NHS providers were encouraged to look for private sector partners, but in practice the rules drawn up by the Treasury made it simply impossible for us to get over the hurdle. When I was given the PFI responsibility in the Treasury it struck me that my experience in the Department of Health was a very good demonstrator of how the public sector was missing both extra access to capital and extra access to good management that could come through a proper partnership with the private sector and I was keen to re-draw the rules to allow that to be remedied.

52. So if you were blowing your own trumpet a bit, you would say that you would actually ease things up a bit in the Treasury to make the Private Finance Initiative rather more likely to succeed?

(Mr Dorrell) I would certainly like to believe that my contributions to the meetings that we held on this subject in the Treasury reflected my experience both as a Health Minister and, before that, as somebody who worked in the private sector.

53. Can we now move on to the present circumstances? I remember, long before you were advocating the PFI in the Treasury, when it was being floated amongst the big contractors who, if I may make a little jibe, very often of course saw it as a means of in fact making more profits and not taking on a great deal more risk and there is no doubt that it did take a bit of time for them to understand what it all meant, but market conditions have changed enormously in the construction industry, have they not? Whereas in, if you like, 1988 the big contractors were looking for ways of disguising profit even and certainly were prepared to risk some of the big profits that they were making from housing in things like building hospitals, the position is transformed now, is it not? For the record, I take your smile and nod as being agreement. I am told that whereas in the past for road contracts there used to be about six big contractors, all of whom were financially very strong, all of whom were prepared to compete very vigorously, of those six, you find now that at least three are in a very dodgy state and that the other three are very reluctant to take on any more work. Now, if all that is true, as I see from your nod, though you would not wish to make a market judgment on this, if the construction industry is in a very dodgy state generally, and I mean big construction particularly is in a dodgy state, is it not the case that you have a fairly weak market for people

16 January 1996] THE RT HON STEPHEN DORRELL, MP AND MR ANDREW NEILL

[Continued]

[Mr Budgen Contd]

coming forward to take up the risks on your behalf?

(Mr Dorrell) I do not actually believe that is true and for a very important reason.

54. You would agree that my market analysis is correct?

(Mr Dorrell) It is obviously true that the results of the big developers are under greater pressure now than they were in the late 1980s. That is transparently, obviously true. What is not true, I think, is the proposition that the trading pressures on the big construction companies is a key consideration in the issues we are talking about now and the reason for that is important. It is that the role as entrepreneur catalyst of a private finance project is very often, although it may be sometimes led and stimulated by a construction company, the actual responsibility for managing it very often does not rest with a construction company because the important point to grasp is that the Health Service is not simply buying access to a new building, but it is buying a service that is supplied in a new building over a period of years and, therefore, what is happening is that consortia are coming together which include construction companies, but include a wide range of other companies as well, and are typically financed independent of the construction company which in fact has the status of a subcontractor to the consortium that is responsible for delivering the service.

55. So whereas in 1988, for the sake of argument, a hospital might have been built with Tarmac as the head contractor and Tarmac guaranteeing the finance, perhaps a large proportion of the finance, what you now find, for the sake of argument, is a consortium perhaps put together by a merchant bank which provides the capital and then Tarmac or Amey Roadstone or whoever it may be comes along and provides part of the contracting services and somebody else provides the medical expertise and all of the rest, so there is a different distribution of roles and risk.

(Mr Dorrell) Indeed and there is still clearly an expectation, a legitimate expectation, on the part of the consortium members that the prime construction risk is borne, as it should be, by the construction company, but the commercial risk of delivering the service to the Health Service or the management of all of these different elements in the delivery of a service for acceptable cost against a price negotiated with the Health Service, that is a risk borne within the consortium, not within the individual construction company.

56. And presumably these sophistications have been made more possible as you have done more of these things and have been able to deal with consortia better?

(Mr Dorrell) It comes back to an important point we were discussing at the beginning which is that this is an initiative with a gathering momentum so that as each new deal comes forward, then people become more familiar with its principles.

57. Whereas in 1988, for the sake of argument, you probably had to deal with, if you like, Tarmac because you were not prepared to consider the divided-up role of a consortium and all the rest and you were not able to assess whether each part of the consortium was able or likely to be good at delivering what it promised to do, now you have experience and are better able to deal with a more unconventional bid?

(Mr Dorrell) And we are also now willing to accept what we were not willing to accept pre-1992, and this is a key change that came with the PFI. We are prepared to accept that access to private sector managements skills does require us to buy it as a totality and we cannot do what Mr Carrington was suggesting earlier we should do which was always previously the orthodoxy, that is, that you look at every conceivable efficiency that everyone suggests to you and say, "Now you deliver that with public capital" because that was the assumption that underlay the Ryrie rules which did not work, never has worked in history and which we no longer accept as an underlying assumption in public finance.

Mr Forman

58. Mr Dorrell, judging by the Treasury publication entitled "Private Opportunity—Public Benefit" which was published, I think, in November of last year, it would appear that so far at any rate, in spite of the great capital expenditure needs of the Health Service in this country as an enormous operation, in fact the Department of Health steer, if I can call it that, has not played a very prominent part in the PFI. Is that true and if so, why is it true?

(Mr Dorrell) It is certainly true that the early schemes that have got off the ground in the Health Service are not unimportant in themselves, but they are relatively small-scale schemes, things like laundry, things like waste disposal, things like information technology schemes. All of these are valuable in themselves, but they are not big numbers in terms of the investment pounds required to finance them. I think, as I said earlier on, it was recognised from the beginning that what we were engaged on in the PFI was not simply continuing business as before but substituting private capital for public capital, but it was actually the generation of these consortia that I was talking about with Mr Budgen in order that the public sector bought a service from people who were responsible for marshalling capital construction management of the different services into the delivery of a single facility over a period of years to an NHS purchaser, in the case of the NHS. That was what the PFI was about and inevitably the bigger, more ambitious schemes took longer to get off the ground than the smaller schemes. As I said at the end of last year, I believe we are now on the crest of a wave. There is a large number of schemes coming forward which are applying these principles to hospital provision in different parts of the country and by the end of this calendar year, I am confident that you will see a significant change

[Mr Forman Contd]

having taken place in the way in which the NHS finances and manages its new investment programme.

59. May the key distinction be not so much one of size, which is what you were just speaking about, but of area of activity and the nature of the activity and whereas, for example, in the transport sector the PFI has made considerable strides and there are quite a number of big tax bills that have happened and increasingly in this field the information process in, say, Social Security and perhaps the Inland Revenue, the Health Service has perhaps understandably not been among the foremost sectors in which it has been tied up and implemented? Is it really not more to do with the nature of what is to be delivered by those services rather than the size?

(Mr Dorrell) I think it is more to do with the nature. I accept that word but attach it to the concept of complexity. We have in the Health Service a large raft (of which we can send you examples) of small-scale PFI schemes that have been going on now for some years that were previously impossible. In the pre-1992 days they were on a very very much smaller, minimalist scale. The 1992 change did change the volume of the number of those smaller schemes coming through in the Health Service. We changed the assumptions underlying major capital investments in the Health Service in 1993 and what we are now seeing is the consequences of that change of capital guidance coming through in projects where we are signing contracts. As I said at the beginning, I think it was inevitable that a change of this complexity would take some time before we had major deals being signed. We are now at that point.

60. You mentioned complexity, but to the layman reading this glossy document, which I imagine is supposed to explain it to somebody coming new to the area from the private sector who might be lured into participating, the terminology in itself is quite interesting because there is a DBFO, there is a DCMF, there is a BOO and a BOOT, which spells boot in any language! Just to add to the complexity and the confusion you say here that all these abbreviations confusingly have the same meaning. Why make distinctions when there is no difference?

(Mr Dorrell) The editorial of this document is something for which I am collectively rather than individually responsible.

61. What does that mean? Perhaps your colleague could throw a bit of light on this rather baffling terminology and whether it is designed to clarify or obfuscate?

(Mr Dorrell) Now I can see what Mr Forman is asking about. I am very conscious of the difference between BOO and BOOT and that is actually pretty obvious when you look at the word that is missed off; one means build, own and operate and the other means do all three and then transfer ownership back to the public sector. That is the

difference between those two. Can you describe easily the difference between DBFO and DCMF?

(Mr Neill) I think different departments tend to have different acronyms.

(Mr Dorrell) Can we write rather than asking for it? It is, as I obliquely referred to it, a document that has the Chancellor's editorial at the front.¹

62. I speak as an interested layman in these matters. If one puts on one's hat as a sort of amateur lawyer, as it were, normally when some facilities are described as being owned by the private sector certain rights go with ownership. Can you just exemplify for me what rights are attached to the ownership which seems to apply to at least BOO and BOOT if not to the other two?

(Mr Dorrell) Can I be clear about how we are applying these principles in the National Health Service because that is the simplest way to answer the question and that is to say that the private finance partners that we are looking for are partners who will deliver a service to an NHS trust, a service that is subsidiary to the delivery of the main service for which the trust as a whole is responsible and that is a medical service against an NHS contract defined by a health authority or a fundholder. The important point is that when a health authority defines an emergency service contract or an elective surgery contract that is a service which defines the quality and standards and so forth for the medical service which that health authority or that fundholder wants to secure from an NHS trust and the trust is responsible for delivering it in its entirety. The health authority purchaser, therefore, has no relationship with the private finance partner. The private finance partner is by its nature a sub-contractor to the trust and is responsible for delivering the services set out in the contract between the private finance partner and the trust. If the private finance partner has made a major capital investment in building a facility where this service is going to be delivered then clearly what the contract does is to provide the terms under which the partner invests his own capital and defines his interest in that building that he has financed and defines the length of time that the contract will run provided that the service matches quality standards and provides what happens on the termination of the contract. The interest of the private finance partner, typically the consortium that we were describing earlier, is protected by the service agreement between that partner and the trust. What that contract will also provide is at the end of that period what happens to the building that has been financed by the partner.

63. Let me give you another example which admittedly is hypothetical at the moment. Just near my constituency and hopefully serving my constituency in years to come will be something called the Sutton Medical Campus, which is little more than a gleam in the local NHS trust's eyes at the moment but we hope we can make progress

¹ See Appendix 21.

16 January 1996] THE RT HON STEPHEN DORRELL, MP AND MR ANDREW NEILL

[Continued]

[Mr Forman Contd]

with it. Supposing in the process of that great project a lot of buildings and a lot of clinical and other facilities have to be built, which I imagine will be the case, who will own those facilities and those bricks and mortar and that concrete and that plate glass and those operating theatres and those instruments and other facilities at the end of the contract period?

(*Mr Dorrell*) It will be defined in the contract, but typically the consortium will own them. The consortium would own an interest in them because typically if it is on NHS land, as it usually will be, there would be a long head lease from the NHS to the consortium and then a shorter agreement under which the consortium would sell the combined service that I am talking about back to the NHS. The consortium would then use its long lease interest to protect its interest and to give it confidence to invest in the bricks and mortar and so forth that would remain its property standing on land where the freehold ultimately belonged to the NHS but where the consortium had a long leasehold.

64. So the ultimate ownership is not alienated from the public sector?

(*Mr Dorrell*) With ultimate ownership in all the contracts so far the reversionary right rests with the public sector.

65. That is some reassurance to those in other quarters of the political spectrum who argue that this is a form of privatisation.

(*Mr Dorrell*) What we are engaged in is using private capital and private management to deliver an NHS service.

66. Perhaps I can just ask you briefly now about something else. Obviously the BMA, like all deeply conservative bodies, feels a bit threatened and worried by some of these developments, or at least it says it is. Do you see any threat to clinical standards implicit in that idea?

(*Mr Dorrell*) On the contrary. I think if you look at the history of the Health Service you will note that one of the clearest lessons is that under governments of all political complexions the management of the Health Service has had the opportunity to improve the quality of service that is delivered to its patients through extra investment and it has not been able to deliver on that opportunity. What we have done through the development of the PFI is to abolish that rationing process for capital and to put the emphasis where it properly is, on the quality and value that is delivered for the revenue spend that is committed to the Health Service. I believe that by providing access to capital on different terms, far from undermining the clinical quality of the Health Service, what we are actually doing is giving a huge extra long-term fillip to the quality of the care that the Health Service can provide.

67. So you do not agree, therefore, with that part of the BMA memorandum which has been

submitted to this Committee—I do not know whether you have had a chance to see it or not—where they say: "The PFI has been described as 'an instrument in its systematic inequality', as those parts of the service owned by private companies"—note the word "owned"—"will attempt to increase revenue and lower costs by seeking out private patients and catering for fundholding GPs with the largest budgets, but threatening the care of others"? You dispute that, do you?

(*Mr Dorrell*) Well, I just think that it implies a direct relationship between the private sector partner and an NHS purchaser which, as I have already made clear to the Committee, simply will not exist.

68. Then finally, obviously my constituents and indeed many other constituents will have some concerns perhaps in this rather complicated area about what might be described as the core clinical service, the things that really matter when you are just about at death's door and the things that you really need in acute cases. Are there any core clinical services which in your view would simply never, and I know that is a strong word, be appropriate for PFI provision?

(*Mr Dorrell*) My approach to the question of private provision of clinical and clinical support services is the same and that is that I am not changing the guidelines that have existed in the Health Service for many years. That is to say, where there is an exceptional circumstance and local managers and local clinicians have come to an agreement that perhaps another model of provision meets a local need, I am not going to withdraw from them a freedom they have had for many years, but I have made it very clear that the PFI is not about extending that principle at all. It seems to me reasonable to assume that the same guidelines to the same people will produce in the future, broadly speaking, the same outcome as they have in the past. That is very much the exceptional case where clinical or clinical support services are privately provided, but equally I can think of no reason for withdrawing that freedom that they have previously enjoyed, though I make it clear that I am not engaged in extending it.

69. In fact is it not possible, just to put the point even more positively than that, that the present system, which is based really on political discretion essentially in public sector capital spending, and we all know of stories where it is postponed as a relatively soft way of getting overall control of public expenditure, is likely to be increasingly replaced by a degree of contractual certainty which, from the point of view of the using public, the patients up and down the country, is actually very beneficial?

(*Mr Dorrell*) Well, I thought I had put the point several times in different words and I wholeheartedly endorse it. The repeated experience of different parts of the country over the whole history of the Health Service is of capital projects being developed to meet local need and then can-

[Mr Forman Contd]

celled because of short-term cash constraints in the public budgets. The PFI offers escape from that because provided that the project is good value, it is entirely immune from the short-term capital planning processes of Her Majesty's Treasury.

Mr Forman: Thank you for being so clear.

Mr Timms

70. Mr Dorrell, would it be fair to say that there is an assumption built into the Department of Health's implementation of the PFI that private sector solutions, generally speaking, are to be preferred?

(Mr Dorrell) No, that would not be true because, as I have said several times, we begin by defining the project that the public sector would build and that is what allows us to assess whether the project is better than the status quo and then what we do is to look for private sector providers of that basic project definition and we require any PFI alternative that is proposed to us to pass a value-for-money test by comparison with that public sector standard. We are not replacing the traditional bias that says that public is good and private is bad with one that says that private is good and public is bad, but we are replacing it with a balance that says that if the private sector can deliver better value to the NHS than the public sector option, we will go with the private sector.

Ms Abbott

71. Mr Dorrell, in your own document you say, "The starting point is a clear presumption that the PFI approach will generally be better than a traditional procurement".

(Mr Dorrell) The starting point is that what we do first is to look at the private finance alternative and where it can show that it delivers good value, we shall build it with the private sector partners, subject to competition and so forth. If the public sector alternative demonstrates better value, then this Committee, the Public Accounts Committee and the House of Commons itself would give pretty short shrift to a Minister who approved a project which was demonstrably less good value than another alternative that was available. The important point is that we compare the privately-financed project with publicly-financed projects where they are realistically available.

Mr Timms

72. I am encouraged by the position of neutrality which I think you have described in your speech about choosing whoever is the better, but that does not seem to be the position in the Treasury document. As Ms Abbott just said, the assumption there is that the PFI approach is to be preferred as the starting point. Given that the Department of Health procedures need to take every project through a PFI process first to see whether they can work before looking at other alternatives, is not the reality an assumption that if the private sector solution can be made to work,

that should be done rather than this neutral assessment being made right at the beginning?

(Mr Dorrell) Well, if I was an NHS manager knowing what I do about the vagaries of the public sector capital planning process, I would certainly regard it, for all the reasons that were being identified earlier, as being a more secure project, one that I would be more confident of and would have less interference with if I was able to demonstrate that it passed good value. Indeed there is another question which needs to be addressed as well and that is that where we have a project which comes forward which does not deliver good value, I think that one of the questions that the Public Accounts Committee might well ask me if I then allocate large sums of public capital to it is, "Here we have got a project which is demonstrably bad value, so why are you doing it?" So we have to begin by setting a project for which there is a real need and which demonstrates an improvement on the status quo and then we have to say that whichever is the best way of building a project for which there is a demonstrable need and which demonstrates an improvement on the status quo, the most efficient way of building it, we will build it that way.

73. One of the points that people in the Health Service make about the PFI is that it seems to act to give encouragement to every scheme that might be a gleam in somebody's eye even if optimism that this scheme could materialise is in fact unrealistic. The assumption seems to be the unspoken assumption that the project which fails to obtain private finance will then be picked up with public funds at the end of the PFI road which clearly in many cases is just unrealistic. Could not more be done to reduce the number of projects to a more realistic number early on to avoid great disappointment after an enormous amount of effort in the public and private sectors at the end of the long process?

(Mr Dorrell) I am not sure that I agree with that. In fact I am fairly sure I do not. I think that if a local management team, a local group of clinicians feel they have got a project which could improve healthcare in their area and they feel confident that it can pass the value-for-money test, it is one of the appeals of the PFI that we can access much larger quantities of capital than ever was possible in the conventional planning process and if it can be shown that they are projects, projects which Mr Timms describes as a distant gleam, if it can be shown that they deliver good value and they are affordable within the context of continuing long-term revenue budgets to the Health Service, I am strongly in favour of going ahead and doing it. It seems to me that it is one of the things which has been wrong with capital planning in the Health Service in the traditional structure, that it assumes that there is a ration of capital and that is the maximum that can be allocated to the Health Service. If there are projects which are viable, which deliver good value and which deliver an improvement in the service that is delivered to

16 January 1996] THE RT HON STEPHEN DORRELL, MP AND MR ANDREW NEILL

[Continued]

[Mr Timms Contd]

patients, then I am against the rationing approach which I think rather underlies Mr Timms' question.

74. But is not the reality likely to be that many of these projects that go into a PFI process will not succeed as PFI projects?

(Mr Dorrell) They will succeed if they deliver good value and if they improve the quality of service that is available from that trust and are affordable within the context of the trust and health authority budgets.

75. Yes, and if they can attract private finance on an acceptable basis which in a number of cases appears not to be the case. Given that having been through a PFI process and failed, there is then the option of projects being picked up by public sector funding, who will decide which of the unsuccessful PFI projects will be funded through public funds? Will that be a decision made by yourself, will it be made at some sort of regional level or will it be made at the district level?

(Mr Dorrell) The answer is that the smaller projects will be made at regional level. There will continue to be an NHS capital budget and there is a structure for the allocation of public capital within the Health Service which will continue to provide for those decisions to be made.

Mr Forman

76. Can we be told by Mr Dorrell what proportion of the bids for the PFI route has been successful and what proportion has failed?

(Mr Dorrell) In terms of the big projects that are coming through, we are still in the relatively early days of those big ones coming through and we are not in the position yet of having turned down any that have come to us for approval.

77. So none has been turned down yet?

(Mr Dorrell) Not so far. Let us be clear, we have only announced one.

78. That does not prove anything because if you have only announced one then that is one which by definition is successful. It would be interesting for the Committee to know how many you have turned down?

(Mr Dorrell) The answer is that we have received one and approved one.

Mr Timms

79. Is it not the case that a number of projects have failed because private finance has not been secured for them?

(Mr Dorrell) There are a number of projects that are being developed and being negotiated and a large number that have been advertised and we do not know yet how successful they will be in finding partners. That is part of the process of attracting partners and then testing projects.

80. Another aspect of this which has been raised in East London recently is that while the PFI pro-

cess for a single project is fairly clear and I think well understood by everybody, matters become very difficult when there are several projects being dealt with as separate PFI projects, but in reality where they are all mutually dependent the position becomes very difficult from the point of view of certainly people in the Health Service in East London. Can anything be done to simplify matters or to provide some sort of overview so that there is some confidence in each of the individual projects so they are not wasting their time because another of the projects is going to fall through for some reason?

(Mr Dorrell) Obviously within the Department we are aware of major projects that are coming forward and we take an interest in the progress of those major projects. If there is an example of one that has come into difficulties because it depends on some variable that is within the Department's control—there are many variables that are not—then we are quite content to enter into a dialogue with the trust or with the partners over what may be happening around that variable.

81. Is not a criticism that could be levelled at the PFI that it does rather fragment things into separate projects and that there is not an overview taken?

(Mr Dorrell) If the Committee has a specific example of a major private finance project where progress is being impeded by unknown variables associated with other private finance projects then I will gladly look at that. I am not actually aware of a project where that is true.

82. I was raising it more as a general concern. What will the role of the Private Finance Initiative be in primary care? In my area of Newham the Health Minister said last year that only about a quarter of GP premises currently meet the Department's basic standards. There is a huge backlog of work to be done, but there is a concern that it will not be possible to fund new doctors' premises under the PFI because of a funding gap and that these resources are running out. Will it be possible to use the PFI to help?

(Mr Dorrell) The answer is it is certainly possible, although there are relatively limited numbers of examples at this stage which I can point to where the principle is being applied. There are a few, I believe, but it is comparatively undeveloped and in the context of the development of primary care it is actually one of the priorities of the Health Service we are addressing.

Chairman

83. Mr Dorrell, I am conscious that you have some other arrangements but I wonder if I could just put one final question to you. The Red Book states: "PFI deals that have already been completed show substantial value for money benefits compared with conventional procurement." If you had to point to a particular arrangement deal which you felt highlighted the benefits of this approach, which one would you choose? A number

[Chairman Contd]

are given, for example, in this document here, but you may have some others in mind.

(Mr Dorrell) I think the best in terms that it is the simplest to understand is the example we were talking about earlier which is the South Buckinghamshire Trust where, as I was describing, there was a public sector option which involved the provision of extra facilities that are clearly needed and that is to be easily compared with the private sector alternative which is to be built which involves the application of much more capital to deliver a much more imaginative solution, but which has a lower total project, total life cost than

the original public sector option would have done. I think it is an extremely good example of where freer access to capital and better quality management of the capital and the service that is delivered within it has allowed a more imaginative solution than the public sector option suggested and it is one that is not only good in terms of presentation of service to the public, but it also has extensive clinical support.

Chairman: Could I thank you and Mr Neill for joining us this afternoon. Thank you very much indeed.

WEDNESDAY 17 JANUARY 1996

Members present:

Sir Thomas Arnold, in the Chair

Ms Diane Abbott

Mr Quentin Davies

Mr Clive Betts

Mr Barry Legg

Mr Nicholas Budgen

Mr Brian Sedgemore

Mr Matthew Carrington

Mr Stephen Timms

Examination of Witnesses

SIR CHRISTOPHER BLAND, Head of Private Finance Panel, and MR DOUGLAS HOGG, Chief Executive, Private Finance Panel, examined.

Chairman

84. Sir Christopher, we thank you and Mr Hogg very much indeed for joining us. We have had a memorandum from Sir Alastair Morton and one of the things he said in his memorandum was that he thought that this Committee had displayed startling incomprehension of the Private Finance Initiative. I was wondering, therefore, for the record, if you could remind the Committee what exactly the Panel does?

(*Sir Christopher Bland*) Sir Thomas, one of the good things about following Sir Alastair is that if you had up until that moment in your life a reputation for being tough, difficult and saying disagreeable things, you suddenly find yourself cast as the "soft policeman" and I wish to get off on the right footing with this Committee by totally dissociating myself from that remark. What the Panel does is to act as a stimulus, a gadfly, a source increasingly of knowledge and experience of projects, both general and specific, and to work with Government in encouraging PFI and also the private sector. So it points in both directions. It is sometimes described as acting as a broker of projects and it is worth reminding oneself on the Panel and on the Executive that the Panel itself has no powers. It cannot tell anyone to do anything; it can simply advise, encourage, warn. Nevertheless, I think increasingly through its experience it has developed a considerable degree of authority and its power, such as it is, lies in that experience.

Mr Sedgemore

85. This presumably is a part-time job, is it, Sir Christopher?

(*Sir Christopher Bland*) Yes.

86. Do you get paid?

(*Sir Christopher Bland*) No. None of the Panel members is paid.

87. Do you know how you would come to be appointed, what skills you bring to it?

(*Sir Christopher Bland*) I can tell you the technical process, Mr Chairman. I was originally appointed to the Panel and asked to take on responsibility for Northern Ireland, and the reason for assigning me the Northern Irish portfolio was

that I come from the Province, I have had some experience there, I was on the Northern Ireland Finance Corporation for a while when Charles Villiers was Chairman of it, so that would account for the Northern Ireland connection, and I am an all-purpose general businessman with quite a lot of varied government experience. So I would assume that is why, but they do not tell you.

88. Was that when you were working for LWT or after?

(*Sir Christopher Bland*) No, it was after.

89. Your predecessor, Sir Alastair Morton, left the post because of a conflict of interest. I am not sure what the conflict was but I know that his company has debts of £1.6 billion and half of it is Government money. Are you going to leave the post now that you have been appointed Chairman of the BBC?

(*Sir Christopher Bland*) Yes. I told the Department that it would be my intention to leave the post by no later than the end of 1996 when a suitable successor can be identified and appointed.

90. Is that because you think there might be a conflict of interest?

(*Sir Christopher Bland*) No. I think there is simply not enough time to do the BBC and this job. I also think that the PFI is a different sort of job from, say, being chairman of a hospital trust, and there could be, but that is not the primary reason. The time constraints are the main reason.

91. You could not help us about how you get appointed. You were on LWT and there was a takeover bid, I understand, for LWT, and you fought it and according to this paper here—this is yesterday's Standard—you thought City shareholders should back you because your "track record was as good as anybody in the industry. He thought wrong and the City stabbed him in the back and he was out of a job. The person who wielded the knife was Carol Galley." What happens when that sort of thing happens? Do you ring up a minister and say, "I'm out of a job. Can you bung us a couple of quangos"?

17 January 1996]

SIR CHRISTOPHER BLAND and MR DOUGLAS HOGG

[Continued]

[Mr Sedgemore Contd]

(*Sir Christopher Bland*) Well, I did not. I suppose you could but if you were financially pressed—and the article will tell you that I was not—then you might, but in that case you would not apply for the job of being Chairman of the Private Finance Panel.

92. As Chairman you would want the companies that get involved to adopt, presumably, best industrial practices, would that be right?

(*Sir Christopher Bland*) Yes.

93. And you must know that the thing that the public are most desperately, or have been most desperately, worried about is the chairmen and directors of privatised utilities making money out of share options. As I understand it, unless everything I read is wrong you have made more money out of share options than several of the private utilities people together. Is that right?

(*Sir Christopher Bland*) I have not done the arithmetic but I have made a substantial amount of money out of buying shares in London Weekend—a different thing, if I may point out, from share options in that in good PFI terms there was some risk involved.

94. Did not a group of you hand yourselves some shares, and the figure I read was £1 million? I saw you defending it on television. Is that right?

(*Sir Christopher Bland*) No, the first part is wrong. I did not hand myself some shares, I invested slightly less than £½ million of my own money in LWT when it was capitalised at about 60 or so million, but over the ensuing period we changed the company radically, won the franchise, won the breakfast franchise, 20 per cent of it, negotiated a significant contract with Carlton, and when the company was taken over it was worth close on 700 million.

95. So it is pretty akin to share options, is it not? You made money on the grant of a monopoly?

(*Sir Christopher Bland*) No, it is entirely different, Mr Sedgemore, and if you do not understand that, then afterwards perhaps I ought to explain it in greater detail, because in a share option there is no risk. In this case I took the risk of losing every penny of that money.

96. I see now. I understand, yes.

(*Sir Christopher Bland*) It is clear now with the benefit of hindsight that it was a good bet. It was by no means clear at the time.

97. I think I do understand it very well, Sir Christopher. The risk you took was that you actually were given a monopoly licence to televise, to make television programmes. Big "risk" that was, was it not? No risk at all. My point is this: that if you saw the shares of companies involved in private finance initiatives going up as a result of work they were doing with some of these schemes, and

they started granting share options, would you criticise the companies for that?

(*Sir Christopher Bland*) Mr Chairman, I do not think I would have to. I think Mr Sedgemore would do it very well for me!

98. Would you be in favour of doing it? Would you be in favour of my doing it, or not?

(*Sir Christopher Bland*) That would depend on the depth of understanding of the position that you demonstrated. If you criticised them in the terms you have just criticised me, no, I would not. If you actually understood the detail and there were fair grounds for criticism, then that would be your privilege and, indeed, your job and I would quite understand that.

Mr Sedgemore: Yes. You get these Quangos, and you have presumably heard of Nolan, and there have been complaints that some of them are politically motivated. We all know, it is common knowledge and you have never hidden it, that apparently you are actually a friend of current Conservative cabinet ministers, are you not?

Mr Budgen

99. It is not a crime, is it?

(*Sir Christopher Bland*) Yes, I am.

Mr Sedgemore

100. When the question of patronage comes up, it may be relevant.

(*Sir Christopher Bland*) As you will have seen in the papers, I have a lot of friends in the Labour Party as well. I do not regard that as a crime. I do not regard it, and it should not be regarded, as a crime to be a member of a political party. We live in a democracy. Everybody round this table has demonstrated the point of being a member of a political party. I have no apologies for that.

Mr Sedgemore: No. I think what concerns us is this: you lose your job and then you have got this voluntary Quango and you have got a paid Quango—

Mr Davies: Ridiculous!

Mr Sedgemore

101. You do not know what I am going to say, so could you just shut-up, Quentin, for a moment? You lose your job and then suddenly you are chairing two Quangos. Your relationship with some of these cabinet ministers is that you entertain them in your home here and your house in France, is it not?

(*Sir Christopher Bland*) No, I do not think any cabinet minister who has appointed me to a job has ever been to my house in France.

102. That was not the point I was making.

(*Sir Christopher Bland*) Well, it was. You said—

103. It was not.

(*Sir Christopher Bland*) The link, Mr Sedgemore, that you made, was perfectly clear.

17 January 1996]

SIR CHRISTOPHER-BLAND and MR DOUGLAS HOGG

[Continued]

[Mr Sedgemore Contd]

104. The link is clear. They talk to each other, these cabinet ministers.

(*Sir Christopher Bland*) I cannot stop them doing that, but I should also point out that members of the Liberal Democrats have been to my house in France, several members of the Labour Party have—

Mr Davies

105. He is jealous because he has not!

(*Sir Christopher Bland*)—and if you will only lay off this unproductive line of questioning, I will invite you too!

Mr Sedgemore

106. That is very kind of you. I was in the car outside your door when Mrs Clwyd professed to be lost on one occasion a couple of years ago and you or your wife spoke to her.

(*Sir Christopher Bland*) Politely, I hope.

Mr Sedgemore: Reasonably politely.

Mr Legg

107. Thank you. I wonder if we could return to more mundane matters. Could you tell the Committee what you consider the risk to public expenditure control posed by the PFI might be?

(*Sir Christopher Bland*) I think the main risk is if the Treasury and the government departments do not improve their methods of recording the revenue implications of PFI and other expenditure. Now, this is something that we as a panel feel very strongly about. The Treasury have taken on board, and they are committed to improving, both the local (that is the departmental) and the central (that is the Treasury) control of the annual costs associated with major PFI projects. That seems to me an essential discipline which is in part, but not in whole, carried out in government departments, but I think needs to be absolutely rock solid and clear.

108. Why are you concerned it might not be rock solid at the moment?

(*Sir Christopher Bland*) Simply that up till now, the whole system of government accounting has been largely based on cash accounting in the year in which it is incurred, and there is no formalised system in every department nor in the Treasury for certainly outside the three years, logging and adding up the totals of future revenue commitments. Some of these contracts have lives of ten and fifteen years and at the very least departments should (and in most cases are beginning to) do the simple arithmetic of what the annual commitments are of, say, 17 PFI projects that may have a life of seven to thirty years.

109. So what you are saying is that, on some of these contracts issued at the moment, the future liabilities for those contracts are not quantified?

(*Sir Christopher Bland*) They are quantified, because they are clear and set out in the contract concerned, but it is the case that the Treasury do

not centrally total those forward commitments for every government department, and it is the case that not all government departments themselves total those forward commitments.

110. So if the department is entering into one of these contracts, you are saying there are cases where the department does not quantify its commitments under the contract?

(*Sir Christopher Bland*) No, that is not quite what I am saying. I am saying that, if you ask some departments "What are the revenue implications of the PFI contracts they have signed in the year, say, 2005?", they would not readily be able to give you an answer, and if you asked the Treasury "What is the sum total of the PFI commitments in the year 2005?" they would not readily be able to give you a total, but the information is there and it needs to be codified, organised, and assembled fairly speedily in our view, and that is a view that is not simply the panel's: that has been registered, I think, very clearly with the Treasury.

111. What incentives are there for a private sector company to be efficient in the provision of services under PFI when it has a guaranteed market in the form of a purchasing department?

(*Sir Christopher Bland*) Well, described in the terms you just have, the incentives would be limited, but that would not be or that does not sound like a good PFI contract. In our view, indeed in everybody's view involved with PFI, the essence of a good PFI contract is some significant transfer of risk to the private sector and if that risk is not transferred in whole or in part, then it is not typically a PFI contract. For example, if the revenue is guaranteed through the life of a project, then it is not PFI, or unlikely to be PFI. On the other hand, if the revenue risk is either shared or taken in whole by the private contractor, if they are on risk for volume and if they are on risk for quality of service—and they should be on risk for both—then the incentive to perform is, for example, if it is a road contract, to make sure that those road lanes are available for the maximum period of time, in quality terms, that the quality of the road does not deteriorate below clearly specified levels. So those are all powerful incentives. The best incentive is that if they do not perform they do not make money.

112. When you say that the risk has to be transferred in whole or in part, that certainly gives a very large element of discretion as to how much of the risk is passed to the private sector. Do you have any firm guidelines at all for departments on that?

(*Sir Christopher Bland*) Projects vary so much that it would be, I think, unwise to give other than guidance in general terms. The risk ought to be transferred or ought to be borne by the organisation most appropriate to bear it. There is no point in transferring all of the risk to the private sector if, through doing that, you effectively have to pay over the odds for that transfer. A good example would be that in a construction or a road contract

17 January 1996]

SIR CHRISTOPHER BLAND and MR DOUGLAS HOGG

[Continued]

[Mr Legg Contd]

typically the responsibility for getting outline planning permission ought to lie with the department; the responsibility for getting detailed planning permission probably ought to lie with the contractor. That would be an example of how risk ought to be shared. Major political changes and risk will not be taken by the private sector except at a price that is not worth the Government paying.

113. Obviously some of these contracts are going to be very complex. Who do the department use as their legal advisers in these matters?

(*Sir Christopher Bland*) There is a wide range of firms and individuals who are used and there is an increasing expertise building up in the private legal firms, but there is not a single answer to that. Some of these invitations to tender can go to from 12 to 20 volumes and both the departments and the private sector would need good legal advice.

114. So do you have a panel of legal advisers that you suggest to departments or are departments free to go out and choose whoever they like in the private sector to act? Are they free to go out?

(*Sir Christopher Bland*) They would normally compete for the appointment of legal advisers.

115. What would that entail?

(*Sir Christopher Bland*) Essentially what they will do is follow guidelines that are laid down in terms of presenting to interested legal advisers the opportunity to tender for providing those legal services to the client.

116. What would happen if a PFI project failed? Would you not in practice be obliged to complete the project from public money?

(*Sir Christopher Bland*) That would depend on the terms of the failure but the contract should be drawn up in a way that ensures that there is a strong probability of the contract being completed at no additional cost as compared with the original tendered price to the public sector. There will normally be step-in rights for banks if they have lent secured against the project, but those step-in rights, for example, would allow the banks to appoint an alternative contractor if, say, the contractor had failed in the provision of services, and that appointment of an alternative contractor would be subject to the approval of the department, and in the last resort, but only that, then the department concerned would have the right to step in itself.

117. So if a contractor failed effectively, the remaining portion of the contract would have to be renegotiated in some way?

(*Sir Christopher Bland*) It might not have to be. If the banks were, as it were, taking over that responsibility they would be bound by the terms of that contract, but if everything fails, if everything goes down, yes.

118. Does not the PFI effectively encourage ministerial spending sprees on capital projects by putting off expenditure to the future?

(*Sir Christopher Bland*) I do not think so, no. Provided, as we were saying earlier, that running totals are kept and monitored, and provided that PFI projects deliver genuine value for money, improved value for money, as the best of them are capable of doing, then I do not think that is a danger.

119. But presumably even with contracts there are a fair number of financial uncertainties as regards future costs of projects which have to be estimated initially?

(*Sir Christopher Bland*) The essence of a good PFI contract is that most of those are extremely closely defined in the contract, and typically, for example, in a PFI contract involving construction, payment will not take place until the asset concerned, whether it is a road or a hospital or a building of some kind, is up, constructed, and available for service. If such a contract had been negotiated in the case of the British Library, not a penny would have changed hands and several people would have gone bust in the meantime.

120. What occasions are there on which a public capital project proved cheaper than a PFI project?

(*Sir Christopher Bland*) I am not sure. I will ask Douglas in a moment. In fact, I will ask him now.

(*Mr Hogg*) Of the projects that we have worked on to date, in those cases we carried out an investment appraisal, where we have looked at the option of the public sector itself paying for the asset and operating it, as it has traditionally done, as compared with the PFI option. In circumstances where we conclude early on or at the conclusion of the bidding process that the public sector option is cheaper and we cannot, therefore, go for the PFI option, the PFI is inappropriate.

121. Have there been many instances of that sort?

(*Mr Hogg*) We have come across one or two projects where we have looked at some of the dynamics and thought that they would be inappropriate for PFI and they have not proceeded down that line. I am not aware of a project having reached a conclusion where the public sector option is cheaper.

Ms Abbott

122. Is it possible to outline what one of those projects was, because we are interested in what types of projects are appropriate for PFI and what are not?

(*Sir Christopher Bland*) Typically, an example of something that is rapidly clearly unsuitable for PFI would be a pure refurbishment project of an existing office building where there was no change in the use of the space. Pure refurbishment of an existing hospital once it had been built would not be good for PFI.

17 January 1996]

SIR CHRISTOPHER BLAND and MR DOUGLAS HOGG

[Continued]

Mr Budgen

123. Sir Christopher, I would like to ask you a bit more about the details of what your Panel does, really taking up the description that Sir Alastair gave of the tasks. He said that the third task was to publicise the essentials of the PFI and to tutor—a typically modest way of putting it—civil servants, financiers, industrialists and all the advisers panting to profit from the PFI in the practical realities of the initiative. To take up one word there, “panting”, it certainly is the case, is it, in the late 1980s, say 1988, that the big construction companies were very attracted by the PFI Initiative but their financial circumstances have, in general, changed very markedly in recent years? Who at present is panting to get into the PFI Initiative?

(*Sir Christopher Bland*) “Panting” and “tutor” are both Sir Alastair’s words, but there is a good deal of interest still. You are right to flag the weaknesses of some construction balance sheets as one of the problems associated with financing certain PFI projects, but in the main that is increasingly dealt with where it has to be. There are still some strong British construction companies around. That is dealt with by consortia being set up and by banks showing an increasing interest in financing good PFI projects. There is a good deal of interest in the PFI process and it is growing as people come to understand that they can make a living out of it, and that although it does involve learning new skills and incurring sometimes quite expensive bidding costs, nevertheless there are good returns to be earned. There is also a negative value to the PFI in the sense that an awful lot of projects will only be financed through this method during the next five to ten years.

124. It is a change of circumstance, because if you take a big contracting company in 1988, it was then making such profits that it could say of, if you like, 5 per cent. of its profit stream “Well, it really is not going to make a vast amount of difference if we lose this 5 per cent. On the other hand, this could be the beginning of a very profitable stream of work. What is wrong with taking a punt with 5 per cent.?” That attitude is not prevalent at present, whereas if, on the other hand, you have consortia led by merchant banks (for the sake of argument) they are not in general trying to take a punt with 5 per cent of their profits or anything of that sort. They are looking at this from a different attitude, and one of the things that surely they will ask themselves is “What indication is there that some of these projects are clearly going to be more profitable than we had thought to begin with?” because there is no track record for a consortium, is there?

(*Sir Christopher Bland*) No, and that is a circular process. Plainly, until we have a large number of PFI projects not merely approved but generating good revenues and good profits for those consortia that got involved with them in the first place, there is not a track record. But to answer your question another way, I think it is fair to say that there is, at the moment, no evidence of short-

age of bidders. There are a lot of grumbles about bidding costs: there are a lot of grumbles about the returns, but in the end I think I would only share your concern if invitations to tender were simply not responded to, if people did not come up to the line, and there is no evidence of that.

125. And going on to your role, presumably all the businessmen who tender, like all businessmen, want as large an amount of profit and as small an amount of risk, as large an amount of subsidy and support from the government, as they possibly can and they complain all the time while signing up. Presumably your job is to some extent to try and tell ministers which of the complaints you regard as legitimate and which are just the normal activities of any businessman who always wants to get the best deal and is quite prepared to complain right up to the time of signing? Is that roughly your role?

(*Sir Christopher Bland*) Yes, I think it is one of our roles, but we have an advisory role in relation to departments and we can certainly encourage them to be extremely robust when dealing with the private sector because many of their complaints are not as well founded as one might think at first blush. Some of their complaints or problems with the PFI need to be taken seriously. We need to distinguish between the two categories, but it is in well-organised, well-staffed private finance units within departments that the real expertise and the responsibility for negotiating contracts has got to lie.

126. But because this is a new concept, presumably at the very beginning at least, these offices (though no doubt highly intelligent and very well motivated and so on) were pretty ignorant, were they not?

(*Sir Christopher Bland*) Yes, but we have come a long way from the very beginning, and if you take the Department of Health now, which has a PFI Unit which is about 24 strong, we would say that is a good example of what a strongly-organised, well-manned and managed mixture of private sector secondees and civil servants can achieve. It is not a coincidence that that department has got the most projects. It is partly, at least, due to the fact that it has got a really good PFI Unit. It is also intrinsic in the nature of health. It lends itself better to PFI. It has operators already in the system, but nevertheless a strong PFI Unit (which Health has) is a good start.

127. So one of your jobs, for the sake of argument, if the Ministry of Transport, say, were having a lot of trouble with our PFI projects, would be to say “Well, as a matter of fact I am not sure your office is quite as strong as it might be” and make suggestions as to how it might be improved? I am not saying that in respect of the Ministry of Transport that is the case, but if it were the case, your job would be to say “Well, as a matter of fact, Minister, you might think of seconding a few

17 January 1996]

SIR CHRISTOPHER BLAND and MR DOUGLAS HOGG

[Continued]

[Mr Budgen Contd]

more people of a certain character into that office" or something of that sort?

(*Sir Christopher Bland*) Absolutely. That is one of our key objectives in our draft business plan for the coming financial year.

Mr Timms

128. Sir Christopher, can I read to you a sentence from one of the items of evidence that has been submitted to us that I imagine you will not have seen but it is a memorandum on the PFI from Diane Dawson of Corpus Christi College, Cambridge and I just wonder whether you agree with her view, and what she says is "No macro economic model exists that suggests an increase in the PSBR to finance a hospital has any real effect on the economy different from a private consortia raising the same funds to build a hospital when, in both cases, the cost of the hospital will be recovered through taxation." What I am trying to get at is an understanding of the nature of PFI and what it is achieving and I wonder whether that comment is one you would accept or not?

(*Sir Christopher Bland*) I think I would have to read it at least a couple of times. Macro economics is straying outside my discipline and competence but the specific question "What does PFI deliver?" is I think argued against implicitly in that statement. PFI is only of value if it offers innovation, risk transfer, and a more effective way of delivering better services to the citizen and if it achieves that then, while I cannot vouch for its macro economic impact, it is plainly to the citizen's advantage that a PFI approach is used.

129. What I am trying to understand is what is the scale of the significance of PFI and I think in the evidence we have seen so far there are two distinct views. One is that PFI is a route to deal with the age old problem of not having enough money to invest in public services. I think that comes through in Sir Alastair Morton's evidence to us when he talks about how society will go limping into the next century if things continue to be deprived of essential investment and goes on to say that PFI makes it possible to invest without X public spending (and I rather got that impression yesterday from Mr Dorrell as well in the context of the Health Service—that they see PFI as bringing in really substantial additional resources to public services that otherwise would not have been there). That is one version. On the other hand, there is the view that PFI really is just about squeezing a little bit extra out of the resources that are available, perhaps doing it a little bit more efficiently, deferring some of the spending and so on. I wonder which of those two views you would advocate to us? Is it going to make a big change in the amount of resources invested in public services, or is it rather more at the margins?

(*Sir Christopher Bland*) I think it will make a big change and I think it will also make (which is the second argument because I do not think they are mutually exclusive) a big change in the efficiency with which those resources are used to

deliver a defined level of service. If you look at some of the savings that are achieved by PFI, if you look, for example, at the Northern line trains, there are over the life of the project something like 20 per cent. of savings over the comparable cost of purchasing that through conventional means of procurement and a very significant rise in efficiencies—almost one train failure per 30,000 kms as specified in the document, which is very nearly four times the best result currently achieved by any train on London Underground. So you have the combination of a better level of service, very clearly specified, by a private sector contractor who has to deliver it and who is financially strong enough not to disappear if they fail against that contract, and, on the other hand, a 20 per cent. saving against a very large number indeed. So there you have a genuine virtuous circle.

130. Could you summarise for us how those savings are achieved in that particular instance? What is it about that package that delivers those savings?

(*Sir Christopher Bland*) I think the main feature—and this is common to most PFI projects—is assigning responsibility for maintaining and delivering the service after the capital asset has been procured. In a typical method of procurement historically the contractor has gone away after the building has been built or the train has been delivered. The subsequent maintenance has been somebody else's responsibility and, therefore, the whole-life cost of the asset has not been of as much interest to the contractor as it should be. It is in designing either buildings or machinery with an eye to not whether it is simply on the day that the tenders are opened the cheapest but over the life of the project, which in this case would be 30 years—

(*Mr Hogg*) Something like that, yes.

(*Sir Christopher Bland*)—that the real advantage lies, and that responsibility should properly lie with him who builds it. I am chairman of a hospital trust with backlog maintenance—that, if it had been originally contracted for on a whole-life basis, would have been a far better and differently designed building.

131. In that context, you wrote a letter to the Financial Times on 21 September last year listing some of the things that PFIs do. You said: "There are now more than 1,000 potential PFI projects, including hospitals, schools, prisons, roads, bridges, water and sewage plants." I just wonder, is it the case perhaps that where the PFI has the greatest benefit is in instances where the asset being created generates cash to the public sector in some way? That is clearly the case with the Northern Line trains. The fact that they are there will increase the revenue to London Underground, but it is not the case in the construction of a new hospital because the fact that the hospital is there, nobody is going to contribute any cash to the public sector by virtue of that hospital. In the hospital case, that ultimately is going to have to be paid for

17 January 1996]

SIR CHRISTOPHER BLAND and MR DOUGLAS HOGG

[Continued]

[Mr Timms Contd]

entirely out of taxation, whether or not it is funded through the PFI or through conventional means. Do you agree with me that there might be a distinction between projects that generate revenue into the public sector and those which do not, and that the PFI is perhaps particularly well suited in the former instance?

(*Sir Christopher Bland*) It is plainly particularly well suited in the former, where either real or shadow streams of revenue can be identified, but it is possible to transfer risk even without those revenue streams. If you take South Bucks, as an example, there are revenue streams associated with the private patients' wing there that are part of the reason for contributing to a lower annual running cost than would otherwise have been achieved. In many cases in a hospital project involving property, if property disposals are involved—and I think that is the case in South Bucks.—the main contractor has underwritten residual disposal values of surplus properties, so that there is a transfer of that element of risk, which is quite considerable in a volatile property market, from the public to the private sector, and if there is dual use of the property, if part of it is required for the NHS but part of it is redeveloped for other purposes, then that will generate a revenue stream that will be part of the total package. So there are various ways of laying off risk even when there is not at first instance an obvious revenue stream. There is no volume or revenue stream risk associated with the NHS patients going to the hospital, nor should there be, but I think there are other ways. There is also obviously the straightforward construction risk that means that whoever gets the contract does not get paid until it is ready and fit for occupation.

132. Which would be the case under conventional methods, would it not, as well?

(*Sir Christopher Bland*) Not always. It should be but historically, of course, it has not been. A typical trunk road has gone 40 per cent over its original bid cost of construction, and the British Library is all too obvious.

Mr Timms: Can I ask one final question. We have been reading in the papers we have been given that over half of the £5 billion target set by the Chancellor for PFI is in relation to the Channel Tunnel Rail Link. I want to ask a specific question about that to help me to understand a bit more about the work of the Panel. The Government announced in 1991 that it was routing the Rail Link through East London, which a number of us represent, in order to secure regeneration in that part of the world. Under the proposals as they currently stand there will be no regeneration benefit for East London at all. However, if the Government were to give the go-ahead to the international station at Stratford, there could well be very considerable regeneration benefits for East London.

Mr Sedgemore: And a disaster in my constituency.

133. Indeed. It is a controversial matter that I am raising, though I would not accept that view. Nevertheless, there could be a considerable benefit. Is the Panel involved in assessing the Channel Tunnel Rail Link or other projects to see whether or not it is meeting the objectives which the Government have set for it or is that somebody else's responsibility?

(*Mr Hogg*) The role of the Panel in relation to the Channel Tunnel Rail Link is limited, for the reason that it is such a huge project that there is a full-time team working in the Department of Transport on assessing what is effectively truck loads of paperwork. They are a very professional team and the view that we have taken is that we stay in touch with what is going on and that clearly a number of people could be absorbed in a project like that, and with the limited resources that we have available to the Panel's executive what we have chosen to do is to take a broader look across the public sector and, therefore, to spend time on projects where perhaps we can add more value. So whilst we are in touch with it, it is very much a single, one-off project in that way.

Mr Betts

134. Sir Christopher, could I say, first of all, we have all received this weighty tome on the way in which comparisons are drawn between conventional funding and PFI funding of individual projects, but can I take you back to the question you were asked at the beginning, when I thought you gave a very succinct and helpful reply about the concerns on monitoring in total what is happening in the course of the project and the failure of the systems at present. Can I put it to you that in some ways it is very difficult for Government to do a global comparison of the different forms of funding because they treat them so differently in their accounts, a bit like trying to add or subtract apples and pears. If you have one system which puts all the costs up-front in the first year and another system which spreads the costs over a number of years, is it ever possible in total terms to make any proper comparisons given the Government accounting system?

(*Sir Christopher Bland*) Yes, I think it is, but you are right in saying that it is more difficult because you are not comparing projects financially treated in the same way, but if you do the calculations and reduce both to net present values then that should give you a clear indication, but it will be based on the assumptions that you make, of which is better value for money. I think, to take your point further, that when, as is promised but not for some time, the Government moves to a capital and revenue form of accounting, accrual accounting, and balance sheets, this does help to transform both the attitude to and understanding of the issues involved. I have no doubt that, having been in the National Health Service for thirteen years, during most of which we had no balance sheet and capital was notionally free and at the beginning of which, because it was so free, the hospital concerned did not even have a proper capital asset register, disciplines which have been intro-

17 January 1996]

SIR CHRISTOPHER BLAND and MR DOUGLAS HOGG

[Continued]

[Mr Betts *Contd*]

duced since the introduction of the proper balance sheets and capital charging are very much improved.

135. I take the point that you can, on individual projects, do a proper comparative analysis by looking at the current costs and future values. I accept that. But coming back to the point about accruals accounting, at present while the Government is developing that system, it is still working in terms of its control systems to cash. Must there not be an incentive, therefore, where there is a given amount of cash in the air, to say "Well, if we can go through the PFI route, that means we can start so many more schemes with the certain amount of money we have got available, because the cost of those is reflected in future years, not in the present one"? Is there not a built-in incentive in the global way in which government accounts actually to use the PFI route?

(Sir Christopher Bland) Yes.

136. Do you accept that that therefore gives necessarily best value in total for the taxpayer in terms of what they receive?

(Sir Christopher Bland) Provided the PFI project stands up, then yes, it will be, and provided (and we come back to that earlier point) the total commitments are increasingly carefully monitored in total. At the moment, PFI forward revenue commitments are a very small percentage of government total revenue expenditure forecastable over the next ten to twenty years, but nevertheless it will become an increasingly large sum and it needs to be carefully and properly accounted for.

137. But, in principle, you prefer to look towards some form of accrual accounting which increases it automatically?

(Sir Christopher Bland) Absolutely.

138. Can I pursue one or two of the issues about the comparisons of individual projects? Why, if there is such a strong emphasis on going through all the details of comparisons in the way that the manual insists, is there a presumption in favour of PFI which is very clearly written in and that it will always be best?

(Sir Christopher Bland) Well, I do not think it should be stated: I would not state it in those terms. I do not think it would be appropriate to say "PFI will always be best". There are plainly situations in which it will not, and each project needs to be tested both against the public sector comparator (where that is appropriate) or through other versions of the same approach. We would expect it, in most cases where PFI is appropriate, to be significantly better than the public sector comparator, but I do not think it would be fair to say it will always be.

139. Modified slightly, and quoting from the Manual, in 3.30 it says "The starting point is a clear presumption that the PFI approach will generally be better than a traditional procurement; the better management inherent in a PFI project will

give better value for money." There are two basic assumptions there: one that management in the private sector is always better and secondly that public projects always overrun. Is there not something that should be being done? I do not know whether it is any part of your role to consider doing a proper analysis and comparison of the alternatives: how we might improve procurements in the traditional route in the public sector, and management in the public sector, for example?

(Sir Christopher Bland) That is plainly desirable but it is not part of our role.

140. It is not? Not at all?

(Sir Christopher Bland) No, it is not, but nevertheless, if you take, for example, a whole area of national life where PFI is never going to be relevant which is defence, you are never going to PFI tanks or strike aircraft or atomic weapons or guns, and plainly traditional methods of procurement will continue to be used for those sorts of purchases. Again, there are large sectors of primary and secondary education where PFI is going to have only a marginal impact, if any at all. There is a great deal to be said and done about traditional methods of procurement, but that is not our primary job. One of the stimuli will be for departments to see a PFI as a method of procurement (which is what it is) and to learn lessons from that that are transferable to traditional methods of procurement.

141. But the presumption in the document somehow, because the constructor and traditional route of purchaser in the public sector is different from the end client, is for building in an inherent cost in a building which will then come on stream later on. The builder will not be interested because he will not have to bear it, but surely that is about proper contract specification, and in doing comparisons between PFI and public contracts, ought we not to be assured that the best contract specification is going into the comparisons on the public sector? There is almost a presumption in the document that comparisons in the public sector will be wrong all the time.

(Sir Christopher Bland) There is quite a lot of evidence to suggest that traditional methods of public sector procurement in a large number of areas have proved extremely expensive, and part of the reason, at least, is the disassociation from constructing and maintaining, or constructing and operating. If you simply specify, as has happened traditionally, that you have an asset to be built, then that is all the contract can cover and if you then take responsibility into your own in-house maintenance department for keeping it going for the next thirty years, you are encouraging a very critical shift of responsibility. Now PFI does not do that. The essence of PFI is to link the two and in so doing it builds in a better form of public sector procurement.

142. Two final points, pursuing it a little further: surely what is being said in that case is that, because the public sector is so bad at controlling

17 January 1996]

SIR CHRISTOPHER BLAND and MR DOUGLAS HOGG

[Continued]

[Mr Betts Contd]

the costs of constructing a building, we will now switch to give it the role of controlling the private sector when it designs, builds and manages the same building. If the failure is the public sector's ability to control the private sector, is that failure simply not going to be transferred on to an even greater dimension in the longer term?

(Sir Christopher Bland) I think not.

143. What evidence is there? Is there anything that can be done about it within government? Is it not part of your job?

(Sir Christopher Bland) I think there is a great deal of evidence. First of all there is a great deal of evidence (all too much) that historic methods of asset procurement have been woefully inefficient and expensive. They have overrun time after time in cost and time terms. The second point, and I come back to it, is linking responsibility for maintaining an asset and providing a service after that asset is constructed and in place. It is, if you like, the difference between simply designing and selling the train and designing, selling, maintaining and cleaning the train and making sure it arrives on time 98 per cent of the time. I think that is the significant difference. This, by the way, is not unique to the public sector. There is a great deal that large corporations can learn from information technology purchasing through the NIRS 2 project and I can think of a number of corporations that wish they had had the kind of specificity contained in that contract in terms of service levels, availabilities, technological obsolescence and so on and that have frittered away vast sums, millions of pounds, on insufficiently defined and specified technology contracts. There are several such examples and it is not unique to the public sector.

144. Finally, there is nothing in your document at all about looking at the skills of the public sector to manage PFI contracts, given the service and purchasing over the long period of time. Is any work on that being done? Is it part of your job?

(Sir Christopher Bland) Yes it is, and it is an important part of the process. As you know, we have commissioned a training programme that aims to train between five and ten thousand civil servants in PFI techniques, and part of that training programme involves the continuous management of projects once they have been first specified and then purchased.

(Mr Hogg) And that has to be in the contract.

Mr Davies

145. Sir Christopher, you are a businessman, indeed with a distinguished business career, whatever some members of the Labour Party may try to portray you as, and you are very familiar with the concept you have already used this afternoon of capitalisation of cash flow streams. Would you not agree that the right way to describe the essential part of the PFI is really that it is the reverse of a capitalisation of future income; it is, in fact, the "income-isation" of present capital, and that what is happening is that the Government is substituting

a present capital expenditure for an undertaking to pay, probably over a very long period into the future, a regular sum of money, a regular cash outflow?

(Sir Christopher Bland) It may be, but there are, of course, accounting standards which will identify projects where insufficient risk has been transferred or where the essence of the contract is simply a finance lease, and those will and should be capitalised.

146. Yes, but let me take an example, one in an area with which you are particularly familiar. If the Government builds a hospital, say, which costs £1 billion, they will have in their current year capital expenditure,—let us say £330 million, if it takes three years to build a hospital—and then there will be no capital expenditure. If they contract with a PFI contractor and operator they will have no expenditure in the current year or, indeed, the next three years, subject, of course, to the contractor suitably completing the hospital. The public sector, the Health Service in this case, will then start to make payments from year 3, to take my example, which may go out to year 13 or 18 or whatever, and then there will be a regular cash outflow over that period. That is basically the perception of the position, is it not?

(Sir Christopher Bland) Yes.

147. My concern in that matter—and I am in favour of the project as a whole, as you probably know—is whether or not the taxpayers, the people who send us to this place, our electors, have a sufficiently clear notion of what is actually happening. For example, if they look at the public sector accounts they see nothing; they do not see the £330 million (to take my example just now); they see nothing this year, next year and thereafter. It so happens, therefore—and perhaps it was not totally accidental that I took three years—when they look in the Red Book they have no indication that a liability has been taken on on their behalf. That is correct, is it not? It is also correct, is it not, that a lot of people pay attention to critical Government fiscal ratios? You in the private sector are used to looking at your balance sheet and looking at the various ratios of debts to equity and times interest covered and so forth and people draw immediate conclusions from those ratios. Similarly when people assess Government finances they look automatically at a number of ratios. One very common one is the PSBR, as it is called in this country, the level of current fiscal deficit. Another is the level of Government indebtedness to gross domestic product. You would agree with me, would you not, that the way the public sector accounts are currently presented, again those ratios as they are published will not reflect the liabilities that are taken on under the PFI Initiative?

(Sir Christopher Bland) No, after three years, that is correct.

17 January 1996]

SIR CHRISTOPHER BLAND and MR DOUGLAS HOGG

[Continued]

[Mr Davies Contd]

148. I deliberately put my example, but you agree, I think, that my example is not an unrealistic one to take?

(Sir Christopher Bland) No, but this brings me back to the point about the importance, first of all, of monitoring future commitments, and I would also point out that future PFI commitments pale into insignificance beside the future commitments of the Government in other respects, which you do not see, as it were, stretching out for 20 years but they are there. They are far bigger than even a PFI that takes off over the next five years. Is that not right?

149. When you were chairman of a plc, what would you have expected your auditors to respond, when they questioned you about a liability that the company had taken on which had not been revealed in your published financial statements, if you had said, "It is really quite small in relation to our total turnover or to our market capitalisation. It is only a million or two"? How would you have expected your auditors to respond?

(Sir Christopher Bland) You misunderstand the thrust of my argument. I am in favour of identifying and accounting for future expenditure obligations of Government. I am simply pointing out that you cannot only do it if you simply focus on PFI. You have to do the job properly and I absolutely agree.

150. So we are not talking about a matter of scale, we are talking about a matter of principle?

(Sir Christopher Bland) That is right.

151. And we agree in principle that the present situation is unsatisfactory?

(Sir Christopher Bland) Yes.

152. And we agree that the national accounts are not sufficiently transparent and we agree something has to be done about that?

(Sir Christopher Bland) Yes.

153. That is very helpful. Can you tell me, do you believe that when a PFI assessment is made, that is to say, when the initial investment appraisal takes place under the department which I think Mr Hogg runs under your auspices as Chairman, is it right that purely financial items should be taken into account or do you take externalities into account and attempt what is sometimes known as a social cost benefit analysis?

(Sir Christopher Bland) Certainly the assessment will not be done solely, or in some cases mainly, on purely financial issues. The level of service, which may be different if you have two competing solutions, should be taken into account.

154. How do you take those into account?

(Sir Christopher Bland) That will depend on the sort of project it is. There are means of identifying levels of service for, say, road availability, road quality, in IT the speed of transaction processing,

the amount of downtime that you have in a week, in a year and so on.

155. How do you quantify those factors, Sir Christopher?

(Sir Christopher Bland) Typically, in a contract, if you look at NIRS 2, to quote an example because it is a reasonably vivid one, the specification of quality will cover such things as availability between seven o'clock in the morning and nine o'clock at night for every day of the year excluding Christmas Day, 98 per cent national availability for each full on-line service on a weekly basis, 99 per cent national availability over a 13-week period, minimum response time for standard functions, 95 per cent. for all transactions.

156. I understand the sort of factors you are trying to take into account. What I am asking you is how you put a cash value on it?

(Mr Hogg) So far as the investment appraisal that is carried out against the PFI proposition is concerned, the guidance for that stems from what is called the Green Book and there are investment appraisal manuals developed within departments that are used to put those public sector propositions together. In other words, the investment appraisal for looking at the public sector option measured against a PFI project uses the criteria and the guidelines and the appraisal means that have been developed within departments in conjunction with the Treasury over the years.

157. Are those manuals published?

(Mr Hogg) In terms of their status, I think a good number of them are available, yes.

158. But only some of them are available?

(Mr Hogg) I could not begin to comment across the whole of Government whether, for example, the very detailed manuals on roads are available or not. I do not know what the exact status is but I do know, for example, that the Green Book itself is publicly available through HMSO.

159. Yes, but, Mr Hogg, you would agree with me, I think, that the conclusions you draw from this investment appraisal and, very importantly, the conclusion you draw as to whether or not you get a lower present cost from a traditionally sourced, traditionally managed public sector financing or from a PFI project will be highly sensitive to the way in which you capitalise, in which you recognise the cash value of some of these items, will it not, and what you are telling me is that these items are given a notional cash value by virtue of some arcane process which may be partially known to the public and the taxpayer and partially not, which differs between departments, which depends upon the backgrounds and presumably particularly the method of operation of individual bureaucracies, and then you turn round and you try and pretend that what we have here is a genuine objective investment appraisal process the

17 January 1996]

SIR CHRISTOPHER BLAND and MR DOUGLAS HOGG

[Continued]

[Mr Davies Contd]

results of which should be considered to have some objective economic validity?

(*Sir Christopher Bland*) I think you are taking the argument and taking it too far.

160. You tell me how far I should take it then.

(*Sir Christopher Bland*) About so far! (indicating) It seems to me that if you are saying that there are going to be elements of subjectivity to which you try and assess and try and attach a cash value, which are subjective, arcane and bureaucratic (those were your adjectives and it is certainly subjective, I will agree), then in certain cases that will be so, but the majority of the service standards that are specified will be as arithmetical as I have described and will be met by competing tenderers in different ways. Those you would be pretty happy with and in most cases those would amount to, in many cases, a hundred per cent. of the decision and in most cases to 90 per cent., so the area of subjectivity, I would guess, would be relatively limited. To pretend it does not exist, however, in either the public or the private sector would be wrong. We are not trying to do that.

161. This is a very important issue, I think you will agree. Let us return to my example of the hospital. Let us say that the public sector, if it had built it to normal circumstances, would have expected to get a tender price or has received a tender for a price of a billion pounds. Let us suppose that the PFI tendering comes in at £1.5 billion but it is possible to argue, because he is taking the construction risk, that because he has provided certain guarantees of co-operation or whatever it is, greater efficiencies or greater benefits in operating the particular facilities when it is up, those will be assessed at more than half a billion pounds. If they are assessed at more than half a billion pounds, you will still say the PFI tender was the best. If they are assessed at £100 million you will say "No, there is a gap of £400 million in favour of the public sector tendering". You can reverse those initial numbers if you want to, but I am simply explaining to you that the final decision may crucially depend on (and this is stronger than my earlier phrase that it "could be sensitive to") the way in which you put a notional and, as you yourself say, judgmental and subjective cash value on these additional benefits.

(*Sir Christopher Bland*) I think that is right. The assessment of risk is, in the end, a subjective process which you try and refine and attach cash values on to, but let me ask you a question: is it better not to try to accept the subjectivity of the process and, if you do not try, then you will always believe that trunk roads get built for 40 per cent less than they actually do?

Mr Davies: Normally the procedure in this Committee is that we ask the questions but I am only too delighted, since you invite me, to give the answers! The Labour party are rather sorry you have given me that invitation, but they will now have to sadly listen, at least for a minute or so, while I provide the answers.

Mr Budgen: Please do not limit yourself to a minute!

Mr Davies: It is nice to have the support of my colleagues.

Chairman: Mr Davies, we do have two more witnesses waiting.

162. I would have hoped you were going to answer, Sir Christopher, that the purpose of the department run by Mr Hogg was to introduce an element of objectivity and rigour and also an element which is obviously currently lacking of transparency in the whole process. Departments would not be allowed to make their own subjective determinations of the cash value of these advantages. They would have to negotiate them with Mr Hogg or his experts, and that process would be a transparent one and we all, and the taxpayer, would be able to satisfy ourselves that the results of this process (which you called an investment appraisal really) were ones which had some degree of objective validity.

(*Sir Christopher Bland*) I take the point. I do not believe it can always be objective. I think in assessing risk you are always applying what I would describe as a quasi science. It is right to do so. It is better than not doing it, but if I was to pretend to you that there were techniques that would give you absolutely clear, irrefutable answers to the assessment of construction risk, I would be deceiving you.

163. Yes. What I am asking for is consistency and transparency.

(*Sir Christopher Bland*) I think both are highly desirable. I think it is part of our job to encourage consistency and it is part of, of course, the PFUs in the department (and we are talking about roads in the case of the Department of Transport) to establish that consistency when they evaluate risk and they, after all, are sitting on the history.

164. Let me take you on to the next point which arises, and that is the issue of the discount rate that is applied. Presumably in the case of the classic public sector financed project, the discount rate is the opportunity cost of capital of the government which presumably is the gilt rate. In the case of the PFI projects there are greater degrees of risk and so presumably a higher rate would apply—perhaps the opportunity cost of capital of the contractor, or of the particular types of businesses engaged in that sector of activity. I am not going to volunteer the answers for you here, Sir Christopher (unless you force me to!) What are your views on the subject?

(*Sir Christopher Bland*) I think we use, do we not, two different discount rates—one for roads and one for everything else. Is that not right, Mr Hogg?

(*Mr Hogg*) That is correct, except when you look at a situation which we were talking about earlier on where you have a potential future cash flow and you ask yourself the question "If the project were to remain in the public sector, could it achieve that cashflow in terms of getting into a business that would exploit that land?" You might

17 January 1996]

SIR CHRISTOPHER BLAND and MR DOUGLAS HOGG

[Continued]

[Mr Davies Contd]

then, within your public sector option, have a different discount rate for your view of the public sector's ability to achieve the same level of profit for that income.

165. Here again, you see, the more you use different discount rates the more you are likely to falsify the answers and potentially distort.

(Mr Hogg) Not when the discount rate is used discretely over that cash flow.

166. What are these two discount rates you have used?

(Mr Hogg) Typically there is roughly a 2 per cent difference between the cost of public sector capital and the cost of private sector capital.

167. Surely there will be a much greater difference, because the private sector, normally, has a considerable equity cost there which will be very much more. I do not think Sir Christopher, running a business, would have been satisfied with a return on capital employed of 2 per cent, above the gilt rate. I do not think he would be such a wealthy man if he had been!

(Mr Hogg) So far as those discount rates are concerned, it is for the private sector themselves to come up with those by, for example, talking to their shareholders, talking to their lenders, and to decide what they think the cost of funds and the risks are.

168. Mr Hogg, let us take the opportunity of this afternoon's session to get these figures on the record. What are those two discount rates today to which you referred, in terms of numbers?

(Sir Christopher Bland) I think they are about 6 and 8 per cent. That is the test discount rate for assessing net present values, is that not right?

(Mr Hogg) They vary from project to project. So far as the public sector discount rate is concerned—

(Sir Christopher Bland) We are simply talking about the public sector discount rate to arrive at net present value, I think. I will check that, but I think they are 6 and 8 per cent.

169. They are extremely low.

(Sir Christopher Bland) But that is because the cost of public borrowing is low.

170. You do not feel the differential discount rate should be employed according to your judgmental assessment of the inherent risk of the activity?

(Sir Christopher Bland) I do not think so.

171. You do not think so, but you are not quite definite about it.

(Sir Christopher Bland) Absolutely, I am. I am being polite. I am absolutely definite: no, they should not be.

Chairman

172. Finally, is PFI expenditure additional or substitutional?

(Sir Christopher Bland) I hope you will ask the Treasury that question as well.

173. We have.

(Sir Christopher Bland) My answer would be it all depends. Additional to what? It is plainly additional to zero. Will it result in more capital expenditure, more capital assets and services being acquired than would otherwise be the case? I think that is pretty clear. Is there an element of substitution? I think that will depend on individual departmental profiles. I would guess that the overall answer is that in any circumstances and under any Government PFI will be used increasingly, and because of its efficiencies will generate the ability to create more capital assets. If you spend money on NIRS 2 and save something like 20 per cent, over many hundreds of millions of pounds over ten years, plainly you have created the ability to spend additional money in other ways. What you do with that is a political decision but it is clear that it offers the opportunity for additionality.

Chairman

174. Sir Christopher, Mr Hogg, may I thank you for joining the Committee this afternoon, and, Sir Christopher, may I congratulate you on your appointment as Chairman of the Governors of the BBC and wish you well in your new post?

(Sir Christopher Bland) Thank you, Chairman.

Memorandum submitted by Coopers & Lybrand

EXECUTIVE SUMMARY

1. Our overall view is that private finance can make a significant contribution to reviewing and strengthening the UK's infrastructure, but that both public and private participants need to undertake a significant learning process, and that changes are needed in the organisation and monitoring of the procurement process to ensure that the full potential of private sector involvement is realised.

THE EVALUATION OF PFI PROJECTS

2. We think it is essential that PFI projects should be rigorously appraised. A number of different viewpoints must be taken into account—social, macro-economic,—the public sector and the bidder—before final decisions are taken. Any appraisal must evaluate all the risks involved in the project taking into account that the quantum of risk is not independent of who bears and manages it and that, for evaluation purposes, an individual project will be interconnected with other existing or planned projects in

*17 January 1996]**[Continued]*

the same sector or geographic region. Once these factors are taken into account, techniques are available to help in the appraisal.

3. Value for money in PFI projects comes from a number of sources, which may be summarised as better management over the whole life of the project. Competitive tendering can make an important contribution to securing VFM but often the test is a comparison against the equivalent public sector option. That approach is acceptable so long as Treasury are prepared to tell bidders what basis they will use for the comparison. Where there is no realistic public sector comparator, a thorough social cost/benefit analysis is required. Disclosure of the public sector option cost to potential bidders may be appropriate in some circumstances, and guidance is required as to when this might, or might not, be the case. Similarly, civil servants need direction on approved methodologies for pricing project risks to enable them to carry out a more systematic evaluation and make better informed VFM decisions.

4. Experience suggests that certain characteristics make it more likely that a potential PFI project will be successful. In order to minimise the time spent pursuing projects which are obviously unsuitable for PFI, it would be helpful to publish indicative favourable and non-favourable pre-conditions.

THE EFFICACY OF PFI

5. The criticism of PFI, that it is merely a form of "off-balance sheet finance", can be refuted if the PFI, as an initiative, is managed properly and the financial impact monitored both individually and in the aggregate.

6. A second criticism of PFI, that risk transfer will lead to increased costs to the public sector, is countered by the fact that cost falls where risk is allocated to the party who can best manage it. The key is to find the optimum degree of risk transfer that can be done at the best price. In this context "more" risk transfer is not necessarily "better".

7. So far, the impact of the PFI on investment levels has been limited in practice. If current plans outlined in the Red Book are realised, future PFI capital spending will make a worthwhile, but relatively modest, net contribution to overall UK capital investment over the next three years. Current restrictions on public spending suggest that it is unlikely that the majority of planned projects will go ahead without private financing, making it all the more essential that barriers to PFI are removed quickly to enable private finance to meet the evident need for infrastructure investment.

ISSUES INVOLVED IN ENHANCING THE EFFICACY OF PFI

8. In our view, the reasons PFI has not yet delivered as fully as it might are more to do with the learning process required on all sides and the need for new vehicles and ways of doing things, than with fundamental weaknesses in the concept of involving the private sector. Suggested actions which would increase the pace of development are:

- further significant investment in staff training and development of the PFI "centres of excellence" in major spending departments;
- guidance to civil servants to clarify their responsibilities in making decisions on acceptable PFI deals and to encourage responsible risktaking;
- the encouragement of investment in PFI projects through, among others, permission to change stake-holding levels;
- clarification of specific legal and tax rules governing PFI issues in advance of finalisation of contracts;
- review and amendment of revenue controls to encourage Local Authorities to undertake PFI projects; and
- streamlining of the bidding procedure to minimise costs and sharing of good practice across the public sector.

CONCLUSION

9. We do not think the issues covered above are insuperable, but they will have to be tackled seriously if PFI is to work properly.

1. We are grateful for the invitation to submit evidence, and hope the Committee will find our observations useful in its deliberations.

2. Having regard to the list of matters which the Committee will be examining contained in the Clerk's letter to us of 15 December 1995, we have set out our observations as follows:

17 January 1996]

[Continued

- *The evaluation of PFI projects*, including techniques of investment appraisal, how value for money is measured and situations for which PFI is suitable
- *The efficacy of PFI*, both in concept and in practice to date, including processes and procedures and the overall impact on investment levels and revenue implications
- *Issues involved in enhancing the efficacy of PFI*, so that its potential can be more fully realised.

3. Our overall view is that private finance can make a significant contribution to renewing and strengthening the UK's infrastructure so as to secure for the country a higher volume of improved public services. However, as a radical departure from traditional public procurement methods, PFI requires both public and private participants to undertake a significant learning process. Changes will be necessary in the way the whole procurement process is organised and monitored if the full potential of private sector involvement is to be realised.

THE EVALUATION OF PFI PROJECTS

Investment appraisal techniques

4. We think it is essential that PFI projects should be rigorously appraised. However, many mistakes in investment appraisal arise from a failure to appreciate that the results—and, to an extent, the techniques—will be different depending on the viewpoint from which the appraisal is being conducted. This is especially true for PFI projects where, by definition, there are several different viewpoints to be considered.

- (a) *the social viewpoint*—seeking to answer the question whether the project will deliver benefits for the nation in excess of the resources it consumes and the external costs it imposes. Almost inevitably, some political judgement enters into this type of appraisal although much can, and should, be objectively quantified;
- (b) *the viewpoint of macro-economic management*—which, in principle, can be captured by the analysis in (a) above but which, for clarity, is better dealt with separately;
- (c) *the viewpoint of the sponsoring public body*—which can be different from (a) and (b) above because of the way scarce resources are allocated across public bodies and through time, and because of the impact of specific public expenditure rules (as well as the view of public sector management);
- (d) *the viewpoint(s) of the private sector bidder(s)*—which will focus primarily (but not exclusively) on financial costs and returns borne or received by the bidder(s) themselves.

5. Two other issues are important in this connection with particular implications for PFI projects.

- First, any full investment appraisal requires an evaluation of the risk. But the “amount” of risk is not independent of who bears and manages what risks. For instance, an issue regarded as high risk for one party (eg construction cost or delay to a public sector buyer) may be routine to others (contractors). The essential thing is that the risks are appropriately allocated.
- Second, the value—social or financial—of many projects is not independent of what other projects are or are not undertaken, now or in the future. For example, the value of a hospital in a particular location will depend on what other hospitals or healthcare facilities are available nearby.

6. Sound investment appraisal techniques have been available for many years but their mechanical application is likely to lead to mistakes. The multiple viewpoints which are involved explain why the different parties arrive at different answers in their investment appraisal, but careful scrutiny from each relevant viewpoint is essential before decisions are finalised.

How value for money is measured

7. Value for money (“VFM”) on PFI projects comes from a number of sources, which may be summarised as better management over the whole life of the project.

8. Competitive tendering can make an important contribution to securing VFM. However, in most cases, Treasury officials will also wish to test the PFI solution against the traditional procurement route to demonstrate that better VFM has been secured. This “public sector comparator” is not used in every case and we consider it would be helpful for the Treasury to say early in any PFI procurement process what the basis of the value for money assessment will be.

17 January 1996]

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9. In some cases there will be no realistic public sector comparator—either because the project intrinsically requires the combination of public and private resources (eg where a facility is to have multiple uses) or because there is no realistic chance of public funding being available. In these cases, demonstrating VFM to the public sector depends crucially on a thorough social cost/benefit analysis.

10. A further question is whether or not the public sector should reveal the cost of the public sector option to potential bidders. Such disclosure would identify more quickly any projects where the private sector cannot offer better value for money and reduce the risk of unproductive bidding and related costs. The opposing argument is that disclosure would result in bids which aim to beat the comparator but do not maximise savings although this may be countered, to some extent, by the impact on pricing of competitive pressures.

11. We have encountered a presumption within the public sector against disclosure of the public sector option. We consider that this complex decision will depend on the individual circumstances of each case and a presumption against disclosure ought to be replaced by more open guidance as to the circumstances in which it might, or might not, be appropriate.

12. There is also a technical issue on the costing of the public sector comparator where further work is needed. Under PFI, risk should be apportioned between the public and private sector according to where it can best be managed. However, there is no agreed methodology for valuing the transferred risks when it comes to assessing value for money against the exchequer-funded option. Several generally accepted risk pricing methodologies are available which can be applied to PFI projects. Guidance on approved methodologies would help public sector participants undertake this work on a systematic basis and thus to make better informed VFM decisions. We are currently assisting the NHS Executive to develop such guidance specifically for IT projects under the PFI. We suggest that similar sector-specific guidance should be developed across the board.

Situations for which PFI is suitable

13. There is now a reasonably well developed understanding of when PFI is likely to yield value for money to the public sector and when it is not. The table below sets out a set of favourable and unfavourable pre-conditions for PFI projects, although none would, of themselves, guarantee success or failure:

FAVOURABLE	UNFAVOURABLE
Scope for additional/alternative uses	Limited additional/alternative uses
Output driven	Asset rather than service driven
Scope for innovation in design	Design solution fixed
Substantial operating content	Minimal operating content
Surplus assets intrinsic to transaction	Any surplus assets wholly separable
Long contract term	Short contract term
Committed public sector management support	Lack of high level public sector management
Political sensitivities manageable	High political sensitivity (eg clinical services in the NHS)
Risks primarily commercial in nature	Risks mainly political/regulatory
Substantial deals (though mega-projects have their own difficulties)	Small projects

14. The requirement introduced in the 1994 Budget that all Central Government capital projects must be tested for PFI has been heavily criticised by the private sector. In our view, this was a necessary pre-condition to demonstrate that Government was serious about PFI and was the only realistic way of getting started. However, there is now a risk that unnecessary time and effort may be wasted by pursuing projects that are palpably unsuitable for PFI. Guidance on this issue (based on something akin to the table above) is needed as soon as possible.

THE EFFICACY OF PFI

15. We wish to comment on the efficacy of PFI as a concept, as well as performance to date in practice.

17 January 1996]

[Continued]

Off-balance sheet finance

16. The concept of PFI has been attacked on the basis that it is merely a form of "off-balance sheet finance", which in the long run will prove more expensive and potentially will create unsustainable levels of revenue expenditure. We think this attack is misguided if PFI is handled properly.

17. First, for an open economy with under-utilised resources (i.e. the UK), the supply of investible funds is not independent of the nature and scale of investment opportunities available. If the PFI can be managed in such a way as to increase both the opportunities and the supply of funds, as we believe it can, then the economy will benefit and the charge that it is merely a form of "off-balance sheet finance" can be refuted.

18. Second, certain (but not all) PFI projects imply a stream of public sector revenue expenditure. These *do* need to be monitored individually and in aggregate. The fact that this is not currently done as a routine is an omission which should be remedied. In monitoring the build up of public revenue expenditure implications in the aggregate, account must be taken of the higher levels of income implied by increased activity, and/or the release of public capital expenditure for other purposes, although in practice this will be problematic.

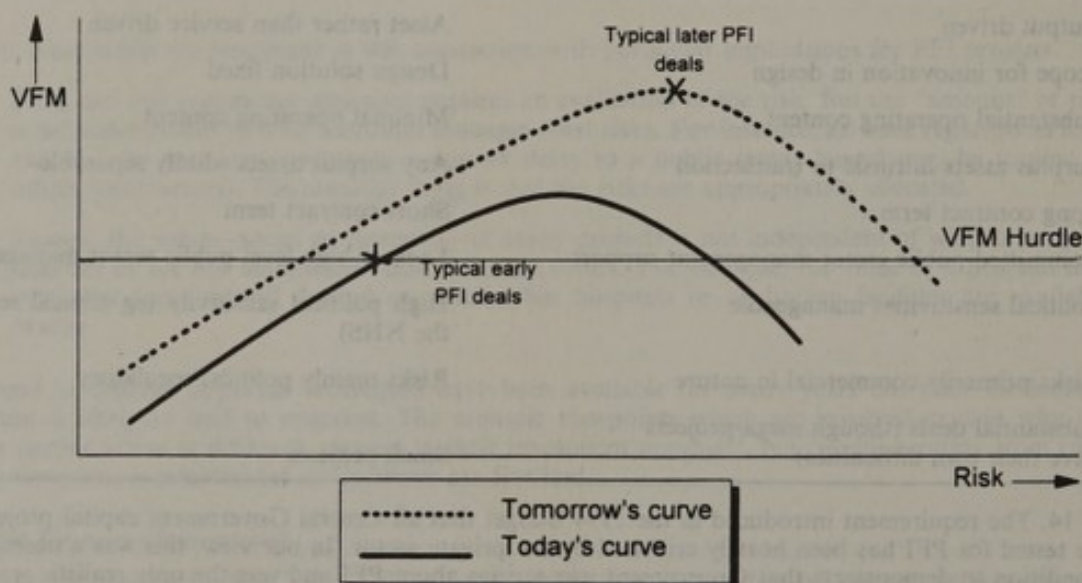
Risk and value for money

19. The concept of PFI has also been attacked because as substantial risk is transferred to the private sector, the price rises to the point where a public sector comparator is cheaper, i.e. the project fails the "value for money" hurdle. Again, we think this is a mistaken view, based on a crude assumption that the "more" risk transferred the "better". We offer diagram (A) in illustration of this point.

20. As risk is transferred to the private sector, value for money rises so long as the private sector is taking on risks with which it is familiar and which it is better able to manage than its public sector counterparts. However, the rise does not go on indefinitely. There comes a point where the private sector may be asked to take on risks which it cannot control, and which it is less able to handle than the public sector. Although such levels of risk may be accepted, they will be priced at a level which represents poor value for money for the public sector.

Diagram A

RISK TRANSFER AND VALUE FOR MONEY



21. The key is to find the optimum position on the risk-reward curve where the best deal in terms of risk transfer can be done at the best price. The slow progress to date suggests that it is not possible to achieve that optimum position in early deals and that it may be necessary to begin lower down the risk transfer curve to build up a body of experience. Hopefully, as the private sector becomes familiar with previously unfamiliar risks, it will become possible to move further up the risk curve towards the

17 January 1996]

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optimum point. A successful track record will also help to drive down the price of some risks, so that value for money to the public sector for any given level of risk transfer will also rise over time.

IMPACT ON INVESTMENT LEVELS

22. So far, the impact of the PFI has been limited in practice. According to the Red Book (Table 6.4) there has only been around £1 billion of capital expenditure under the PFI in the three years to 1995/96. This is less than 2 per cent of total public sector capital spending over the same period and only around 0.4 per cent of total UK investment.

23. Looking ahead, the same Red Book table indicates total PFI capital spending of around £7 billion over the next three financial years, representing around 12 per cent of total public sector capital spending and perhaps around 2 per cent of total UK capital investment over the period. This is expected to increase further in later years.

24. If these plans are realised, this will represent a significant level of PFI activity from the perspective of contractors and individual government departments. At the macroeconomic level, however, £2–3 billion is well within the margin of error in forecasts of total UK investment spending so its impact should not be overstated.

25. However, the key question is whether this is additional spending or just a change in financing of investment that would have occurred anyway. No hard figures are available on this split, but the discussion in the Red Book (paras 6.15 to 6.19) might be interpreted as indicating that the government views the drop in public sector financed capital spending as being due to a switch to PFI projects. Certainly, gross publicly-sponsored capital spending, including the PFI, is only projected to remain constant in cash terms between 1995/96 and 1998/99. This represents a fall of 8 per cent in real terms (and an even greater fall as a proportion of GDP) although from a relatively high level compared to the average of the 1980s.

26. Overall, the figures in the Red Book (assuming these plans are achieved) suggest that the PFI will make a worthwhile, but relatively modest, net contribution to overall UK capital investment over the next three years. Realistically, given other current pressures on public spending, if the majority of these projects do not go ahead as PFI projects then they will not go ahead at all. The depressed state of the UK construction industry at present, and the evident need for investment in some areas of our national infrastructure (eg railways, social housing) highlight the importance of removing the remaining barriers to the PFI and targeting new initiatives on areas where private finance will be additional to existing capital spending plans.

ISSUES INVOLVED IN ENHANCING THE EFFICACY OF PFI

27. In our view, the reasons PFI has not yet delivered as fully as it might are to do with the time taken to undergo the learning process on all sides and to put in place new vehicles and ways of doing things, not with fundamental weaknesses in the concept of involving the private sector. Specifically we would point to:

- over-enthusiastic risk transfer at the early stages;
- the need for new skills in the public sector;
- the need to grapple with difficult issues of public accountability;
- the need for new funding vehicles;
- the need for new or clearer rules in some situations;
- the need to streamline bidding procedures.

Over enthusiastic risk transfer at the early stages

28. As Diagram A above explains, value for money can only be achieved with an appropriate allocation of risk between the parties. In the early stages of PFI there was a mismatch between the risks which the public sector wanted to transfer out and those which the private sector were willing to accept. The public sector were looking for maximum risk transfer, while the private sector were willing to take on public projects but only where the risks were underwritten by Government. This caused immense frustration on both sides and delays in negotiating early deals.

29. More recently, it has become accepted that risks should be allocated where they can be best managed, and "risk sharing" is more in evidence both in language and practice. However, it is important that the lessons learnt from negotiating early deals are disseminated throughout the public sector, particularly to Departments lower on the PFI learning curve, to enable the negotiating process to be streamlined and costs reduced.

*17 January 1996]**[Continued]**The need for new skills in the public sector*

30. PFI contracts are complex, and their negotiation requires specialist skills on both sides of the negotiating table. Such skilled resources are in limited supply across the economy, in both the private and the public sector. However, we are particularly concerned about the lack of deal-making skills within the Civil Service. In the short term there may be little alternative to buying-in these skills from outside but this is not a long term solution. Further significant investment in staff training and development of the PFI "centres of excellence" in major spending departments may progressively fill the gap, but this will only be effective if there is sufficient input of skills, and culture and strong sponsorship from the top of the Department.

The need to grapple with difficult issues of public accountability

31. Additional training is not the whole answer and the issue of public accountability must be addressed if the current level of activity is to be turned into a flow of deals. The decision about whether a PFI solution is acceptable or not is based on two tests—value for money and risk transfer—which are both difficult to measure and applied subjectively. There are no set rules and all the circumstances of the transaction must be taken into account in determining the right balance between the two. Any decisions are open to later challenge by a myriad of watchdog bodies—the Public Accounts Committee, the National Audit Office or the Audit Commission—all of whom can use the benefit of 20:20 hindsight to help determine whether the decision was the right one or not.

32. This psychological barrier for our public servants, and the effort that will be required to overcome it, should not be underestimated. Our civil servants are understandably hesitant to sacrifice their careers on the altar of pushing the boundaries of acceptability on PFI, and steps need to be taken to clarify their responsibilities in this regard to produce an environment in which risk-taking is more acceptable in appropriate circumstances.

The need for new funding vehicles

33. Typically, PFI financing packages are currently being assembled on a project by project basis, usually with a substantial fixed interest element. Yet the nature of the projects, the time periods over which they will be operational and the transfer of risk to the private sector all argue for a significant equity component. To date, equity has too often been seen by project financiers as a potential exit route for lenders at the end of the construction phase rather than as an up front, long term investment alternative.

34. One of the problems is that none of the parties presently directly involved in PFI projects have the financial capacity to absorb the equity financing needs. Alternative sources of long term equity capital are needed and, in the UK, the obvious source of funds on this scale are the institutional shareholders. It is encouraging to note the establishment of the first equity infrastructure fund which will provide a route for institutions to invest in potentially high return projects while reducing project appraisal costs and spreading the risk across a number of projects. In time, these funds could also offer a secondary market in the underlying investments.

35. We do not consider that there is a direct role for Government in financially supporting the establishment of these funds. Their growth will, and should, depend on the successful growth of PFI projects requiring funding. The contribution which Government can make is to take steps to ensure that the initiative works to its potential.

36. In addition, many early contracts contained a prohibition on changes in ownership, or control, of the corporate vehicle established to undertake the PFI project. This was driven by the public sector's understandable desire for continuity among the partners involved in such long-term arrangements. However, it will be necessary to permit changes in percentage holdings to encourage recycling of equity or third party involvement. For example, those best equipped to handle the construction phase of a project may wish to take a large stake during the construction phase but to reduce their holdings when it is completed in favour of the operators who will take the project through the concession. This will release the contractors' equity to move on to other projects and increase the incentives for efficient operation to the long term operator.

The need for new or clearer rules in some situations (especially in local government)

37. The PFI procurement process, being new, gives rise to situations where the governing law was formulated before PFI was envisaged. As a result, the impact of the law on the deal is often unclear. Good legal advisers are essential in each negotiation but, where a similar issue arises repeatedly, there is a danger that the same legal enquiries are undertaken by several different parties, increasing the overall costs of deals. For instance, the issue of the "vires" of NHS Trusts to contract with the private sector was investigated by several different sets of participants each of whom paid for a legal opinion. Where possible, clarification of particular problem areas should be issued by the sponsoring public sector body in advance of the negotiations.

17 January 1996]

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38. There is a particular need for more clarity in the application of the tax regime to PFI projects. The Inland Revenue appears unwilling to provide guidance on, for example, the eligibility of spending for capital allowances, before the final signed contract is available, by which time it is too late to reassess the pricing structure. In these circumstances the logical approach for bidders is to assume for pricing purposes that no tax allowances will be available. This could kill off some projects which might otherwise be viable, or, if allowances are in fact available, mean that the public sector pays more for services that it needs to. It would be helpful if the Revenue could provide indicative or conditional opinions in advance of final negotiations.

39. Local Authorities have been very slow to take up PFI. In our view there are very substantial opportunities to bring PFI into the Local Authority arena and authorities themselves appear to be increasingly interested in so doing. Progress to date has been slow because the financial regime governing Local Authorities is loaded against PFI, specifically through the controls on revenue expenditure. Recent relaxation of the financing rules relate largely to capital expenditure controls and the issue of the impact of restrictions on revenue spending on the ability of Authorities to undertake PFI projects needs to be resolved.

The need to streamline bidding procedures

40. The construction industry, in particular, has been critical of the costs of bidding for PFI contracts and the bureaucracy of the bidding procedures which they see as driving up costs. The growing body of experience should lead to reduced costs—but only if the lessons learnt in one area are disseminated to others. A particular problem area is the incidence of non-compliant bids which could be minimised with better defined specifications and more clearly identified evaluation criteria. Examples of good practice exist but these must be distributed so that all can benefit.

CONCLUSION

41. We do not think the issues covered above are insuperable, but they will have to be tackled seriously if PFI is to work properly.

January 1996

Examination of Witnesses

MR STANLEY WEBSTER and MR ANDREW JORDAN, Senior Partners, Coopers & Lybrand, examined.

Chairman

175. Mr Webster and Mr Jordan, thank you very much indeed for joining the Committee this afternoon. I believe I am right in saying that so far investment under PFI has been modest. To what extent does this reflect a reluctance of the private sector to become involved in projects, do you feel?

(Mr Webster) I do not think it reflects a reluctance. I think it reflects the very real difficulties of learning to procure by a very different route from what has been traditionally done.

176. The Treasury has published projections showing a rapid increase in the amount of investment in PFI. Do you think these expectations will be fulfilled?

(Mr Webster) I do not know. I think there are still some quite real difficulties to overcome, but there is no doubt that there is a very considerable number of projects in the pipeline which could result in quite a flood coming through fairly quickly.

177. If you had to highlight the more important of those difficulties, what would you choose?

(Mr Webster) I think, first of all, look at the public sector's need to learn. There are difficulties in terms of the abilities of units in some depart-

ments. I was interested to hear what Sir Christopher said about the importance of strong private finance units in departments and I would endorse that, but they are not by any means universal right now. I think there are some very genuine problems of public accountability when you ask civil servants to go into deal-making and negotiating, taking risks, which, if we are going to make the Private Finance Initiative or anything like it work, have to be tackled. I think those are exceedingly difficult issues. I think there are some regulatory and public sector rules that probably do get in the way and could do with another look. There is a whole list of things but I think the issue of public accountability is quite a difficult one.

Mr Carrington

178. What is your assessment of the reality of risk transfer? Does it actually happen or is the PFI really a financing vehicle rather than a risk transfer vehicle?

(Mr Webster) I will ask my colleague to add to my answer on this but my assessment is that it is entirely possible for it to be a real risk transfer. It ought to be, which is not the same as saying that all the risk ought to be transferred. Some risks plainly should not be transferred and would only

17 January 1996]

MR STANLEY WEBSTER and MR ANDREW JORDAN

[Continued]

[Mr Carrington Contd]

be accepted by the private sector at a ludicrous price.

(Mr Jordan) Mr Carrington, I think there has been some risk transfer so far. There could be more. One of the things that makes risk transfer easier is if you have a project where, in addition simply to the procurement of the capital construction, there is a significant involvement of the private sector in managing the asset, in maintaining it throughout its life, and to the extent that that is a bigger factor in the overall financial package, you can pass risk across to the private sector. There has not yet been, if you like, a blatant replacement of public sector money by private sector money because of the Treasury rules against that, because, as we have heard already, private sector capital is substantially more expensive than public sector capital. But you do need to go substantially further than simply having a financial lease in order to get proper risk transfer.

179. As I understand risk transfer, there are three elements to it. One is clearly incompetence, that one can transfer the risk of incompetent contracting from the public sector to the private sector, and the one that is always put up, rightly or wrongly, fairly or unfairly, is the British Library contract, which has gone considerably over original estimates, where it was suggested that if that had been done under PFI it would have been done under a fixed-price contract and the contractor would then have gone bankrupt, whereas what has happened is that the public sector has had to pick up the bill. The other two elements, which are actually much more interesting in terms of the normal run of the mill, are one that you have mentioned, which is the continuing management of the project after it has been built, but that is actually not risk transfer, is it? That is a separate type of contract, because what one is saying is that one is entering into two contracts; one is the build contract and one is the management contract, and those can be separable in realistic form, so that the public sector could build the hospital, say, and they could go out to the private sector and say, "What would you do to manage this building?" and those are entirely separable risks. The other risk that is transferred, we are told, is the residual value risk, in other words, that, say, an asset has a life of 20 years and the public sector enters into a contract to use that asset for ten years. That is a much more interesting risk in the sense that one can understand that on some assets, for instance a building which has multifarious uses in a readily accessible location. It could be used either for public service use, say a hospital, a school or whatever, or it could be used as an office or it could be converted into residential or whatever. That is less true with a road. If a road is built, the private sector knows that a road is there at the end of the ten-year or 20-year contract the public sector enters into, the road is still going to have to be used, so that there is no question but that the contract is going to be renewed. It has to be renewed, does it not?

(Mr Jordan) Not necessarily.

180. Because there is no possibility that the public sector is going to be able to build a competing road next-door because of planning constraints?

(Mr Jordan) If you take, for example, the current tranches of DBFO roads—design, build, finance and operate roads—which are being let under PFI, those would typically have a contract length of 30 years and so the private sector knows that, having constructed and maintained this road for 30 years, it is going to have to hand it back in a usable condition to the public sector. The public sector has an option at the end of that 30 years of either receiving the road back into public sector ownership and potentially, therefore, keeping it and maintaining it publicly, or, indeed, reletting the contract. There is no guarantee that would give the private sector player confidence that he would be the incumbent after that 30-year period were up.

181. But that is a financing lease, is it not?

(Mr Jordan) No.

182. Because what one is saying is that at the end one has a road. The private sector is going to look at it for over 30 years, get its capital value back over 30 years profits or whatever, and at the end it is going to be out of it and hand it back to the public sector. There is not going to be any residual value on that road at the end of 30 years?

(Mr Jordan) And even if there were, at discount rates looking thirty years ahead, it would be quite small. No, it is not a financial lease, because you are asking the private sector to take on a potentially significant risk of routine and periodic maintenance of that road.

183. But we have already discussed that there are two separate contracts there: one is the contract which is the leasing of the road in some form and the other one is the contract to maintain the road and the two are separable and differently priced.

(Mr Jordan) But if you separate them completely, you will lose part of the benefit of what PFI is attempting to achieve which is that it is attempting to ask the private sector to take on the provision of the whole solution for the public sector: not separately to build the road and separately to maintain it but, for example, to build it in a way that takes into account the maintenance that is required afterwards. If you talk to a number of contractors involved in road building (and I assume that the Committee will take evidence from them) a number of them will suggest to you that they would prefer to build a road with a greater quality of pavement than would normally be procured under public sector procurement because they, the contractor consortium, would then have the responsibility of maintenance (both routine and periodic) during that contract and they would prefer to take the risk of investing (simplistically) in a tougher road so that they who carry the risks

17 January 1996]

MR STANLEY WEBSTER AND MR ANDREW JORDAN

[Continued]

[Mr Carrington Contd]

throughout the thirty years are able to benefit from that earlier investment. Typically, public sector procurement of that road has not gone to that level of specification.

184. But you are accountants and presumably deal, to some extent, with the Inland Revenue. If I were a private sector company and I said to the private sector "I am going to buy a piece of equipment which I would like to lease, thank you very much, under a financial lease with all the tax advantages that has, as opposed to an operating lease which has different tax implications", if I have a piece of equipment which I want to lease under a financial lease and I said "I am going to lease it to zero residual value but that is all right, it is still a financial lease because the person who is providing it to me is actually going to maintain it for me", they would look at me and they would say "You are off your head, Charlie—this is an operating lease" and they would write straight back into capitalisation of our own balance sheet the value of that equipment, would they not?

(Mr Webster) I am not a tax expert, but under the right circumstances I could see that could happen.

185. But you are still saying that it is a financial lease on a road?

(Mr Jordan) No.

(Mr Webster) No, I think he was saying it was not.

(Mr Jordan) No. A financial lease would, in my view, be simply where you did not pass risk to the private sector beyond the construction and financing risk, and where essentially you were replacing direct public sector procurement of an asset with public money by public sector procurement of the same asset at private sector rates, which would clearly be unacceptable. Indeed, there are very clear Treasury guidelines that prevent PFI schemes going to that end of the spectrum in terms of risk transfer.

186. I accept what you are saying but it sounds to me that, if I was in the private sector, I would have some difficulty in persuading the Inland Revenue of that. It will be interesting to see if anybody tries to use the example of PFI to justify tax write-offs on their own operating leases, because the example is there under the Treasury rules. If I accept what you are saying (and I do) there are no tax implications in this because we are talking about government sector. The principal advantage of a PFI transaction for the government, given that the government borrows money cheaper than the private sector and given that the PFI is for the full economic value of the asset (whatever that may be), or the only advantage to the public sector is the fact that the private sector can manage the asset cheaper than the public sector's financing advantage.

(Mr Webster) No, I do not think that is true. I think for one thing there are a great many different kinds of PFI project that we are talking about, and

in some instances they will be projects that have to be a public/private partnership of some kind in order to happen at all, because some part of the project is in private hands already. The PFI is actually a route for making a project happen that might not otherwise happen at all and might be for public benefit so that might be a case where there would be a very different sort of advantage. I think also the solution one comes up with to the original challenge, the original desire for service, whatever that might be, could be different under a private finance route and the very act of going out to look for innovative solutions might well give a public benefit in addition to the better management point that you make. The linking of the responsibility for construction and for operation and maintenance which my colleague has already alluded to, and which Sir Christopher alluded to, is another potential advantage which gets a better design solution, a better technical solution, to the problem in the first place—maybe a higher standard of road than would otherwise have been built, a more appropriate standard when you look at the whole lifetime cost. I think when you take the totality of the projects and the very different kinds of projects we are looking at under PFI, I would not agree that you can just point to one simple advantage such as you have pointed to.

187. But if you are saying that there is an advantage in design specification, there you are talking about the technical specification of the contract when it is issued. If the public sector said, in taking your example of the road, that what they wanted was a greater depth of foundation of the road when it was built, the public sector could define that and could state that that is what it wants built—thank you very much.

(Mr Webster) It could.

188. And probably should, because if it was costing its project directly, it would say that that would reduce the public sector's maintenance cost and therefore, over time, it would be an advantage.

(Mr Webster) But it might be constrained by short term financial pressures to go for a cheaper road than it ought to be going for.

189. Well quite, but then we are getting down to what the other criticism of the PFI is: that what we have is a way which is saving present day capital cost against greater future cash flows, and that the difference between the future cash flows which would occur if it was public sector expenditure or if it was PFI expenditure is purely down to the question of management. In other words, that the private sector can manage a contract better, and therefore the cash flows in the future will be lower than they would be if the public sector did it, because the contract specifications could be the same and one could specify whether it is public or private sector.

(Mr Webster) The question is whether it would be and whether, under traditional public procurement methods, you actually tap into all the solu-

17 January 1996]

MR STANLEY WEBSTER and MR ANDREW JORDAN

[Continued]

[Mr Carrington Contd]

tions and the thought that is available. The public sector very often does not really have an interest in the asset as such: it has an interest in providing the service and the detailed way in which the service is provided is a matter which can be looked at by many different minds and not just the minds that happen to be currently provided in whatever department of the public sector is charged with the responsibility of providing the service.

190. I do not agree with that. I agree that is one of the elements of what the public sector has to consider. The other one is the cost to the taxpayer.

(Mr Webster) Exactly.

191. And that is what they want to get down.

(Mr Webster) Yes.

192. My next question, and it is really my final question, is: given that a lot of the advantage of PFI comes down to the ability of the private sector to be able to cost, manage and deliver contracts at a cheaper price than the public sector, why is it not possible for the public sector to be able to buy in the expertise to be able to deliver a project at the same price as the private sector?

(Mr Webster) I think my colleague can add on this one but I think the public sector does have to buy in expertise, but expertise of all sorts is in pretty short supply and has a price. I do not think one just assumes that they could go out into the market and buy it in any sensible form.

(Mr Jordan) You need, I think, to take a whole-life approach to the asset, and if the public sector wants a road constructed and run for it for 30 years, you could in theory import the skills to do that, but quite soon they would be out-of-date because you would need to keep dipping back into private sector expertise to ask how contractors really behave, how maintainers and managers of roads actually behave, and I think the public sector would be failing to get the benefits of transferring real risk to the private sector if it did that, because it is not a like for like comparison of the contract for building a road in the public sector and the contract for having a road built and run by the private sector. One is a capital construction contract and the other is a whole-life contract of a consortium that includes the constructor, the maintenance provider and their financiers and, depending on the project, potentially other parties as well.

193. And that would be cheaper than the public sector just employing consultants on an as-required basis? You are talking about employing. Nobody would employ people to do that. They would employ consultants to do it, would they not?

(Mr Jordan) It could be, yes.

Ms Abbott

194. Mr Webster, I am old enough to remember hire purchase and I also remember the prudent housewife avoided hire purchase, because although

it seemed like a very attractive way of buying the fridge or washing machine today which you could not actually afford, in the long run it actually involved you in long-term outflow of cash which could ruin you. I see Sir Peter Kemp in an article in *The Times* last September—and he headed up his article: "Plans to bust Britain"—put the same point in a slightly different way, that the Government should beware of being "seduced by energetic merchant banks fighting for their big up-front fees. In the wrong hands the combination of resource accounting and PFI could be a witches' brew, leading to borrowing off balance sheet and paying dividends out of capital or unrealised gains. That sort of behaviour has sent many a private company into bankruptcy." Could you comment on that?

(Mr Webster) Yes. First of all, I entirely agree—and the point has been made already this afternoon—that any future commitments, the equivalent of your hire purchase payments, do need to be logged and monitored centrally and properly looked at. Secondly, if all you are doing via the PFI is buying your fridge on hire purchase rather than paying cash for it, then I also agree that PFI is not much of an initiative and is not getting us very far. I happen to be very strongly of the opinion, however, that this country desperately needs to refurbish and renew its (for want of a better phrase) social infrastructure and it appears that the cost of doing that is beyond the public sector's appetite for raising cash with which to do it. So as a society I believe we have to seek to tap other sources of finance but to do that in a responsible fashion, not to do it by running up vast hire purchase payments that we cannot afford in the future, but doing it in a way in which genuinely we increase the supply of investable resources, increase the opportunities to invest in this economy, manage and monitor the results of doing that properly and tap into the efficiency gains that I believe can come, not only because I think the private sector can be more efficient in some respects, but also by bringing together public and private assets that, if they are left separate, cannot actually be combined into the sorts of projects that could benefit everybody.

195. My second question refers to something you said very early on. You talked about the problems in relation to PFI and one problem you flagged up was accountability. I notice in evidence that we have had from the National Audit Office they talk about traditionally the importance they have seen in open competition, which is probably problematic in relation to PFI. Could you expand on what you think the problems are with accountability so far?

(Mr Webster) Yes. I will say a couple of things and I think my colleague would probably like to add particularly on the competition point. I think it is genuinely difficult, and I have been in a situation where I have been on both sides of this fence, for someone who has the traditional public sector accountabilities to negotiate in a way in which the private sector is used to negotiating.

17 January 1996]

MR STANLEY WEBSTER AND MR ANDREW JORDAN

[Continued]

[Ms Abbott Contd]

196. Why?

(Mr Webster) Because in order to maintain public accountability one tends to have to account for every aspect, every detail, of what I might call the inputs. This is the reason that public sector tenders tend to be done the way they are, very detailed specification of the inputs that are going in rather than what I would be interested in doing as a businessman, that is, buying the outputs. That, I think, is unhelpful in terms of getting things done. There is also, of course, the perfectly natural fear on the part of civil servants that if they take a risk and it goes wrong they are going to be pilloried by yourselves, by any of a number of investigating bodies subsequently, and why should I, as a responsible civil servant of 25 years' standing or something, take the risk of trying to push out the frontiers of the PFI and then find that my career is laid in ruins by someone looking with the benefit of hindsight three years later? I think that is a genuinely difficult problem that we have to find ways round. I really do.

(Mr Jordan) Let me comment on the competitive procedure. You have mentioned, Ms Abbott, that there are some difficulties in running a competition for a PFI project. I think the bigger the project in some ways the fewer the difficulties are. A typical project competition would involve, first of all, an advertisement in the Official Journal of the European Communities because most of these competitions fall within the category where they are within European procurement directives. A number of potential bidding consortia would then write in to the department involved and they would answer a number of questions in a questionnaire to see whether they would be suitable candidates for pre-qualification. Following pre-qualification, you might get, for example, in a hospital project perhaps a dozen consortia responding to the European Journal advertisement, and then you might pre-qualify perhaps five. Those pre-qualified parties are then invited to tender; they are given an invitation to tender. That is usually a very complex document indeed because it combines all the bits that the public sector is asking the private sector to do. So in the case of a hospital it would be the design and construction of the hospital and it would be the arrangements for the hospital operation, for the waste management, for running the computer systems, everything but the patients essentially.

197. So are you saying there is no problem with the PFI?

(Mr Jordan) I am saying there is a well-defined procedure. I think there are two or three problems I would draw attention to. One is the problem of scale. There is a certain amount that needs to be done, however small the project, and I think one of the ways in which we might push PFI forward more successfully is not to oblige departments to have every single project, however small, tested in the private market. I think it would be possible to have a de minimis level above which you must, as a department, test it and then other incentives for a department to consider whether a project below

that level would be relevant, but not to take every single one slavishly to the private market, because there is great diseconomy of scale in a number of these processes and it is just not worth it for a £5 million ward extension of a hospital. The second problem I draw attention to is the real problem in capturing creativity as against public sector accountability. Let me give you an example. If you have a road project and a constructor, as Sir Christopher mentioned earlier, you would usually get the outline planning approval done by the public sector and then you would invite the private sector to bid. If the constructor comes up with an idea and says "We want to reconfigure this junction, we have got a better idea and we think it would serve the surrounding community better. We think it is better than the one in the public sector plan—will you accept our idea?", there are many examples already where public servants, because of accountability constraints, feel constrained to say "I am sorry, we do not want that piece of creativity, we will stick with what has gone through the planning inspector", and that is a risk resulting from an attitude driven by lack of experience and the fact that they are frightened in a career sense to take too many risks. I think we have got to try and educate people so they are prepared to take reasonable risks to exploit the creativity of these solutions rather than being slavishly obliged to constrain creativity in order to improve the ability to evaluate the schemes.

198. Finally, I am very interested in what sort of projects are suitable for PFI and what sorts of projects are not suitable for PFI. Both political parties are very keen on PFI at the moment. They are a bit like two housewives on HP. The Labour housewife wants to buy on HP because she thinks she can buy a fridge and a washing machine and a vacuum cleaner and the Tory wife wants to buy on HP so she can lie to her husband about how much money she has borrowed! So it is in everybody's interests that you can buy every form of domestic appliance on HP. What sort of projects are suitable for PFI and what are not? We have had some very opaque answers so far this afternoon, but I notice in your evidence there is this really handy table which has "Favourable projects" and "Unfavourable projects" and the criteria which jumped out at me were, under "Favourable", "Substantial deals" (mega projects), "Politically sensitive" (I do not know whether that means you can pull the wool over people like us), "Long contract terms" (in other words, the poor taxpayer is locked up into the millennium to pay you), and the other one which caught my eye was "Surplus assets intrinsic to transaction", (in other words, the possibility of the private sector to asset strip). You would agree that these are the sorts of projects which are suitable.

(Mr Webster) I would not agree with the way you have interpreted our shorthand listing! This was an attempt to get down in very few words some of the, at least, predisposing factors that it seems to us make it worth going down the PFI route. We say "Substantial deals" for the reason

17 January 1996]

MR STANLEY WEBSTER and MR ANDREW JORDAN

[Continued]

[Ms Abbott Contd]

that Mr Jordan has already pointed out concerning significant diseconomies of scale and this new procurement process for very small projects, or certainly at this stage until some more experience has been built up. Let me pick up the point about surplus assets intrinsic to the transaction and any surplus assets wholly separable. The point we are getting at there is if, as a result of this project, there are assets which can then be separately utilised for something else, or sold off or whatever, that does not require a PFI solution to recognise that benefit or to gain that benefit. If, however, there are assets which are in some senses intrinsic to the transaction to make the project happen, (maybe you want to swap two pieces of land, one in private ownership and one in public ownership or something like that), then that is much more likely to be conducive to a PFI deal and again, the long contract term and the short one really is not a question of locking up anybody into the millennium.

(Mr Jordan) Which is only four years away.

199. I can tell you are accountants!

(Mr Webster) It is rather the same point as the economies of scale point and whether it is really worth going through the whole process.

Chairman

200. In your memorandum, you talk about the need for new funding vehicles on your list of issues involved in enhancing PFI, and you refer to what you describe as "equity financing needs" and you list some of those needs as you see them. Are these needs widely recognised by other people? Are the arguments that you are putting forward here novel to you, or is this part of the general debate that is taking place at the moment?

(Mr Webster) I think it is part of the general debate.

(Mr Jordan) We do try to be novel, but in this case I think there are a number of people in the private sector who would agree with this. One of the requirements in a PFI solution is that the people in the private sector side quite clearly have to put up (much of) the money. You can usually get quite good levels of debt into these projects but there is still a need for quite a lot of equity from the private sector and, as we heard earlier, the balance sheets in the United Kingdom in the construction and related industries are not necessarily that strong. While these companies can afford to put some equity into big projects, if they have to start making significant investment into projects that, for them, would have been previously routine public sector procurement, then they are going to run out of balance sheet quite soon, so we think there is a need for funding of the balance sheets of the vehicles, the special purpose consortium vehicles, that take on these projects. We also think there is a need for the refinancing of those balance sheets to recognise the different lengths of interest of the different players in the private sector. The person who builds a hospital has a primary interest in the contract, which will last potentially a couple of years. The waste management company might

be used to five or seven year contracts: the hospital operator perhaps five to ten year contracts. The public sector needs a thirty year solution, so there would be, we think, improvement possibly in the success of PFI where more schemes could emerge for the funding of these projects on the equity side. We do not think this is something the government needs to step in and do. It may well be just a matter of time and experience where the private sector will begin to provide funding. There is limited evidence already of a couple of pension funds who are interested in funding PFI vehicles, but when that really develops into a strong sort of supply PFI will move more quickly, in our view.

201. Broadly speaking, do you feel at the moment that project financiers accept the intellectual argument that alternative sources of long term equity capital are needed? Do they accept the argument you put here, for example, about the role of institutional shareholders?

(Mr Jordan) I think they would, because they are being asked in the United Kingdom to apply schemes of techniques—BOOT techniques, as they are called (Build, Own, Operate, Transfer techniques)—which they have previously applied to very large capital projects. They are being asked to apply them across the whole spectrum of United Kingdom public sector capital procurement: they are being asked to apply them to much more modest projects than previously, and therefore, I think, they would accept the need for equity sources to emerge.

Mr Betts

202. As one of the groups of organisations who have no risk in this whole enterprise are actually accountancy firms—

(Mr Webster) We have our normal risks, as (if you read the press) you will be aware!

203.—presumably you are making quite a lot of money out of this whole venture?

(Mr Webster) Not particularly. Our interest is, of course, in seeing United Kingdom business expand and taking a share of this expansion, so we are interested in anything that we see to be worthwhile, as far as the United Kingdom economy is concerned. It has not been, to date, a particularly lucrative source of fees. It is no more so than any other. It is something we would think is a worthwhile thing for the United Kingdom to learn how to do.

(Mr Jordan) Can I add to that that in a number of situations our clients do not pay us unless the schemes are successful. That is point one. Secondly, there is not much long-term benefit for us as businessmen in our firm being associated with projects that fail. So whilst cynically you might think there are always advisers, this is a paradise for advisers, in reality we need to back the best schemes and we often need to take a risk alongside the other people in consortia in order to get paid. So we are not just looking at it in an altruistic, good for the United Kingdom, sense.

17 January 1996]

MR STANLEY WEBSTER AND MR ANDREW JORDAN

[Continued]

[Mr Betts Contd]

204. Can I take up the issue of risk and take one particular example in terms of apportioning risk on projects, which I certainly am trying to get my head round and cannot come to an answer for, and it is this problem about changes of Government policy or changes of demographic factors, these sorts of issues which are very difficult to apply to a private sector organisation. Say a private sector organisation is contracted to build and run a hospital and to provide all the services associated with that—the maintenance of the building, the provision of heating, the provision of cleaning and that sort of thing. That may be contracted for on a 20-year or 30-year basis typically, according to the documents we have seen. During that period it is quite possible that either there will be a change of Government policy, which means that fewer of those sorts of hospital are required, or there will be a population shift, so that fewer people in the area will actually be around to need the hospital service. You could say if the public sector built the hospital they still have the building, which is true, and they still have to pay for the costs of providing that building, which again is true. Presumably with a 20- or 30-year contract for providing a building and the related services, you are tied in to the private sector providing a clean building, even though people will not be in part of it possibly, a heated building, because they will be in part of it, a maintained building because maintenance might be necessary in some cases, but the public sector will have to carry on paying because you cannot actually get the private sector to pick up some of those risks unless there is a change of Government policy or a shift in demographic factors, can you?

(Mr Webster) You can, in some instances.

205. And the private sector are willing to do that, are they? They always complain to us of that.

(Mr Webster) In any negotiation people will try and minimise their own risks, that is certainly true, and it has been difficult to get people to take some of the risks that are particularly long-term and also are out of their control in terms of demographic shifts and the like. I think in individual instances a lot will depend on the assessment that the private sector makes of the alternative uses and how it could cope if things went wrong with the specific kind of risks that it had contracted to take. But the whole essence of risk transfer is actually getting it into the hands of people who can manage it better. If nobody can actually manage it better one way or t'other, then there is not much point in transferring it. If it is something that is beyond the control of the private sector and beyond the control of the public sector, then there is no *prima facie* case for saying either of them should bear it. It is a straightforward negotiation.

206. In that case either the private sector are going to carry on being paid for a service that might no longer be required if the Government takes a certain policy, or if the private sector do not require an automatic payment, are prepared to take some of that risk, they are going to put a lot

of cost into that contract for taking the risk on board, are they not?

(Mr Webster) Yes, of course, and there is no point in transferring that risk to them unless they can actually handle it better than the public sector can handle it.

207. So there may be cases where the private sector get paid for providing a service that is no longer needed in that scenario?

(Mr Webster) If the contract is wrong, it could happen, but the whole essence of trying to get these contracts right in the first place is that you do not do that.

208. Can I touch on one other aspect and that is the comments in the information you provided to us, the memorandum. You talk about the totality of the PFI, I think both in paragraph 18, where you talk about the need to monitor projects not just individually but also in aggregate and looking at future public revenue implications, and later on you talk about the Red Book figures, the fact that really the pressures on public spending are such that schemes are going to be forced down the PFI route because that is the only way they are going to get off the ground. Do you see any problem with Government accountancy in the way it is done and the fact that PFI projects, as Ms Abbott said, are really a bit like hire purchase in the sense of "gain your benefit now and pay later for it. Get something now but you have to pay for it probably in two or three years' time"?

(Mr Webster) It is more a question of paying for the benefits when you get them rather than—

209. There is a different way of accounting for it in a way which is likely to drive government departments into using the PFI because it means that they do not have to pay in the current or the next financial year; they can postpone the cost till later on?

(Mr Webster) I agree entirely with what Sir Christopher Bland was saying earlier about the need to monitor the revenue implications of what you are doing, and I agree that it is inadequately done at the moment. It is not sufficiently transparent.

210. So you need a change of Government accountancy systems?

(Mr Webster) I do not think it is a very big change. As was said, the information is there in the contracts that are being entered into. It is a question of collating that information and pulling it together and being able to see it stretching out into the future.

211. But is it not more than that? If you collate the information there is surely still a built-in incentive for anyone working within a given budget to take the option which postpones the cost. That is their business. It may not be a real cost but it is a cost in terms of the cash in their budget, because the scheme will not show in the budgets until two

17 January 1996]

MR STANLEY WEBSTER and MR ANDREW JORDAN

[Continued]

[Mr Betts Contd]

or three years pass. You can put it down as a cost entered into for the future but it does not actually appear. You do not have to pay for it in the budget this year. Is that not a problem when schemes are treated so differently?

(Mr Webster) Yes. Let us not disagree on this because I do feel that there is a danger, which has already been alluded to, if we do not actually monitor the liabilities that are being stacked up. I am just saying that I do not think it is a terribly difficult thing to do.

212. You would agree with Sir Christopher when he talked about the need to go into an accruals accounting system?

(Mr Webster) I do agree with him, yes.

(Mr Jordan) If you are buying a fridge, TV and a washing machine over a two- or three-year period, if you add up both the cost of buying it for the ones you buy and the cost of hire purchasing it for the ones you hire purchase, then you are going to make the better decision as to which to do for each one if you take all of that into account. If you are looking each year at a combination of revenue and capital items, you are going to make the better decision. That is what we are saying, and focusing just on capital or just on revenue gives you a distorted picture.

213. So we have to move away from the simplistic cash flows on which things are done at present?

(Mr Jordan) Yes.

Mr Timms

214. Can I put two questions quite briefly. The first question goes back to your favourable/unfavourable list that you were speaking about earlier, and it is a question I put to Sir Christopher. I suggested to him that perhaps projects which are particularly well suited to PFI treatment were those where a revenue stream is created as a result of the investment in the asset, whatever it might be. Would you agree with that? Should that be on the list? Is it perhaps in the air implicitly already?

(Mr Webster) I agree that it can be helpful but what I would not want to do is to suggest that that should limit the PFI as a possibility. That is in a sense why it is not on that list because there are, I think, a number of examples one could give of socially well worthwhile projects which would not actually produce a revenue stream but which could be done under a PFI solution to everyone's benefit. So I would not want to limit the applicability of the PFI simply to things you could charge a price for in the market.

215. Can you give an example of the kind of thing where PFI might be particularly well suited where there is no revenue?

(Mr Jordan) I can give you an example. You might want to construct a road and you might take the view that, being uncertain as to the future road network in that area for two or three decades, you did not want to impose tolls on it, you want

instead to impose shadow tolls, so that the private sector receive revenue not from cars and lorries using the road but from the Department of Transport because the road was provided, but that does not make the road any less socially necessary, the fact that that method was chosen.

216. What are the advantages of shadow tolls on the PFI route?

(Mr Jordan) In that particular instance you would not distort the potential movement of traffic in that region by imposing tolls. You would simply record the use of the road and reward the private sector directly with a payment from the Department of Transport, or on behalf of the Department of Transport, for that road. If you put tolls on the road, have a tolled motorway, for example, then there will be some behavioural change in motorists, both commercial and private, and they will start finding other ways of driving from A to B to avoid using that road.

217. Why is it better to do that by the PFI route than it would be to have a conventional public sector investment in that piece of road? What are the benefits to the public sector from the PFI route?

(Mr Jordan) For the reasons we described earlier, that by taking a whole life solution, or a whole life approach to a road, you might get a combination of better value for money and some risk transfer. You might not. It has got to be a properly structured project, otherwise PFI is not the right solution.

218. Finally, your diagram A about risk transfer and value for money showing that there is an optimum risk transfer and if you go beyond that you might actually have less value for money is rather similar to something in the Treasury hand book. This question reflects my ignorance, but is there any comprehensive literature somewhere about the theory of risk and risk transfer, or are these diagrams simply a reflection of a common sense type view on how this all works?

(Mr Webster) There is quite a lot of literature on the whole issue, not in perhaps the context that we are currently talking —

219. Which context is it, and is there literature on it at the moment?

(Mr Webster) There is a tremendous amount of economics literature on the subject of risk in general and how you look at it and so on and so forth. It is also approached by other professions. I happen to be a statistician originally by profession and obviously there is a lot of material there, but risk transfer in this kind of context is something that people have really started to think about since the ideas of builder and operator schemes which pre-date by maybe five or ten years the PFI, but commercially we have been looking at this kind of thing for some long time. It is common sense at the end of the day—like most things are.

17 January 1996]

MR STANLEY WEBSTER AND MR ANDREW JORDAN

[Continued]

Chairman

220. I have only one further question, if I may, and that is this: again, in your paper, you talk about the need for new or clearer rules in some situations, and then you refer in particular to local government. You say that local authorities have been very slow to take up PFI. Is the government sympathetic to the argument that you advance here that there is a need to relax restrictions on revenue spending?

(Mr Webster) I do not know, is the honest answer to that. I have had various conversations that suggest that there may be some degree of sympathy and there has been some degree of movement in the direction of relaxation, but precisely the point that Ms Abbot has already made is actually the critical point in the whole government situ-

ation. People are terribly afraid if the cap comes off revenue expenditure. The problem is of course, under the local government rules, if revenue expenditure is capped. The fact that you can do something on the capital side does not necessarily help you very much if the project concerned is going to require revenue expenditure later, and people are, and have been, terribly concerned that if you lift that cap, all kinds of things will go rushing out. So it is a very tricky one to resolve. I believe it can be done.

221. On the theme that where there is a will, there is a way, but it requires political will, is that what you are saying?

(Mr Webster) Yes.

Chairman: Thank you both very much indeed for joining us this afternoon.

MONDAY 22 JANUARY 1996

Members present:

(In the absence of the Chairman, Mr Forman was called to the Chair)

Ms Diane Abbott

Mr Clive Betts

Mr Matthew Carrington

Mr Nigel Forman

Mr Stephen Timms

Examination of Witnesses

DR STEPHEN GLAISTER, London School of Economics, examined.

Mr Forman

222. Dr Glaister, it is very nice to have you with us this afternoon. We are going to aim to be as succinct and to the point as we can in our questioning of you. For the benefit of me and other Members of the Committee, could you begin perhaps by telling us a little about your experience and involvement with PFI work and the areas of expertise that you would claim?

(Dr Stephen Glaister) Good afternoon, Mr Forman. I am a reader in economic geography at the London School of Economics and I specialise in transport economics. Over the years I have done a fair amount of consultancy work for the Department of Transport. I was a member, part-time, of the London Transport Board for nine years until the middle of 1993 and so I was involved with the London Bus Tendering Exercise quite closely. Apart from that, I have worked for the Transport Select Committee on their roads inquiries and other pieces of consultancy of that kind.

223. We are very grateful obviously to you for coming to give evidence to the Committee. We are aware of the fact, from our previous questioning, that the PFI seems to have made considerable strides in the sector of transport as compared with other sectors. What are the main reasons for that, in your view?

(Dr Stephen Glaister) Well, the transport sector is one where the demand for the service tends to grow more or less in line with economic activity, so there is typically a buoyant demand for the service and one sees that over the years with the Underground, with bus services and particularly with the roads sector where there is a need for new investment and a fairly clear case that these are justified investments and there is a need for them. At the same time I suppose that the traditional public sector methods of funding have come up rather hard against public expenditure constraints and so there has been a particularly strong tension there and an incentive to get on with the private finance method of funding.

224. Would you apply those general arguments to all aspects of transport infrastructure or does it

apply more to roads than, say, rail or other forms of transport?

(Dr Stephen Glaister) I think it clearly does apply more obviously to roads than to railways where the growth in investment perhaps is not as high.

225. Do you think that has anything to do with the inherent economic justification for rail investment as opposed to roads or do you think it is neutral in that regard?

(Dr Stephen Glaister) I think the case is different, is it not, and I am now talking about the particular economic case, and there are a lot of much broader issues that are different, but for roads, given the way that policy stands at the moment and has stood over the last 20 years, I suppose, it has been inevitable that there will be a strong growth in current shipping use and the need to ship goods around. For railways there has been a balance; demand has grown because income has grown, but on the whole demand has fallen because of the growth of car ownership and so the strength has not been quite as great for railways. On the other hand, the argument for rail investment, as I said, would be different in nature in that it would be broader in terms of transport policy more generally.

226. And environmental questions.

(Dr Stephen Glaister) Exactly, yes.

227. The Red Book shows that transport will account for about half of all PFI expenditure over the period 1996/97 to 1998/99. If that is correct as a projection, I would be interested as to whether or not you think that is a realistic projection. What kind of schemes would you expect to benefit from the PFI in transport over that period?

(Dr Stephen Glaister) On the question of whether it is correct, I do think that one needs to be cautious in accepting these forecasts purely on the basis that everybody I speak to who is concerned with this business says that there is a great deal of talk about contracts about to be signed, but rather less talk about contracts which have actually been signed, and I suppose naturally the Government is optimistic that these contracts will come to fruition, but one should really wait until it

22 January 1996]

DR STEPHEN GLAISTER

[Continued]

[Mr Forman Contd]

is in the bag before one comes to a judgment about that. The Northern Line project is in the bag and I think is a very interesting example that you will be referred to a great deal because I think it is worth something in the order of £400 million in its own right. The Channel Tunnel Rail Link I guess is another one which appears in the Red Book, does it? That again is an enormous project, but it remains to be seen whether it comes to fruition. We will see more road schemes. I believe one DBFO scheme was let just last week which is the first of a package of five or six schemes and they are beginning to come through.

228. Is it implicit in what you have just said that to a certain extent the time spent in preparation of a PFI scheme up to the point where a firm decision is taken is necessarily more lengthy and more complicated than the time spent when organising a standard form of public capital expenditure?

(Dr Stephen Glaister) I think that has been the experience, has it not? The investing interests do complain a great deal about the costs and the time that have been involved in these stages so far with the PFI. It is something new and I guess that all departments would say that they are learning and putting much more resources into their side of the exercise. The way it is done at the moment does require things to be done twice. There is the private sector appraisal and also the comparison in the public sector, so inevitably that in itself means more effort. The other thing I would say on this is that the PFI has been going for a lot longer than perhaps some people would have us believe. The first PFI with a capital "P" was 1992, I think, but of course the Green Paper called New Roads by New Means was 1989 and that was setting out much the same principles. London bus tendering started in 1985 and the Dartford Crossing was also in the 1980s, so there have been attempts going for a long time to get the roads investment going and so far very few of them have come to fruition, so I think you are right in saying there has been a great deal of effort which has not been fruitful so far.

229. Would one of the explanations possibly be that departments within Whitehall which have made more progress with PFI or have had earlier experience have not been as good as they should have been at sharing information as to how to make progress with this approach with other departments? Is that part of the difficulty, do you think?

(Dr Stephen Glaister) I cannot comment on the question of sharing with other departments. I do hear it said that the people in the private sector putting the bids together have been unclear about what it is that is required of them, that the rules of the game are not clear, and that has been an obstacle to them. If one looks at the documentation which has been available, it has not been terribly clear in the past and I think it is getting a lot better. The publication from the Treasury in November entitled *Private. Opportunity—Public Benefit* is very much clearer on what is required, I think, and things have crystallised a great deal.

230. Do you think that fills the gap in a sense in terms of explaining it to people who might be interested in the private sector?

(Dr Stephen Glaister) Yes, I do. I think it makes things much clearer.

231. In his Budget speech, the Chancellor stated that PFI schemes "can deliver big gains in value for money for the taxpayer", and you probably recall that, and it has been noted by many of our witnesses that in the past cost overruns and delays were fairly typical features of public sector capital projects and the example given by Sir Christopher Bland when he gave evidence to us recently was that in some trunk-road building programmes the outturn is sometimes as much as 40 per cent over bid. Do you think that is a typical reflection as to the extra cost involved in the traditional way of doing these things or would you part company with Sir Christopher on that analysis?

(Dr Stephen Glaister) I think it is very hard to say on a researched basis because in the public sector it is actually quite hard to get good information of what the original cost estimates were and what the outturns were and this is one of the problems that faces us in the research sector, to get good information. I know the National Audit Office have done work on this and one could look back at their work. There is a general perception, I know, that public sector projects overrun. It is not true in all cases, though it may be true in general. However, I would expect on first principles that shifting liability for cost overruns more clearly on to those in the private sector who face bankruptcy or face loss of personal wealth, I would expect that to discipline cost overruns more effectively.

232. Over a period of time?

(Dr Stephen Glaister) Over a period of time, yes.

233. But is this the right way to measure it? The measurement given to us was of outturn over bid, but is it not at least possible, since bidding is a competitive process even in the conventional system, that people may deliberately bid low and, therefore, this may overstate the gap?

(Dr Stephen Glaister) That might be an argument if, having accepted and signed a contract on the basis of a bid, there were subsequent claims which made the real cost high, say, if people were deliberately bidding low on the expectation that they could later extract money in the form of contractual claims. But if people are held to their bids, then I do not see that that is an argument.

234. But it is not uncommon for a contractor to argue, whether it is a large project or a small one, that the rules and the spec. have changed somewhat in the process of the project, particularly if it goes on over a number of years, with the result that he feels justified in claiming some upward revision in the price.

(Dr Stephen Glaister) Yes, and I think one of the benefits of the PFI way of doing things, which incidentally I regard really as in many cases little

22 January 1996]

DR STEPHEN GLAISTER

[Continued]

[Mr Forman Contd]

more than a sensible means of public procurement, one of the benefits is that one has to be much clearer about the nature of the contracts both for construction and for operation after opening. Almost always these contracts will have conditions attached to do with the quality of service delivered and the penalties on the contract if the contractor fails to deliver the quality of service. I think that is one of the unseen benefits of this whole process. The fact that there is a written-down contract and people know what the quality of service is defined to be and that there will be monitoring of the contract tends to produce better quality of service, whereas in the past these things were not written down and not contracted and if a road failed or a transport service failed, nobody really knew about it and there were no penalties, so I think clearer contract-writing is a benefit and it may help with the construction costs.

235. If one considers PFI as the leading alternative at the moment to traditional ways of financing public sector capital projects, is it not at least possible that there is a third alternative as well which applies particularly to the transport sector which is that of user charging, as it were? Can I refer you to the memorandum which has been submitted to us by Professor Newbery of Cambridge University—I do not know whether you are familiar with it—commissioned by the Automobile Association, entitled *Reforming Road Taxation* and there is a statement there that I would just like to get your comment on. Professor Newbery says, "It would help to identify a defensible source of finance to provide for transport investments and the logical source for that finance is the road users who are currently paying substantially more than is required for an appropriate road improvement programme". Do you see that sort of charging, if it were ever to be generally used in future, to be a worthwhile complement or supplement to PFI or do you see it as a direct competitor with PFI or can all these things happily sit together?

(Dr Glaister) I see that kind of charging as being something to aim for in the long run, with enormous benefits, and it will inevitably have to sit side-by-side with PFI as conceived at the moment, with shadow tolling and conventional public sector procurement. The point, as I understand it, that Mr Newbery is making, and I would agree, about charging users is that at the moment in the current British system we do not have a mechanism whereby the willingness to pay for new roads or for use of new roads can be communicated to those who build them. In some parts of the country there are unmet needs, in other words congested local highways, where road users would be willing to pay enough to commission the building of new roads but we do not have a charging mechanism. Such a charging mechanism of course would be the toll, and the difficulty at the moment is that I do not think anybody is convinced that the means of collecting tolls is sufficiently well-developed to make that work in practice. I note that the Birmingham North Relief Road will be a toll road in a place where there is considerable road congestion, and the judgment has been made

there by the private sector that the toll revenue will be enough to construct the road.

236. So you do not see it as an alternative to PFI, rather something which could produce an additional income stream for road building?

(Dr Glaister) That is right, because there will be situations where the state in some form decides roads are needed in places where there will not be enough traffic for the toll to pay for it. So, of course, then some other conventional form of funding will be required, and it may be shadow tolling with subsidy or straightforward conventional public sector procurement.

Mr Timms

237. Dr Glaister, the note we have received from the Department of Transport makes the point that the Department assesses all capital spending and suitability under the PFI under its current arrangements. Do you think that is the right approach or is there a danger of introducing unnecessary delays and bureaucracy in some projects for which it would be easy to establish at the outside the PFI is not an appropriate road to go down? The point that prompted that question is a note we have received from the infrastructure group, S J Berwin & Co, and perhaps I can just read one of the comments they make. Mr Mark Johnson of S J Berwin says: "We constantly receive complaints from clients and prospective clients that they are forced to explore private finance options for projects which are plainly not financially viable by the private sector. A larger minimum value threshold should be established for PFI." Do you think the Department's current procedures have that balance right or not right?

(Dr Glaister) I have heard similar comments made in connection with the Health Service and information technology procurement where, and it is a similar argument, the benefits from PFI may or may not be there but they are so small as to not justify the amount of effort. I think there is a danger of that kind of thing and I think it is a danger with the very large projects as well as the small ones, so it is not just a matter of size. Some people would say, looking at the history of the PFI, that the exercise is actually effectively a smoke-screen, that it is a way of slowing down the approval of projects and therefore reducing the rate of public expenditure. I am sure it is not as simple as that, I would not say that myself, but there may be an element of that in the whole exercise. I think the public sector needs to be very aware of the damaging effect that delay has on the private sector when people put a lot of money up-front in design work and in bidding for things. That is terribly expensive, and even if a company wins the contract it is expensive because the delay between doing the work and paying the money for the work to be done and receiving the revenue from the contract down-stream can be, I do not know, five years, and interest costs of course are accruing all the time. So if PFI is to work smoothly and expand in the way the Government would like it to, they need to be careful to make sure they do not create

22 January 1996]

DR STEPHEN GLAISTER

[Continued]

[Mr Timms Contd]

unnecessary bureaucracy and put things through hoops unnecessarily.

238. Do you think there are measures the Government might take to identify at an earlier stage whether a project is suitable for PFI? Do you make suggestions for how one might establish that rather than going through this rather cumbersome process you have referred to?

(Dr Glaister) I am sure there are. I am not sure exactly, as I sit here, what they would be. I gather a lot of the delay is involved with negotiation about the nature of the risk to be transferred. It is clear to all of us that some risks are much more easily defined and quantified than other risks, and that clearly would be one criterion one could use for filtering out things which were suitable for PFI. If the nature of the risk is such you could see, you could easily write contracts which would be enforceable to deal with the particular risks involved, that would be a good candidate. If a project comes forward which is going to be hedged about with all sorts of worries about the risks which are difficult to write contracts for, that would be one criterion for saying, "Let's get on with it in the public sector rather than in the private sector."

239. You suggested, and I think I heard you correctly, it might even be possible this delay might have been part of the intention, that in some way—and you used the word smoke-screen—there was something going on rather covert. Whether or not that was part of the intention, do you think the reality has been a slow-down in the commitment of transport projects?

(Dr Glaister) I believe it has been the effect in some cases. I mentioned I was on the London Transport Board, and during that period I was involved with the design and promotion of several of the large new underground schemes like CrossRail and ThamesLink. CrossRail is a scheme I happen personally to believe has a substantial economic case. Be that as it may, it has been certainly on the surface held up because of the Government's insistence that it should be financed through the private sector to a degree when, in my opinion, whilst it is a good project the chances of funding CrossRail through the private sector are very slim indeed, simply because the revenues cannot be clearly identified and attributed to the project. So I am sure one can find examples where the insistence on private finance have delayed things. Whether that was intentional or not is another issue of course.

240. One of the pieces of evidence we had comes from Diane Dawson of Corpus Christi College, Cambridge, and I want to read a sentence to you. She says: "No macro-economic model exists that suggests an increase in the PSBR to finance a hospital has any real effects on the economy different from a private consortium raising the same funds to build a hospital when in both cases the costs of the hospital will be recovered through taxation." What I am wondering is whether that is a view you

would share or whether you would argue there are benefits for the economy even where the project—and it might be a road to be funded through shadow tolls or something—will ultimately be financed entirely out of taxation?

(Dr Glaister) I have a lot of sympathy for the thought behind the view you have quoted. It seems to me that in the round the private finance route will not essentially provide more new resources. It is another way of financing things, not a new way of finding new funds out of the sky. There is a large element of borrowing from the private sector rather than the state paying up-front and therefore implicitly borrowing from the public sector. It is just another way of financing it. Having said that, you ask whether there are gains and I think there are gains to do with efficient procurement, that one can hopefully get things done more efficiently at less cost by shifting liabilities—and I prefer to use the word liability to risk in some contexts—on to bodies who are more able to deal with those liabilities and handle them in an efficient way. That produces real economic gains. But on the major point which I think you quoted, I do agree. I think that does raise some interesting questions on overall public expenditure control which I know from the evidence you have received the Treasury is beginning to worry about. If there is a large quantity of projects financed over, say, 20 years through PFI, it suddenly means they are not appearing in the cash controls, the traditional three-year PES system, but they are of course liable to appear over the next 20 years, and if the Treasury retains its overall role in controlling total use of the nation's resources, for perfectly good macro-economic reasons, it clearly needs to get a control of this process because otherwise it will slip away as private finance projects when they would have been controlled as public finance projects.

241. In the roads programme do you think the adoption of PFI is likely to change the priority order for the schemes? Some projects are likely to go forward and others will slip back. Is there a danger that considerations like environmental benefits or benefits to people who are not going to be using the roads, third party benefits, would become less important and that the financial criteria will dominate more than would have been the case before?

(Dr Glaister) If one was charging real cash tolls for highways, in the manner that we were talking about earlier, then I think that is inevitable. That in a sense is part of the point of the exercise, to make sure roads are built where there is a demand for them and fewer roads are built where there is not the demand for them. If one is not doing that but building roads funded by shadow tolls, I do not see that your hypothesis is a necessary consequence. Because then the state, after all, is deciding what to do, it is deciding it wants to build roads in particular places for whatever reasons, and the same considerations would apply under the old system as under the new system. So if environmental considerations are uppermost, the Department of Transport can promote a particular scheme, and

22 January 1996]

DR STEPHEN GLAISTER

[Continued]

[Mr Timms Contd]

if it is a particularly unattractive one in terms of traffic flows, then that will be reflected in what people will pay in terms of the shadow tolls they require to build the road. It will throw up into the public domain the financial performance of the road, but I do not think that means it is necessarily hard to fund through that mechanism.

242. You said in your answers to Mr Forman earlier—and I think this is right—that you were not aware of evidence of the traditional public sector commissioning method being inefficient in the sense that things always came in over-budget and that sort of problem arising. Does that mean that you think there is no evidence of that, or is it just there is evidence and in the course of your work you have not come across it?

(Dr Glaister) I was meaning to say we all know of examples where they have come in over budget. I do not know whether that is a systematic tendency. One feels in one's bones that it is but if one were to research it properly, I do not know what the answer would be. There may well be schemes, in fact I am sure we can all think of examples actually of schemes, which have come in under budget and have offset this. How systematic the bias is, I do not know, that was really the point I was trying to make.

243. Given the fact that you are not aware of any systematic work on that, does that suggest there is not any or is it perhaps there is some but in the course of your work you have not had cause to come across it?

(Dr Glaister) I am pretty sure there is not enough.

244. There is not enough evidence?

(Dr Glaister) No, there is not enough research work, enough follow up work to see what the outcomes have been both on the costs and on the benefit side. I was a member of the Leitch Committee, the Advisory Committee on Trunk Road Assessment in the 1970s, and one of the points we made then was that whilst the Department put a lot of good work into appraising roads before they were built, they did not put anywhere near enough effort into looking back and seeing what the outcome was. I think the National Audit Office made a similar point within the last two or three years when it looked at the subject. We have a tendency not to try and learn from our mistakes or indeed find out if there have been mistakes both on the cost side and particularly on the revenue side, on the traffic flows and that kind of thing.

245. Are you saying the benefit of PFI methods are a matter of faith rather than being grounded in any firm evidence?

(Dr Glaister) I think there is an element of faith but there is also evidence. Certainly the experience of service procurement, where I am aware of good evidence, is very favourable to the PFI kind of way of doing things. I referred to bus tendering, which I was deeply involved in, and I think myself can be

shown to be a very substantial success story. There is nothing really different between the Northern Line example and London Bus tendering where the private sector was given specified contracts and took those contracts on. That has been researched and typically 20 per cent was saved on those contracts compared to what they would have been had they stayed in the commercial and private sector. That is a rule of thumb, tongue in cheek almost, but there is something in it. I tend to say this to my students: if you put something in service procurement to the private sector that was previously in the public sector, there is an economic law that says you will save about 20 per cent.

Mr Forman

246. It is fair to say, Dr Glaister, that the 20 per cent figure was used by Sir Christopher Bland as well.

(Dr Glaister) Yes, I noticed that.

Ms Abbott

247. This is an important point. I wanted to know exactly how do you think those savings were arrived at?

(Dr Glaister) I can only talk to the example that I have been involved with on the research side. Before I say that though I would remark that there are examples in the health service—going back a long way—where the health service procured laundry services and that kind of thing and also refuse collection. In the case of buses, part of the cost saving came about because the private sector used its labour more flexibly than had the public sector. That is reflected in the way the bus engineering is done. Previously London Transport had two big bus engineering factories, they disappeared and bus engineering was done by the private sector differently. Part of it is because the terms and conditions on which people are working are less generous, there is no doubt about that. It is because the private sector is much closer to the competitive world of labour than the public sector has been.

248. You talked about the health service, and actually I am fairly familiar with how the health service drove down costs for cleaning and laundry, it was a combination of no unions, no career structure, no training and all that.

(Dr Glaister) Yes.

249. That is what I thought it was.

(Dr Glaister) Yes. In the case of London Bus tendering, the terms and conditions under which the private sector employed its labour are standard national labour law conditions. That has meant a lot more part-time working, a lot more women have come into working on bus contracts than there were before because that is the nature of work that suits some women. The whole nature of employment contracts has changed and that has brought the costs down. Rightly or wrongly that is what has happened.

22 January 1996]

DR STEPHEN GLAISTER

[Continued]

[Ms Abbott Contd]

250. It is not some magic management ingredient, it is a simple matter of driving labour conditions down, driving down terms and conditions.

(Dr Glaister) Yes, and I would expect that to happen in highways.

Mr Timms

251. A final point on this: what you are saying is that in infrastructure construction there is not any evidence that the PFI route is better and since the work has always been carried out by the private sector anyway as opposed to public sector road building, presumably what you have said in the private sector would apply in this case?

(Dr Glaister) I do not know that there is not evidence. I do not know of the evidence. Can I answer the other point that you make. You are quite right, people forget that road construction is done by private contractors, always has been done under competitive bidding, but I think the Department's case would be that there are real gains from shifting the long-term liability for maintenance, for instance, on to the people who are doing the design work, especially if the revenues are associated with the traffic flows because they will take proper account when they design the road of the long-term maintenance cost. It has been a longstanding complaint of road engineers that they are not allowed to build to "a sensible standard" under the existing system because of cheeseparing and cost cutting to meet the Treasury's immediate needs. The result is that five years down the line the roads break up and they have to be shut and there are cones all over the place. That imposes all sorts of costs on the travelling public which are not taken account of properly when the roads are designed. The gain comes from shifting the liability for maintenance to the design stage and so we can have what is called whole life costing which does properly account for these things. That is a real cost saving in the long run.

Mr Betts

252. Could I return to one question with regard to the nature of the savings, Dr Glaister, in terms of the answer you just gave to my colleague. I think the research done in local authority CCT contracts is that 70 per cent of the savings came from poorer wages and conditions in the private sector. Would you anticipate that would be a similar result in the PFI contracts?

(Dr Glaister) I do not see that it would actually because as we have just said the construction work is already done by competitive private sector companies, the Wimpeys of this world, Tarmac and so on. Presumably whatever labour contracts they have there would continue in much the same way. I do not see that there would be much scope for change there. Where would that kind of effect come in?

253. You are saying that the saving is primarily one of a recognition at the design stage of the need to construct in such a way and produce low maintenance?

(Dr Glaister) I think that is one of the major ones, yes. The argument is that there are risks and liabilities and that there are gains from shifting some of those into the private sector. One of the risks and liabilities listed is the construction one. I think some of the others are to do with traffic forecasting. The argument there is that however roads are built there are risks because we cannot forecast accurately what traffic will be on particular roads. It is a very difficult science as we all know. There are advantages in making the private sector bear some of the risks on traffic forecasts because in some sense they will be better at it and can design the road in such a way that it mitigates the risk. There are many things one can do in designing the road to mitigate the risk if you get it wrong. To give you an example, if you are unsure about how much traffic is going to use a road you can build it with a narrower carriageway but wide bridges and then if the traffic materialises you can widen the road without having to widen the bridges because bridge widening is a very expensive operation.

254. Surely people in the public sector are perfectly capable of designing roads taking account of those risks? Is it not that they are generally asked a set of questions different from that for the PFI, namely they are asked to try and minimise the front costs because that counts year one in the capital accounts for the Department whereas any problems with maintenance that occur down the line, and in PFI schemes all the costs appear down the line, therefore there is a benefit in reducing the total cost?

(Dr Glaister) Yes, both things. As I said the public sector have traditionally felt themselves squeezed, the engineers have felt themselves squeezed by first, as it were, cash constraints, but also I suppose because the discipline has not been there there has been no attempt to do a proper risk analysis until I think perhaps very recently on traffic forecasts. Traditionally, as I understand it, highway engineers have asked themselves what the traffic will be at one point in time, 15 years down the road, and 15 years after opening they make a forecast of traffic. They then design the road to meet that forecast, end of story. That is obviously not a terribly subtle piece of risk analysis. Now, of course it could be done in the public sector, and I am sure it should be done in the public sector, but the incentive has not been there in the past. This is one of the benefits of the PFI, it forces people to start thinking carefully about those issues.

255. If the two problems are, one, the issue of traffic forecasts and the risk analysis and also the making sure that you have in the initial design taken account of long-term maintenance costs, then you could in fact replicate in the public sector contract the benefits that are now claimed for the PFI. Is there not then a problem with the way PFI contracts are drawn up that does not occur in the public sector, the problem being that very obviously now there is an encouragement for

22 January 1996]

DR STEPHEN GLAISTER

[Continued]

[Mr Betts Contd]

conglomerates to come forward for the very reason that contracts have been seen as design and build and then operate the scheme and very often there are different firms who want to get involved in different aspects of that—it may be less true of road building but certainly in other PFI contracts—and there is an attempt to bring a group of people together who have got various skills? Is not one of the problems that the component parts of the conglomerate may not themselves be the most efficient at delivering each of those particular jobs, that in the public sector at least you know each aspect of that work can be tendered for, if necessary separately, and the best price can be gained?

(Dr Glaister) There are clearly risks on both sides. If the conglomerates consistently get it wrong in the skilled way that you are suggesting and if we believe in, as it were, the forces of competition and bidding then conglomerates will start losing money over it I would suggest.

256. Not necessarily, it might be that Conglomerate A can deliver a better price than Conglomerate B but it might just so happen that there is a split between design and build and operate and the designer and builder who are most efficient might not be linked to the same conglomerate as the most efficient operator. That is entirely possible, is it not?

(Dr Glaister) Yes, it is entirely possible and I suppose your judgment then is whether the private sector members of conglomerates are more or less likely to get it wrong than is the public sector. I do not suppose there is any way of being sure.

257. Can I just come on to two other areas of risk which I think are worrying. One is a probably very obvious risk but it does not appear that it is written in anywhere into any of the sums that are done on comparing PFI with public sector contracts and that is the issue of potential bankruptcy of a company which is doing a PFI scheme. Now, the answer we have had from Government tends to be: "Well, it is all right, the next firm in line, next conglomerate in line, will pick up and carry on where the other one left off" but presumably in a position where a road is half built, or a road may even be built and be open, the Government then is not in such a good bargaining position, is it? Should there not be some contingency built into the analysis and comparison of PFI schemes? There is a risk to the public sector side that ought to be accounted for somewhere.

(Dr Glaister) Absolutely, yes, there must be. In my view the whole of the gain from the Private Finance Initiative relies on the possibility that people will go bankrupt. If people are negligent in putting forward bids that are too low then there must be a risk that they will be bankrupted. Put it the other way: if the Government always bails out every entrepreneur who gets into difficulties then it will clearly mean there is no risk involved and then it will become straight forward borrowing from the private sector. Yes, there has to be the prospect of bankruptcy and, therefore, yes there has to be a

means of dealing with it when it happens, and it will happen, it has to happen occasionally. I am familiar with the railways legislation which makes specific provision "What happens if the train operating company were to go bankrupt?" There are specific provisions in the contracts to make sure that the assets become available immediately to carry on the service. I am not aware of what the situation is on highways contracts. You are right that the eventuality must be properly covered so that a service can continue. I am sure it can be by the way, it is not a fatal obstacle.

258. But there ought to be something there.

(Dr Glaister) Yes, clearly.

259. Is not another risk, again it seems a very difficult one to deal with and the private sector have indicated very clearly, that they are worried about Government attempts to put on to them any risks that are associated with changes of Government policy or new public decisions given that we could be talking about contracts lasting 30 years? If one thinks of what has happened in road building over 30 years there have been enormous changes. A very simple one: a town needs a bypass and one goes to the east of the town—not thinking of Newbury at this stage or anything controversial—and one is built. Will not the people building that bypass want to have some degree of certainty that in 10/15/20 years' time the bypass will not be built on the other side of the town either with no charges at all if theirs has to make a charge for the bypass, that is one possibility, or indeed it might be that once the bypass is built on one side of the town 20 years hence you are never going to get anyone to build a bypass on the other side of the town if it is needed because you will never be able to compete with the one built 20 years ago? Those are the problems of future Government policy, can they really be taken into account in PFI contracts lasting 30 years?

(Dr Glaister) One of the clarifications in the Treasury's recent publication is the recognition that what they should be doing is sharing risk in an appropriate way. There is some phrase to that effect. They recognise now that risks should lie where they can best be handled and there is this sort of partnership idea. That is a very welcome clarification because I think the private sector felt in the past they were being asked to bear the kinds of risks you are talking about in a totally unreasonable way and they would say that is one reason that the PFI has not moved on as fast as it would otherwise have done. As I said in an answer to Mr Timms, yes there are certain risks which it is much harder to write into contracts and probably would not sensibly be shifted on the private sector. I think particularly of the risk of fundamental changes in the tax structure and that transport policy might change very fundamentally over the next ten or 20 years. That would fundamentally change the economics of a shadow tolled road. A good example recently was the policy risk to do with fares capping. The Government decided, for

22 January 1996]

DR STEPHEN GLAISTER

[Continued]

[Mr Betts Contd]

whatever reason, that British Rail fares would be capped. That immediately had implications that I do not think people had thought through for London Transport fares which in turn had fundamental implications for the financeability of things like the Docklands Railway Crossing to Lewisham and the Croydon Tramlink, things like that, it affects the revenues available. Now, I do not see how the private sector can be expected to bear that kind of, as it were, big picture policy risk. A way has to be found of sharing those risks it seems to me.

260. Can I finally raise one issue going back to shadow tolls which you have just raised. In some ways tolls themselves, everyone can understand them whether you agree with them or not, they put the cost of providing the service on to the people who are using it and you link risks together to some extent. Is there not some perverse way in which shadow tolls could actually give an encouragement to the people who built the roads to encourage people to use them? You could almost get a situation where Shell and Granada, say, were part of a conglomerate which has entered into a contract to build and provide and maintain roads and you get a free gallon of petrol or a free cup of coffee for every 50 miles you go because the toll that was paid by the Department of Transport to the company was more than the cost of bribe they are giving to people to drive down their road? Is that something that can be thought about?

(Dr Glaister) It is an interesting possibility. I am sure that wherever you have contracts which have schedules of payments in them there are incentives of that kind to cheat in some way. That is the kind of reason that one has to have monitoring of contracts. This is something that I do not think has been thought about a great deal. Contracts with service specifications in them do have to be monitored very closely and that is not cheap. Fraud has to be detected and all of that kind of thing. In the London Bus tendering case, I mentioned the 20 per cent gain but four per cent of that gain was dissipated in contract enforcement. You get 20 per cent and then you have to pay four per cent of it back in monitoring the contract. That is actually good news because it means the service standard is looked after and actually there is a benefit there. Yes, the contracts have to be properly enforced.

Mr Carrington

261. If I could just come on to what we were touching on before, which is the reality of the risk transfer on these types of projects. On some of the projects obviously one can see that the risk is transferred completely. It is quite conceivable to design a project where the public sector moves out from the risk element and it is taken on by the private sector. There are some projects where that is less clear, and I am thinking particularly, for example, of the Northern Line trains where the private sector is delivering this service on which trains will run, and a service where trains will run

for a number of years, I believe it is 20 years or so. The lifetime of trains is considerably longer than 20 years but there is no likelihood at the end of that 20 year contract that, provided the Northern Line is still in existence and there are still people who want to travel on it, the proposed trains will not be used in some form. In other words, the reality is that the public sector may be notionally entering into a 20 year contract but the operator of those trains knows full well there is a very high probability that the contract will be renewed at the end of 20 years. In those circumstances is there not a real proper risk transfer, or what is the definition of a risk transfer that takes place?

(Dr Glaister) Yes, I can see that is a very real problem. What happens towards the end of a contract is generally speaking quite a difficult issue, is it not? It is the kind of thing which is very difficult to analyse from the beginning. I think you can see that as you come towards the end of the contract there are things which the two parties can do and there will be a bit of negotiation and game playing to shape up, as it were, to negotiate and that will have to happen at the end of the period. For instance, if London Transport wishes to exercise its right to walk away from those trains at the end of the 20 years, which I believe in principle it does have, it will start making threats towards the end of the contract to start buying in replacement trains from other people and cascading them down and that kind of thing and indeed start executing that threat as the time gets closer. I do recognise the problem you identify and I think it has also been raised in the context of hospital buildings, which are very specialist, where the terminal value of the building at the end of the contract is very low unless it is used as a hospital so who is going to take it on and on what terms?

262. A lot of the justification comes down to the difference in pricing which we have touched on before. One of the aspects of that is the so-called cost of capital both in the public sector and the private sector.

(Dr Glaister) Yes.

263. What do you think is an appropriate measure of the cost of capital in the public sector for this type of project?

(Dr Glaister) I noticed in the evidence you took the other day a figure of eight per cent was mentioned for roads and I think six per cent for most other things. That is a standard Green Book figure which has been used. Incidentally that is a real figure, it is net of inflation. One would add on the inflation rate to get to the nominal figure. It is not as low as it looks. As you know it is a very difficult area. The regulators of the privatised industries and the Monopolies and Mergers Commission have undertaken some very big exercises to calculate appropriate discount rates to be used in gas, electricity, water and those exercises look at the nature of the risks in a lot of detail and come to a view. I could not answer your question without doing a similar exercise. I think a similar exercise can be done. I would say one thing though, that

22 January 1996]

DR STEPHEN GLAISTER

[Continued]

[Mr Carrington Contd]

there has been this tradition of using a substantially higher rate in roads than in other parts of the public sector for a long time. It has always been eight per cent and six per cent or seven per cent and five per cent. Part of the reason for that I think has been a view that in roads appraisal there is a tendency for the appraisers to be optimistic, over-optimistic and so, as it were, the hurdle is made higher to compensate. I do not think that is a very sensible way of dealing with the problem because what it does is to mitigate against projects which produce benefits a long way into the future. It biases the whole thing to make you more likely to accept projects which produce quick returns and that is not what you want to do. You want to find the right rate of return recognising the appropriate risks. So if the risk structure for these things is similar to gas, the answer to your question would be something over six per cent, six per cent real plus inflation, but I do not know what the right rate is for roads.

264. How would that compare to what you would expect to be the typical cost of capital here for a private sector bidder in a PFI project?

(Dr Glaister) I think the conventional answer to that would be that it would be lower. In other words, you would expect the private sector to be asking for a higher return because it is more explicitly exposed to the risks that we have been talking about. To the extent, as I said earlier, one is indeed borrowing from the private sector rather than borrowing from the public sector there is a cost there. The logic is that that cost is offset by the efficiency gains which have come from risk transfer that we have been talking about. Whether they are big enough to make the balance, it is difficult to judge. That is quite a difficult piece of research.

265. It is an important differential in deciding as to whether the cost benefits really are there for PFI projects?

(Dr Glaister) Yes.

266. It is a crucial calculation?

(Dr Glaister) Yes.

267. That somebody ought to have had some view on?

(Dr Glaister) I would hope so yes. I would say about the Northern Line project that the deal is a superb one, everybody you speak to says that. It should have been done in the private sector or in the public sector, it was a profitable thing that would have been done to advantage if it was done in the public sector. Therefore the decision to do it in the private sector meant that one was, in a sense, deliberately incurring these additional financing costs in return for some gain to do with risk transfer. One could have done it the other way.

268. Is it risk transfer or is it better operation of management?

(Dr Glaister) That is what I mean, yes. I said at the very beginning I regard a large proportion of the PFI to be good quality procurement and by that I mean integrating the various management risks so the people who have to manage the thing are responsible for designing it in the first place. It can be managed in a sensible way if the people who have to maintain it are responsible for design so they then do it in an appropriate way.

269. Now, on something like the Northern Line trains where there is a benefit which comes from the management, how much of that management is due to the inherent incapacity of the public sector to be able to design and manage a project and how much of it is due to an historic experience in the public sector that once a project has been contracted in the public sector it tends then to be reviewed on a regular basis adding substantially to costs? The opposite example of that is the British Library at St Pancras where one understands that the initial contract which was issued was revised endlessly to different specifications thereby escalating the costs. It has been said to us that if it had been done under the PFI there would have been an initial contract and the public sector would then have been unable to change the specification which clearly produces an apparent reduction in the cost of the project but probably not a real reduction in the cost of the project because presumably the changes justified would be then renegotiated and redeveloped in any case. Do you think that therefore the apparent cost savings that appear by projects are more illusory than real and more dependent on the fact that the public sector loses, at least on the face of it, some ability to change the contract once it has been negotiated?

(Dr Glaister) I think that in principle the public sector could gain a great deal of what I have identified as benefits from the private sector involvement but the fact of the matter is they have not in the past. Let me take two examples. The PFI, quite rightly in my view, encourages procurers to specify what it is they want in terms of outputs, not a lot of detail how the output is to be achieved, and therefore it allows the supplier to decide on the best way of developing that outcome. It was always open to British Rail and London Transport to do it that way and they have started doing it very recently but for many, many years they did not, they over-specified and that created all sorts of problems. The calculation of risks of projects is another example. Until the PFI exercise I do not think London Underground did a great deal of risk analysis; they should have done, it is the natural thing for any business to have been doing, indeed I am sure ICI and any big corporation does it all the time. They now have a substantial body of expertise, probably just as good as the private sector, doing this kind of work. It is what they should have been doing all along. The PFI has encouraged them to do it and to that extent you can get these benefits, providing the incentive is there, in the private sector or the public sector.

Mr Carrington: Thank you, Dr Glaister.

Mr Forman: Thank you very much. One final round of quick questions from Ms Abbott.

22 January 1996]

DR STEPHEN GLAISTER

[Continued]

Ms Abbott

270. Do you agree that shadow tolling is a forerunner to real tolls and that in the long run PFI roads may cost the road user more?

(Dr Glaister) If we move—if—from shadow tolls to real tolls, I think if you look at Mr Newbery's calculations you will see it is not necessarily the case that it will cost the road user more in total. What will happen is they will pay more for using those particular roads and less for other forms of charge, particularly fuel tax and vehicle excise duty. In other words, it is a policy option to introduce tolls and to use the toll revenue to offset other sorts of taxation. It is not a matter of logic that tolls mean motorists pay more, it is a matter of policy.

271. Shadow tolling could be a forerunner?

(Dr Glaister) Shadow tolling could certainly be a forerunner. I did do a piece of work for the Automobile Association, I think it is referred to in their evidence, about the case for shadow tolling. At that time the Government was, as in this Green Paper, very keen on real tolling and rejected shadow tolling. The case there was that shadow tolling was a way of getting on with it, it got 90 per cent of the way without getting involved with all the difficulty of real tolling. Certainly in my mind personally shadow tolling was a way of getting started and moving to real tolls when the technology is available. However, it will be some time before the technology is right and it may be forever before the general public is willing to accept it. If that is the case one can stop with shadow tolling. In my personal view shadow tolling has a great deal to offer because it provides the incentives that we have been talking about on the construction side without upsetting or affecting in any way the experience of the motorist.

272. Finally, on this vexed issue of value for money. Given that the cost capital for the private sector is probably about six to nine per cent above the gilt rate, how is it possible for these options to prove better value for money?

(Dr Glaister) If, and only if, they achieve lower construction costs, more efficient maintenance in the long run. That is the balance one is making. It is accepted, I think, by many people that the cost of borrowing will be higher but one is offsetting that against these perceived efficiency gains that we spoke about earlier. That is the trade-off.

Mr Forman

273. But is not the key point there really the lifetime costs of the project?

(Dr Glaister) That is right. It is looking at the thing as perhaps an aircraft manufacturer or the leaser of an aircraft would look at it, recognising that ten years or 20 years down the road one is going to have to do major maintenance work on this thing, this asset, it is going to have to be maintained. So you design it from the beginning in such a way that that can be done cheaply instead of forgetting about all of that and building something in such a way that it actually failed disastrously after five years and then had to have very expensive repairs. We see that all around us. We have seen motorways breaking up and having to be repaired after a very short period of time because not enough care was given to the long run maintenance.

274. You could almost say that in relation to the original stretch of the M4, the cheapest thing they ever did was build it!

(Dr Glaister) Quite, yes.

Mr Forman: Thank you very much, Dr Glaister.

Memorandum submitted by the Department of Transport**INTRODUCTION**

The Department of Transport, with its Nationalised Industries and Executive Agencies, has been at the forefront of the Private Finance Initiative since its inception in 1992, having already pioneered private sector solutions for the Dartford-Thurrock Bridge and the second Severn Crossing, and approved the development of the Heathrow Express rail link scheme as a joint venture involving (now) Railtrack and BAA plc. The Department now looks to assess all capital spending for suitability under the PFI.

2. In addition to financially free-standing projects like the estuarial crossings, and joint ventures such as Heathrow Express and Midland Metro (given the final go-ahead last year), the Department also has experience of a third type of PFI deal—whereby the private sector contracts to supply a service over an agreed period in return for performance-related payments over the life of the project. A good example is the Northern Line trains deal, agreed in November 1994.

3. In aggregate, private sector-supported transport schemes with a capital value of over £1.5 billion have already been approved, and by the end of the current financial year the Department expects to have approved further private finance projects with a capital value of nearly £4 billion. Over the next 3 years, publicly-funded provision of some £14 billion for the Department of Transport is expected to be supplemented by over £1 billion of private sector capital.

*11 July 1996]**[Continued]*

4. This Memorandum describes how the Department has sought to exploit the benefits of PFI, with reference to specific cases.

NORTHERN LINE TRAINS

5. Under this deal, which is worth £400 million (capital value equivalent), the supplier—GEC Alsthom—is financing the entire cost of a new fleet of over 100 trains for the Northern Line, including their maintenance. An obvious benefit to LUL is that they are relieved of the up-front capital costs of purchasing the much-needed trains, at a time when there are other pressing priorities for expenditure. Instead, payment will be made by London Underground on the basis of train service availability and performance against demanding criteria. The contract offers very substantial improvements on the current levels of reliability and performance risk. The result is not only that Underground passengers enjoy the benefits of the new rolling stock sooner than they otherwise would; it also ensures that the supplier has a direct interest in reliability of the assets throughout the 20 year life of the contract.

DESIGN, BUILD, FINANCE & OPERATE (DBFO) ROAD SCHEMES

6. The first of this new form of roads contract—the A69 including Haltwhistle Bypass—has now been let. Under a DBFO contract, the private sector contractor is responsible for realising the design of a road scheme (statutory procedures having been previously completed), for building and financing the scheme, and for operating it and any adjacent roads which may be covered by the contract. This gives the private sector the opportunity to demonstrate how it can bring to bear efficiencies in road construction with an eye to future efficient operation.

7. The A69 project is one of 4 road projects in the first tranche of DBFOs launched in August 1994. A further tranche was announced in February 1995, and a third in November 1995. Taken together these projects contain schemes which have a combined capital value in excess of £1 billion. The DBFO approach is helping to sustain investment in the national roads programme despite reduced public funding. In addition, it is showing there is a keen appetite in the construction industry for taking on the risks involved. Contractors will be remunerated on the basis of usage. So it will be in their interests to ensure that maintenance etc is carried out with the minimum of disruption to traffic. The DBFO contract provides for the road to revert to the Secretary of State at the end of the 30 year period, to predetermined standards.

CHANNEL TUNNEL RAIL LINK (CTRL)

8. The CTRL is the flagship of the Department's PFI projects. A decision on the choice of preferred bidder is expected within the next few weeks. The competition provides for the successful bidder to design, build and finance the 68 mile rail link to a new terminus at St Pancras and to operate international services on it. The promoter will take over European Passenger Services and Union Railways—the company which has carried out the development work on the route so far. The Government is progressing the necessary Hybrid Bill through Parliament.

9. The Department has agreed to make a substantial contribution, in recognition of the benefits to international and domestic passengers, and the stimulus which the project will give to regeneration. Competitive bids are being assessed against two main criteria: the size of the Government contribution being sought by the private sector, and the division of risk between the public and private sectors.

NEW SCOTTISH ATC CENTRE

10. The New Scottish Centre will replace the existing air traffic control centre at Prestwick, Ayr, which handles air traffic flying over Scotland and the North Atlantic. The need for this arises because, by the year 2000, air traffic control (ATC) equipment in the existing control centre will be over 20 years old, by which time its reliability will have deteriorated. A straightforward replacement of the equipment is not attractive as by 2003 the predicted level of traffic will be too great to be handled by the existing centre.

11. The NSC is a crucial part of National Air Traffic Services (NATS) Two Centre strategy. NATS currently operates three ATC centres; at West Drayton, Manchester and Prestwick. The functions of West Drayton will eventually be taken over by the Swanwick Centre in Hampshire. The NSC will take over the functions of the Manchester ATC centre and will be able to act as a contingency for the Swanwick Centre.

12. The project will be financially free-standing, but will be operated by the National Air Traffic Service, a branch of the CAA, as part of its integrated ATC network for the UK. The contract with the private sector consortium will involve the letting of a 25 year concession. Income will be derived from a share of the ATC charges levied by NATS and will be based on the availability of the Centre's system. Financial risks, such as cost overruns and fluctuations in revenue from air traffic, will fall to the conces-

11 July 1996]

[Continued]

sionaire. After 25 years an overhaul of the NSC would probably be needed, and this would be the subject of a new concession.

13. The Invitation to Participate was issued in the summer of 1995. Several consortia expressed an interest in bidding for the project, the total cost of which is expected to be around £200m. The CAA has now invited prequalifying bidders to submit tenders. These will be evaluated following the 6 month bid period, and the CAA hope to be in a position to let a contract this summer. Target date for completion is the winter of 2000/2001.

SUMMARY

14. The Department has some notable successes in the PFI, with more to come. As the Treasury acknowledge, not all investment is necessarily appropriate for PFI. For example, it would be difficult to achieve significant risk transfer in respect of some core asset renewals on the London Underground. PFI solutions may also be difficult to achieve where there are complex interfaces with systems remaining under public sector management. The Department's current priorities are to press ahead with those projects which have already made significant progress. In the coming year, key milestones should include letting of contracts for CTRL, Croydon Tramlink, and the New Scottish Centre ATC, and a number of further roads DBFOs.

15. The Department's aim is to consider the potential for PFI as a normal part of the procurement process. Experience to date suggests there is a wide range of projects where the involvement of the private sector through PFI can bring welcome benefits to the transport sector, both in funding and expertise.

Examination of Witnesses

MR JOHN WATTS, a Member of the House, Minister of State, Department of Transport, MR HENRY DERWENT, Director, National Roads Programme (Grade 3), and MR DAVID GRAY, Private Finance Unit (Grade 7), Department of Transport, examined.

Mr Forman

275. Welcome, Minister. I am sorry we kept you waiting. We do achieve our punctuality tables at least 95 per cent of the time!

(Mr Watts) Better than some of our trains!

276. If you get the reference. I wonder if you could kindly introduce your colleagues for us, please.

(Mr Watts) Yes, certainly. Henry Derwent and David Gray.

277. Which parts of the Department are they responsible for?

(Mr Watts) Mr Derwent is in the Roads Directorate and Mr Gray from the Finance Directorate.

278. Thank you very much. It is amusing to have you sitting across the table from us.

(Mr Watts) It is a novel experience for me as well.

279. Your previous experience being in this hot seat. Well, Mr Watts, can we begin with some factual information. How many PFI schemes are now under way in the Department of Transport?

(Mr Watts) We have the various tranches of DBFO roads. We have out to tender eight, the first four where one contract has already been

awarded and three others very close to award and the second tranche of four where the tenders are currently being evaluated. We announced at the time of the Budget a further group of five projects but those have not yet been put out to the private sector. We have the Northern Line deal for the supply of rolling stock for London Underground, the Channel Tunnel Rail Link competition and added to that the building of the second Severn Crossing which is under construction. Those are the major projects.

280. So they are all in prospect, they have not yet been finalised?

(Mr Watts) One DBFO road has reached fruition and the contract has been awarded, that is on the A69 including the building of the Haltwhistle Bypass.

281. If one were to add up the number of others you have just mentioned in conversational style what would the total come to, those that are in prospect and those that have actually been finalised?

(Mr Watts) In terms of capital value?

282. No, in terms of the total number of projects first of all. Are we talking about a dozen, two dozen? What sorts of numbers are we talking about in all?

22 January 1996] MR JOHN WATTS, MP, MR HENRY DERWENT, and MR DAVID GRAY

[Continued]

[Mr Forman Contd]

(Mr Watts) Two dozen if you add all the small ones.

283. Including the small ones?

(Mr Watts) Including some of the small ones.

284. To what value, if we aggregated the value of those projects together?

(Mr Watts) The estimated value of the whole lot in capital terms is £4 billion.

285. Over what period of time?

(Mr Watts) The DBFO roads, of course, will be contracted over a 30 year period. The Channel Tunnel Rail Link competition envisages payments over quite a lengthy period because part of the contribution will come in capacity charges for the use of the link by domestic services. The precise length of the time will be one of the matters determined by the competition which again is coming fairly close to its conclusion but which has not yet been concluded.

286. This refers to something which was taken up in the cross-examination of our previous witness, Dr Glaister, that many people involved in tendering for the PFI projects complain from time to time at the length of time which is required to get the specifications right and to reach final agreement. They also complain about the alleged complexity. Do you see this problem as being greater with the PFI than it was in the normal tendering process for public sector contracts which preceded these arrangements?

(Mr Watts) I think it is difficult to give an answer that covers every type of PFI contract because of the ones I have described some are very different in nature. If we look at DBFO roads for example, clearly a contract which involves taking on the management and maintenance obligation for a period of 30 years is necessarily more complex than a conventional procurement of the capital construction of a new piece of road for which the contractor is then paid effectively in a lump sum and essentially walks away from it. I think though that having had the experience of negotiating contracts for the first four DBFO roads, hopefully the negotiations on the second tranche will be that much easier because as we have negotiated we will have been dealing with a number of matters of principle where the principle will continue to run into future schemes. The Channel Tunnel Rail Link project, of course, is a mega project. Inevitably that has required a great deal of effort by the bidding consortia and then with our officials and advisers a great deal of negotiation to get to the point where we will shortly be able to nominate a winner.

287. As time goes by you are confident you are building up some common principles and some case law, if you like to describe it that way, which will abbreviate what has hitherto been a rather lengthy process?

(Mr Watts) I think it should, yes, and particularly with roads where we have a number of pro-

jects in the pipeline. Clearly that is more the case than if you take a very large one-off project like the Channel Tunnel Rail Link. I cannot envisage that we have in prospect anything quite on that scale likely to come along in its wake.

288. I think it would be fair to say that is more in a category of one, is it not, that particular project?

(Mr Watts) Yes.

289. Are you aware of the views of the Construction Industry Employers Council which has made its views known to us in a memorandum for the benefit of this Committee for this particular inquiry in which they say—let me just quote the particular sentence—"The present complexity of putting together a PFI bid deters smaller and medium-sized contractors from taking an interest in projects which would usually be well within their range if the construction work was being procured in the normal way". Now are you aware of small and medium-sized enterprises having a special problem in dealing with these new procedures?

(Mr Watts) I can see that some of the largest projects might be difficult for them to handle but the first DBFO contract which we have awarded has been awarded to a consortium of middle sized contractors. They are not amongst the largest of the nationally known road building contractors. We have, within the portfolio of schemes that we are offering, some which are smaller and some which are bigger and we did that deliberately in order to try to provide some opportunities for the medium and smaller contractors so it was not exclusively for the large company club.

290. Does that include the lead contractor in that particular case being a medium-sized enterprise as well?

(Mr Watts) Yes, all of the members of the consortium are medium to small contractors.

Mr Carrington

291. Could I just ask a question on that because if the project has got a 30 year life and if you are dealing with small and medium-sized contractors, what contingency is built in there in case these contractors go bust over that 30 year period? Nothing to do with this contract but if they go bust, as small contractors tend to for a variety of different reasons to do with cycles of the industry?

(Mr Watts) If they did we would have to appoint another company to take over the contract. Because we are also remunerating in line with the use which traffic makes of the road over the period of the contract we would not have committed all of our public money to paying the contractor either.

292. You might have to reissue the contract at a higher price, that is always a possibility to get somebody else to take it on, is it not?

(Mr Watts) I am not quite sure at which stage in the contract you are envisaging this catastrophe.

22 January 1996] MR JOHN WATTS, MP, MR HENRY DERWENT, and MR DAVID GRAY [Continued

[Mr Carrington Contd]

293. Twenty years down the line.

(Mr Watts) If it is 20 years down the line then the main responsibility would be for the management and maintenance of the road itself rather than for any major element of construction. By that stage, because also we are developing new arrangements for our agency management and maintenance of the network generally and encouraging a great deal of competition, 20 years ahead is a long way to look but I would imagine that there would be a considerable competitive industry there ready to come forward with value for money bids.

294. It might even be cheaper?

(Mr Watts) That is always a possibility, but knowing from my previous membership of this Committee how difficult any forecasting is even a year ahead I am reluctant to try to forecast 20 years ahead!

Mr Forman

295. I think I should be cautious, Mr Watts! Presumably in your present role you believe very much in the benefits of the PFI as applied to the Department of Transport. If that is the case why does the Government need to start with a presumption in its favour?

(Mr Watts) I do not think that we need to start with a presumption in its favour, indeed within my Department we do not start with that presumption. We recognise that not every capital project that we wish to build is necessarily suitable for delivery by PFI means. For example, if we are looking at DBFO roads, in the latest group of five that we have announced, we have included the A13 in East London and that is the first time we have tried to apply the technique in a predominately urban area. We believe there may be difficulties in applying the technique in urban areas. At the moment we are trying different types of schemes to assess whether the technique is more applicable to some types of projects than to others. Some schemes standing alone would be far too small, either in capital value or in the management task that could be attached to them, so we will continue to take those forward on a conventional procurement basis. If we look beyond roads, for example to London Underground, the provision of rolling stock we have found is a very cost effective method of procuring through the PFI but some things, for example such as renewing the pumping and drainage on the network, seem to us to be less suitable for that sort of treatment and that is being procured by London Underground conventionally. So we do not make that presumption but certainly our experience is that where we are applying it where it is appropriate it can provide very good value for money.

296. I think that is a very pragmatic view, if I may say so, but have you talked to your Treasury colleagues about that?

(Mr Watts) I have not discussed that specifically with Treasury colleagues but we have not so

far found any difficulty in identifying sufficient schemes which we consider are suitable for this treatment in order to have a viable programme.

297. You are aware that their line is to have a general presumption in its favour?

(Mr Watts) My understanding is that the Treasury would expect departments to consider whether a particular capital project can be procured through the PFI before asking for funding for conventional procurement but I am not aware we have had any difficulty in being able to follow a conventional procurement route where we are satisfied and the Treasury can be satisfied that that is most appropriate in the circumstances.

298. One final question from me, Mr Watts. You mentioned in passing just now that there was a threshold level for such projects below which, other things being equal, really it was not worth going down the PFI route. What level in terms of pounds and pence does that come in at?

(Mr Watts) I do not think it is quite in those terms. For example, the construction of the Haultwhistle Bypass, as part of the A69 DBFO, from memory I think the capital value for that is only about £5 million¹ but the management task of running the whole of that road over a distance of more than 50 miles still makes it an attractive proposition. I think if you had a £3 million to £5 million bypass scheme you could not attach a significant management and maintenance responsibility to it as well and you would probably conclude that was not worth trying to offer somebody over 30 years.

299. It is slightly case by case?

(Mr Watts) It is all case by case. I think in bringing PFI schemes forward, while there will be certain principles about achieving risk transfer and so on, they are all tailor-made. They may not be completely a la carte but they are certainly chosen from an extensive table d'hôte.

Mr Forman: Thank you very much, Mr Betts.

Mr Betts

300. Minister, can I say that there appears from the Red Book to be a substantial reduction in the Government forecast for public sector net capital spending from 1995-96 for the next five years from one and three-quarter per cent of GDP to three-quarters of a per cent of GDP. Could you identify what share of that reduction is likely to fall within the Transport budget?

(Mr Watts) Yes. In this year's spending round our provision was reduced by £1.1 billion in cash or about ten per cent of the total reduction which was embodied in the budget. Taking the last two years together: in the 1994 settlement the total transport provision was reduced by £2.4 billion and within that roads by 0.7 of a billion and in

¹ Note by witness: Figure subsequently confirmed as £9 million.

22 January 1996] MR JOHN WATTS, MP, MR HENRY DERWENT, and MR DAVID GRAY

[Continued]

[Mr Betts Contd]

1995 our total provision was down by a further £1.1 billion and roads by a further half a billion.

301. And looking forward to the year 2001?

(Mr Watts) I do not think we have planned that far ahead. We do not have indicative allocations of funding as far ahead as 2001.

302. The next three years?

(Mr Watts) Those figures I believe were in the Red Book. I do not have those with me.

303. There is a reduction then. Do you therefore see PFI as helping to fill the gap created by that reduction in expenditure or are you claiming that it is additional expenditure? The Chancellor in his Budget Statement seemed to indicate there was now a reduction in capital expenditure funded by the traditional route which would be met by the PFI as an alternative method of funding. Is that how you see it?

(Mr Watts) If I take roads, for example, over the two years that I have mentioned we have had a reduction of £1.2 billion and the DBFO road schemes which we have brought forward total about £1.1 billion. We have certainly used the opportunity of PFI and DBFO to ensure that within that same four year period, the two three year planning periods, while we have lost £1.2 billion in provision by using the PFI we have been able nonetheless to carry forward within the programme as DBFOs £1.1 billion worth of schemes in terms of their capital cost.

304. So there has been a switch from traditional methods of procurement to PFI?

(Mr Watts) Yes, because we clearly wish to deliver urgent schemes as rapidly as we can and our experience of DBFOs so far indicates that it is a more cost-effective way of delivering schemes than if we used the same amounts of money to procure them conventionally.

305. Does that not lead on to the question that if in order to get the capital programme you would like to achieve funded and there is not sufficient resource identified in the Red Book for traditional procurement really any comparison of whether a scheme should go ahead by PFI or the traditional route in some cases is not really a comparator at all because you have not got enough traditional funds in it and in order to get your total programme you have to have some schemes going by the PFI route?

(Mr Watts) Well, if we consider that schemes are not suitable for DBFO treatment we would not try to carry them forward as DBFOs simply because we do not have the funding to take them forward as rapidly on a conventional basis. It is important, I think, that all times we are able to demonstrate that our methods of procurement are delivering good value for money and that we use this technique, this innovative technique, where it is appropriate and do not use it where we consider that it is not appropriate.

306. What you are saying then is that if you are assuming that you have not come to a view in advance as to which method will deliver the best value for money, given you have now got less money to spend on the capital schemes through the traditional route you have just identified, what would happen then if it came out in most cases that the traditional route was better value for money, would you simply do less schemes or would you go ahead with PFI schemes which are more expensive?

(Mr Watts) This is becoming very hypothetical but if that were the case, if a DBFO would provide poor value for money, we would not use DBFO.

307. We would have less schemes?

(Mr Watts) You would have the same number of schemes in the programme but you would have them delivered more slowly.

308. Less schemes per year would go ahead?

(Mr Watts) That is possibly the case, yes.

309. Can we just look at this issue of a possible bias in the system. As Mr Forman said you have been pragmatic in your approach but the memorandum from the Treasury actually does say in 3.30: "The starting point is a clear presumption that the PFI approach would be generally better than a traditional procurement." It appears that the system being set up to do the comparison between traditional funded schemes and PFI schemes has an inbuilt bias as a belief that a traditionally funded scheme always over-runs, there is always a cost over-spend, the Department cannot control what it spends when it is going for a traditional contract with a construction company for the building of roads. Is that how you see it?

(Mr Watts) No. I do not think the method of assessment assumes that PFI will always be better. Certainly, as we established earlier, the Treasury requires us to consider whether a scheme could be delivered by PFI before we should be looking at conventional procurement but the method of assessment is rigorous. In the case of a DBFO road what we look at is the capital cost of the scheme under a conventional procurement, we make a forecast of the management and maintenance costs that we would expect to incur over a 30 year life, we discount those costs back to the present values in a well-tried method, we also have to place some value on the risk transfer, and that becomes the yardstick. We do not have a real comparison to make of course until we have put it out to tender and received bids from contractors who wish to take on the contract. It is at that final stage where we can decide whether a PFI procurement provides adequate value for money.

Ms Abbott

310. Just on that point, if you look at the evidence which the Construction Industry Employers Council gave us, and they in principle support PFI, they say: "In practice public sector bodies are

22 January 1996] MR JOHN WATTS, MP, MR HENRY DERWENT, and MR DAVID GRAY [Continued

[Ms Abbott Contd]

continuing to explore PFI options in manifestly unsuitable projects".

(Mr Watts) I would reject that criticism as far as my own Department is concerned.

311. It is not you?

(Mr Watts) No, it is not us. We are not guilty.

Mr Betts

312. Dr Glaister, who was giving evidence before you, identified some very interesting points. Really the one fundamental saving he could see was that the problems of long-term maintenance in the PFI scheme would apply to the same organisation that was doing the design. That almost begs the question as to why in the design of traditionally procured schemes in the past the issue of long-term maintenance has not been a significant factor in determining what those designs were.

(Mr Watts) The Highways Agency has been looking at its conventional procurement as well and last week published a consultation document, which I have a copy of. I do not intend to read it to you today but we can very happily supply it to you. This is looking at a number of issues, such as that one, that it will not always be the case that the best long-term value for money comes from awarding the contract to the lowest cash bid. It also looks at issues such as how risks should be managed. In part, of course, we are looking to learn lessons from our DBFO experience which we can carry through into conventional procurement as well. I think you have asked a good question and made a good point and it is one to which the Agency is responding.

313. Is not one of the problems that it is not simply a matter of the design and organisation within your Department but the problem is that there is almost an incentive in some ways in the way that the traditionally procured schemes are accounted for to reduce upfront costs because they count in the first year even if that reflects downstream costs of higher maintenance in future years? The PFI, as a comparison, treats all costs similarly because it is a flow of costs over the period of the project. If you have to increase construction costs slightly in order to get the maintenance costs down then there is an incentive because it is a lifetime cost but on traditionally procured schemes there is not that incentive. Is there not a problem about the financing arrangements that ought to be addressed as well?

(Mr Watts) It certainly is the case that the approach that contractors are adopting towards DBFO schemes seems to have a bias in favour of more robust construction initially in order to reduce maintenance costs later, and of course the structure of a DBFO contract provides an incentive to do that because as the remuneration is in relation to traffic flow if you have maximal maintenance requirements rather than minimal you reduce the flow of revenue in the years of the contract. I think that is one of the benefits which DBFO will be delivering to both the Department

in better value for money and also the motorists because they should find themselves less disrupted by over-regular maintenance as a consequence of less strong initial construction.

314. In the public sector should we not be looking to learn some lessons about how we do our accounting mirroring what happens in the PFI?

(Mr Watts) That is precisely the sort of issue which is set out in the Highways Agency Consultation Document. I think developing DBFO contracts has been maybe not the first but certainly the most recent rigorous look at lifetime costing rather than short term costs. I agree with you that we can learn lessons and apply them to conventional procurement in the way in which we take forward schemes which are not suitable for DBFO.

315. Is there not a downside to that, that because none of the costs is upfront on PFI schemes they are all spread over the life of the contract? There is not really any proper contingency accounting system in Government. With the costs which have been entered into which will appear in the accounts in some future years there is almost an incentive to try and get the PFI contracts because they postpone the evil day when the cash is accounted for in Departmental accounts. What are the mechanisms of control?

(Mr Watts) Certainly in the short term one of the advantages of DBFO, as I explained I think, is that it allows us to put out to the construction industry a bigger capital value for the contract than we could if we were just procuring conventionally and it allows us to make more rapid progress and that is an advantage. In terms of looking at conventional procurement and capital costs and maintenance, while you are right that the major maintenance hit does come years down the track of course it is happening all the time. So somewhere around a third, I think, of my trunk road budget is for capital and major revenue maintenance. If part of that cost could be shifted back to the initial construction that would not cost us any more over the life of the road and it would provide a better service for road users.

316. There is not a proper system of accounting for future commitments entered into by the PFI schemes, there is nothing in the Red Book at all? I do not know whether your Department has something that is not here?

(Mr Watts) At the time of the Budget, of course, we had not awarded any individual DBFO contracts and what the precise costs are will depend upon the contract negotiated in each individual case.

317. You have a clear system of future accounting for these in your Department?

(Mr Watts) We will be able to extrapolate from the contracts what the costs in future years will be on certain assumptions. It will be partly related to the actual levels of traffic generating the real shadow tolls.

Mr Forman

318. You said, Mr Watts, if I can just intervene, that at the time of the Budget you did not have any completed contracts on which to base your assessment there.

(Mr Watts) Yes.

319. You now have what, one?

(Mr Watts) One, but there should be three more fairly shortly.

320. You would agree you need a bigger sample than that in order to draw some reliable conclusions?

(Mr Watts) Yes. By the time we have delivered all 13 projects, including the five that were announced at the time of the Budget, we will then have I think it is about 12 per cent of the entire motorway and trunk road network being operated under DBFOs. That would be far more of a cross-section because there will be schemes that involve essentially new motorway construction, others that relate to the management and maintenance of a network of roads, as one of the schemes in the Midlands will do, some that are upgrades of major trunk roads to motorway standard, so there will be far more of a cross-section of types of scheme and management tasks. I am no statistician but probably from an eighth of the network you could start to make some valid assumptions about the network as a whole.

Mr Betts

321. Two points that you have made, Mr Watts, to follow them through very briefly. Firstly, in answer to Mr Carrington when you were talking about schemes that might fail and somebody else might pick them up. Is this not again a worry that does not seem to be addressed, that if for the mere benefit of a PFI scheme it links the problems of future maintenance into the designers and contractors of the schemes then one of the reasons the firm might fail is because they have got the design and construction badly wrong, the road starts to collapse in some way and the cost of maintenance goes through the roof and they cannot afford the liabilities and they go out of business? Your Department is then left certainly to pick up the mess that results, to find another contractor to take on the maintenance presumably at a very increased cost. Now that is a possibility that will happen at some stage. Is there any contingency written in or are there any assumptions made about the possibility of that in any analysis done of the comparison between the traditional procurement and the PFI route in that scenario?

(Mr Watts) In the scenario that you have described, we would be in no worse position than if the same contractor had built a road badly under conventional procurement and had been able to walk away from it a matter of months after it was completed. Indeed, we would probably be in a better position because on a conventional procurement we would probably have paid him in full for building the road before he went bust and so

we would have a badly built road and would need to pick up the maintenance costs for the rest of its life whereas your scenario as applied to a DBFO contract if it happened five years into a 30 year contract we would only have paid I would think still a fairly small proportion, even of the capital cost, so we would have expended less public money at the time the catastrophe occurred than if we had been procuring it conventionally and it had been built to a similarly bad standard.

322. Twenty years down the road that might not be the case and surely the arguments on the better value for money that will appear in the analysis for PFI contracts is that all the risk of that problem of maintenance—high maintenance coming on stream not predicted—is borne by the contractor. In fact it is not, is it, if the contractor goes bust it is borne by the public sector?

(Mr Watts) As I have said, depending on the point in the contract at which the bankruptcy or liquidation occurs, we may well have expended far less public money both in cash and in real value terms than we would have done in a conventional procurement. If the catastrophe does not occur until 20 years, many roads that we have currently have only had a design life of 20 years before they require major capital works, such as works going on on the M4 at the moment in my constituency.

Mr Forman: We all remember it well.

Mr Betts

323. I have an issue about the way payments are made through shadow toll usage of the roads. Do you believe there could be an incentive on behalf of the operators of the roads to get people to use them if they are going to get paid for them? Could we not see, for example, the same example: if Shell and Granada were part of a conglomerate which decide to get together to build and operate these roads, you get a free gallon of petrol or a free cup of coffee for driving 50 miles down the road because the cost of that is less than the shadow tolling. You can see scenarios where there will be incentives to encourage people to drive.

(Mr Watts) I doubt that we will see advertising campaigns encouraging people to use the M40 rather than the M1. I think on the whole traffic balances itself out according to what motorists want.

324. Is that part of the free market advertising?

(Mr Watts) Yes but I do not see it occurring here. On the whole I think motorists choose a route where they have alternatives according to which they find more reliable. In that sense, if the contractor is good at building the road, is good at maintaining it in a way which does not disrupt the flow of traffic or does it to a minimal extent, then motorists will find that road more reliable and they will want to use that in preference to other routes if there is a choice of route. The contractor will get his reward from the shadow tolls. The contracts do cap the amount that is paid in shadow tolls so even if somebody did decide to drum up

22 January 1996] MR JOHN WATTS, MP, MR HENRY DERWENT, and MR DAVID GRAY [Continued]

[Mr Betts Contd]

business for one particular road there would be a limit on how much he would be able to extract from us for increasing the level of traffic on the road. It would be interesting to see how things develop but I am not envisaging we will see such marketing of a particular route.

Mr Carrington

325. You mentioned about the evaluation of the project inside the Department of Transport. What is the cost of capital you use for the public sector?

(Mr Watts) I will refer to Mr Gray for that.

(Mr Gray) I do not know the answer I am afraid.

326. Can we have a note on that?

(Mr Watts) Certainly.¹

327. Presumably the cost of capital is reflected in the discount rate you use, presumably the capital element is not just the cost of the risk and so on?

(Mr Watts) I think that the answer is eight per cent real for the discounted rate but we will let you have a note on that.

328. That is for the discounted rate as opposed to the cost of capital and the two are not necessarily the same?

(Mr Watts) We will supply you with a note with an accurate answer.

329. Presumably the discounted rate is adjusted? I am looking because Mr Derwent is really twitchy at the end.

(Mr Watts) Or even knowledgeable.

(Mr Derwent) I was just wondering whether Mr Carrington's question was right in that it assumes that we would be making different approaches to the discount rate and the cost of capital, in other words the cost of borrowing. If you take the public sector comparator exercise for road schemes, for example, the cost of borrowing is only going to be seen on the private sector side. We will be comparing it with the public sector comparator which was constructed through a process involving the use of the discount rate.

330. You do not use a risk adjusted discount rate on the public sector?

(Mr Derwent) We would be adjusting for risk but we would not be specifying changes in advance to the basic discounting calculation. We have tried to identify the risks and account for them or value them separately.

331. Could we have a note on that going into the aspects of that because I think it is technically quite complex and it would be of considerable use.

(Mr Watts) It is certainly beyond me.

332. When you are doing comparisons for what you would expect the bids to come in at, or when you are indeed evaluating the bids, what sort of

cost of capital do you then assume in the private sector?

(Mr Watts) We do not need to make an assumption because we are comparing our comparator with an actual bid. That will depend partly on how innovative the contractor is in raising cheap finance.

333. You do not try and evaluate as to whether the contractor has put in a realistic bid which he is likely to be able to sustain?

(Mr Watts) We would certainly want to be assured that his financing plans are rigorous so that we do not award the contract to somebody who cannot actually fund what he is saying he can fund. We would look at the cost of the bid in the round because it is possible that some bids will have a higher cost of capital in them but will have other efficiencies which still make them more attractive. We should not look at each separate element of a bid, we can only look at the bid as a whole and compare it with conventional procurement and see whether it provides us with good value for money.

334. I understand that. The reason behind my question is that when you are evaluating the bids part of the evaluation of the bids is going to be whether the contractor is able to sustain the bid without going bankrupt?

(Mr Watts) Yes.

335. That involves then the assessment of what his cost of capital is going to be because if he has under-estimated his cost of capital he is much more likely to go bankrupt than the people who were realistic.

(Mr Watts) We would not conclude a contract until we could see that he actually had the finance in place on which he was depending. We would want to see agreements with his bankers and so on. Indeed, his bankers would want to do due diligence on the contract before they would sign up. I think we take adequate precautions on that side.

336. You mentioned on the Northern Line that the pumping was part of the project which was not appropriate.

(Mr Watts) That is not part of the Northern Line project. I was comparing the Northern Line rolling stock procurement with some of the more basic stuff that has to be done such as, in parts of the network, the replacement of pumps and drainage.

337. What would be the general criteria that you would apply as a Department to determine whether a project fitted into something that should be done under PFI or something which clearly should not be under the PFI like pumping? Is there a definition of a project?

(Mr Watts) A project where there is either a real revenue flow or a quasi-revenue flow can be created, such as with a shadow toll, such schemes are more appropriate for PFI. I cannot really think

¹ See Appendix 20.

22 January 1996] MR JOHN WATTS, MP, MR HENRY DERWENT, and MR DAVID GRAY [Continued

[Mr Carrington Contd]

how you would generate a quasi-revenue flow for pumping water out of Underground tunnels. That is certainly one of the factors.

338. That is a principal factor, notional or real revenue?

(Mr Watts) That is one and the other is the extent to which you can transfer risk. If it is something akin to the pumping side of things—Let me take the West Coast Main Line where there is a need for a new signalling system, cab transmission based signalling, as a major contributor to the plans that Railtrack has to refurbish and upgrade the line, there it requires the development of a new system as well as the provision of the kit and its installation and the contract for the development is being let on PFI principles where the risk of development will be with the contractor. So where there is an opportunity to shift real risk into the private sector that also makes the PFI route more attractive.

339. In entering into the PFI contracts you are committing the expenditure of the Department for a long time into the future and you are committing to expenditures, which is a very normal concept in public sector financing as major commitments ahead. In five years' time what proportion of the Department's budget is going to be taken up in the leasing payments that we are looking at?

(Mr Watts) If we look at 2000-2001 we would expect payments on DBFO roads to be £264 million², the Northern Line around £75 million³, although of course that is out of London Underground's provision. That would be a total of £340 million⁴. If you compare this with our total departmental budget that is £4 billion.

Mr Forman

340. Is that in today's money?

(Mr Watts) This is in cash. So DBFO payments plus the Northern Line would account for around eight to nine per cent of our total provision.

Mr Carrington

341. What per cent would you expect it to stabilise at? Has the Department done any projections as to that?

(Mr Watts) No. Essentially that would depend on how far we develop the use of the DBFO technique in procuring roads.

342. But ballpark. If in five years it is going to be nine per cent, it could stabilise somewhere between ten and 20 presumably?

(Mr Watts) Yes. All of these three groups of schemes will be fairly mature by the year 2000-2001.

² Note by witness: Figures subsequently confirmed as being in the range of £250-£275 million.

³ Note by witness: Figures subsequently confirmed as £40-£50 million.

⁴ Note by witness: Figures subsequently confirmed as up to £350.

343. So it might be nearer ten per cent rather than 20 per cent?

(Mr Watts) Yes, it could be. Indeed, if we bring forward the tranches it will go further.

344. Will the future commitments that the Department has been reported in some form? At the moment obviously we get the departmental vote reported to us but that does not necessarily go forward into the future commitments and into the time frame that the PFI is over.

(Mr Watts) I do not see any difficulty in reporting the level of DBFO and similar payments. There is a limit as to how far we can project those though because the further into the future you go the more factors such as traffic levels and so on will influence them. In broad terms that certainly can be done.

345. Would that be broken down project by project?

(Mr Watts) No, I do not think that would be sensible because there are issues of commercial confidentiality of the individual contractors. For roads or for Underground rolling stock and so on I do not think there is any problem with reporting in broad terms.

Mr Forman

346. On the point of commercial confidentiality, Mr Watts, there have been some concerns expressed by colleagues on this Committee about the extent to which with PFI in whatever form it takes, whatever acronym we are talking about, DBFO or the others, BOO or BOOTS and the rest, the extent to which public accountability could be obscured or to some extent reduced by this phrase "commercial confidentiality". Is there anything you can say to reassure us on that point now? Obviously we do have the mechanisms of the National Audit Office, the Comptroller and Auditor General and the Public Accounts Committee but can you be fairly confident in making an assessment of this expenditure as it rolls forward that Parliament will have the maximum amount of information that is consistent with the principles of commercial confidentiality?

(Mr Watts) Certainly there is no bar on the NAO or PAC from looking at individual contracts as they do currently at individual contracts under conventional procurement. I think the prime accountability to Parliament about value for money issues is through that route. There is nothing in the arrangements we make that could impinge upon the rights of the NAO or the PAC.

Mr Carrington

347. I have just got one last question. It is a question really about transfer of risk and how realistic is the transfer of risk. I can see in some projects transfer of risk is going to be very straight forward: the project stands alone, the risk is transferred. There are other projects where the transfer of risk in certain aspects is much hazier, the obvious example to me is the Northern Line trains

22 January 1996] MR JOHN WATTS, MP, MR HENRY DERWENT, and MR DAVID GRAY [Continued

[Mr Carrington Contd]

where the Northern Line trains, as I understand, have been contracted for 20 years but an underground train has a life considerably beyond 20 years. It would be extremely difficult for London Underground at the end of the 20 years to go out and buy a completely new set of rolling stock to replace the trains if they decided that they did not want to continue with the project. So the contractor would not have a certainty of renewal at the end of 20 years but he would be pretty certain that the contract would have to be renewed and would therefore be able to price his renewal of the contract in such a way as to make it very advantageous to him financially but still just cheaper than the available alternatives to London Underground to do that. How in the contracting do you avoid what in general parlance is known as being taken to the cleaners at the end of the initial contract by the contractor?

(Mr Watts) Firstly, there are break points in the contract so London Underground is not committed to continuing a contract for the whole of the life of the trains. As you have pointed out they have a life considerably beyond 20 years. There are some actions which London Underground could initiate if it wanted to if it was not satisfied with the performance or, if it felt that the rolling stock was no longer best suited to its needs, it could exercise its right to terminate and go into a new procurement. That is one thing. Apart from residual value risk, which to some extent is falling on the contractor, there are other risks which are of very much more value on a day to day basis which is the contractor is taking the risk that he has not built the thing properly or he is not maintaining it properly because there are very severe penalties if they fail to deliver the contracted number of trains in full working order every morning. That is a risk transfer of considerable value.

348. But at the end of the initial contract of 20 years there is no provision in the initial contract negotiation which governs the price at which the contract will be renewed? Assuming the contract had been run perfectly, everything had gone very well, London Transport were delighted with the contractor but the contractor knew that at the end of 20 years, we will say in year 19, that London Underground had two options, one was to renew the contract or to go and buy new trains from somebody else because presumably the contractor had taken his trains somewhere else if the contract was not renewed, the contractor would come along and say: "I know it will cost you x million to buy new trains and I will renew the contract at x minus whatever, let us start talking".

(Mr Watts) If the offer which was made was considered by London Underground to be good value for money for them, if that was cheaper than a new procurement or procuring secondhand rolling stock from somebody else, there would essentially be a competitive market. By then perhaps the rolling stock leasing companies that are supplying rolling stock for heavy rail might also be trying to move into the Underground market. We are hoping generally to create a competitive mar-

ket for rolling stock. I do not think that the contractor is really in a monopoly supplier position even at the end of the contract. He could be if the management had not started to review its options and negotiate early enough and found that they either had to run them with these trains or not have the trains at all but I do not envisage that happening either.

Mr Timms

349. Minister, you have emphasised to us that the Department of Transport is pragmatic about its use of PFI and you do not force people to look at private finance options if they are plainly unrealistic. The point has been made that several witnesses have complained that somewhere in Government that does happen. The Memorandum that we have from the Department of Transport says: "The Department now looks to assess all capital spending for suitability under the PFI." How is that assessment carried out? For example, you have given us the example of London Underground pumping, how quickly was the decision reached that that was not suitable for PFI? Was there a lengthy process that had to be gone through before that conclusion was reached or are you in fact able to make that decision quite quickly?

(Mr Watts) I think that that is a decision that could be made fairly quickly. We have in mind the framework of characteristics, as I have described, which makes a scheme more realistic for PFI than not. I do not think it is difficult to see that something which has no revenue stream and probably little opportunity for transferring risk is not particularly suitable. I do not think that there was any difficulty in persuading our colleagues in the Treasury that that was the case.

350. But when the memorandum says: "The Department now looks to assess all capital spending for suitability under the PFI", does that mean there is a formal process that has now to be gone through to certify that in this instance this project is not one that we would want to see funded under the PFI? What does that assessment consist of?

(Mr Watts) Not in the sense of boxes to tick and so on, but all of our officials who are involved in the procurement assessment or procurement itself are undergoing training in PFI; what sort of things to look at; how to make that assessment. Because really every capital project we have is in some way unique you cannot have a completely standardised approach to that assessment. We have to do enough to be able to sustain our conclusions in discussions with our colleagues at the Treasury.

351. How can the Department's need to plan the nation's transport structure in an orderly way be reconciled with the unpredictable ability of private companies to bid for specific projects?

(Mr Watts) Part of the assessment of whether a project is suitable for PFI is advice on whether it would appear to be attractive to the private sector

[Mr Timms Contd]

as a basis for bidding. Before we put any DBFO road projects out we had to trawl the whole of the road programme and had made an assessment as to which would look more attractive as DBFO opportunities than others. The same is true of the Channel Tunnel Rail Link and other similar projects. So part of the basis of making an assessment is considering whether it looks as if it will be attractive to the private sector.

352. Do you think there is some additional uncertainty being injected into the transport planning by that or are you able to manage it?

(Mr Watts) I do not think so because it seems to me on the whole so far we have managed to get it right. We have had no shortage of people bidding for DBFO roads. We did not have difficulty in getting a good vigorous competition going for the Northern Line trains, I think initially three companies were bidding for that contract. Although it is not directly ours, the Heathrow Express project had quite intense interest and competition. As you know we started off with four consortia bidding for the Channel Tunnel Rail Link. I do not think there has been difficulty in getting enough market interest.

353. How would you characterise the Department's experience of procurement in the past? I ask that question because some of the evidence we have been given has indicated that there has been a large number of catastrophes in the Department of Transport's experience of procurement. For example, I think Sir Christopher Bland told us that there had been examples of roads that had come in at 40 per cent over budget and that one of the benefits of PFI is that it moves us beyond those problems. Has it been a bit of a shambles in the past?

(Mr Watts) Not in terms as dramatic as those. I think you have to look at the nature of the contract. Some types of contract are let on the assumption that there will be add-ons. For example, if you are very unsure of ground conditions when you are building a new road there are two ways of approaching it, you can undertake very extensive ground surveys in advance so that people have the information and then bid a firm price or you can build into the specification an assumption of the conditions that will be encountered and provide for negotiated variations if the actual conditions turn out to be different. I think it is largely in respect of the latter type of contract where some of these headline high percentage cost over-runs arise. They are not really over-runs if they were envisaged in the contract initially. There might be a need for extra payments of variation orders.

354. How common has a 40 per cent cost over-run, or however one describes it, a 40 per cent higher cost, been in the past at the outturn of a road building project?

(Mr Watts) Off the top of my head, unless I have brought something along with me—Mr Derwent reminds me that the NAO has conducted

an inquiry and reported on that. If it would be helpful I am sure we could obtain that for the Committee and send a copy to your clerk.

355. It would be helpful, yes. Given that I have not seen this report, was this frequent or extremely rare?

(Mr Derwent) They drew attention to a number of examples where the figure was averaging out at 38 per cent. They were examples which, as the Treasury minute in response indicated, were ones which, as Mr Watts has said, were cases where you would expect quite a large volume of claims after the point which was the basis for the 38 per cent comparison. We would maintain that it was not a terribly fair comparison but the figures were there to be seen. The more you move towards design and build the more you are actually forcing private sector contractors to take responsibility for elements of the deal which under conventional procurement they would be claiming for afterwards and we think that gives us better value for money on the whole.

356. You are approaching the final system of specification for charging for the use of motorways and other inter-urban roads, what role do you see private capital playing in that?

(Mr Watts) We are a little further back than you have said. The next stage is to invite a number of companies who want to demonstrate electronic tolling equipment to show it to us at the Road Research Laboratory and then on a bit of the M3. The first stage is that we have to be satisfied that there is equipment available which is reliable enough for the purpose of charging tolls on a free flow motorway system. Certainly the experience of our German colleagues in carrying out similar trials has not led them to the conclusion that there is sufficiently reliable equipment available yet. Unless we are satisfied that the equipment is up to the job technically we would not go any further. If we are so satisfied then the next stage would be to seek legislation to enable us to charge tolls on motorways. We have no existing powers to charge tolls on existing roads. Subject to that legislation it would be a matter of deciding how to procure. If we reach that stage my view is there probably would be a significant opportunity for PFI both in developing the equipment, installing it and perhaps in operating it as well so that no upfront capital cost would fall on our budget. In effect the contractor would supply a tolling service to us and would be remunerated out of part of the toll income. I must emphasise that no decisions have been made about that, I am just giving you my own opinion of how the PFI could be used for the provision and operation of the equipment.

357. So when toll charging does become technically possible will you prefer that to shadow tolls or will it be horses for courses?

(Mr Watts) The real tolling proposal, which was announced I think in the Budget of 1993, was to introduce tolling primarily on the motorway

22 January 1996] Mr JOHN WATTS, MP, Mr HENRY DERWENT, and Mr DAVID GRAY [Continued]

[Mr Timms Contd]

network subject to technical matters and legislation. There are some DBFO projects which involve motorways but the majority do not. Those that do involve motorways there are provisions within the contract which would allow us to introduce real tolling but there is no reason for the presumption that every DBFO road which is currently shadow tolled will automatically become real tolled. The two policies are quite separate although they are not incompatible.

Mr Forman

358. Finally, Mr Watts, before we let you go, obviously in a Committee like this, as you will recall when you were the Chairman of this Committee, one always hears more from people who have complaints as a general rule than from people who are happy. In the former category we have had a memorandum from SJ Berwin & Co, a firm of lawyers, who acted for Graham Network Operators in its bid for the A69 DBFO project and there they had some significant complaints about the bidding procedure on behalf of their client and more broadly they alleged in their memorandum to us: "some public bodies pursuing PFI are wasting their own time and resources and those of the private sector with ill thought out schemes." They gave two examples, the Highlands and Islands Airports project, which may not be your ministerial responsibility since it is in Scotland, I do not know, and the Doncaster MBC. Would you like to comment on either of those two cases?

(Mr Watts) I have no knowledge of the Highlands and Islands Airport, it is certainly not part of my portfolio.

359. What about Doncaster?

(Mr Watts) I am not aware of the scheme to which they are referring.

360. This was apparently for an interchange project. Maybe it did not get very far and therefore it did not reach your desk.

(Mr Watts) As far as I am aware we have not offered the Doncaster Road interchange as a DBFO, certainly not as a single scheme.

361. I think it was more of a proposal rather than a firm project I gather from this. The point they made was that they thought most financiers agreed that it was not viable so presumably you would not take it very far in any case.

(Mr Watts) It really does not ring any bells. I described earlier that before we got around to identifying and letting any DBFOs we scoured the programme and had a look to see which ones might make sense. I cannot imagine that we would have invited only private sector firms who have done any work at their own risk on something that we had not identified as being a viable project.

362. Maybe you could look into that with officials.

(Mr Watts) If there is anything which I should know and should be able to tell you I will give you a separate note.⁵

363. Thank you very much.

(Mr Watts) I can say in general that although there are complaints about the cost of putting bids together we also get extremely violent reactions when we start to shortlist and if we decide to shortlist two then three and four very often object to being deleted. Those arguments from contractors go both ways: they do not like to incur costs but they certainly do not like to be excluded.

Mr Forman: That is human nature. Thank you very much, Mr Watts.

⁵ See Appendix 20.

MONDAY 24 JANUARY 1996

Members present:

Sir Thomas Arnold in the Chair

Ms Diane Abbott	Mr Quentin Davies
Mr Clive Betts	Mr Nigel Forman
Mr Malcolm Bruce	Mr Barry Legg
Mr Matthew Carrington	Mr Stephen Timms

Examination of Witnesses

MR ANDREW LIKIERMAN, Director, Financial Management Reporting and Audit, MR STEVE ROBSON, Director, Financial Regulation and Industry (Grade 2), and MR DOUGLAS HOGG, Director, Private Finance Unit (Grade 3 equivalent), HM Treasury, examined.

Chairman

364. Thank you very much for joining us this afternoon. It is very nice to see you again. For the record, could you introduce yourselves to the Committee?

(Mr Likierman) Can I introduce Steve Robson, who is Director of Finance Regulation and Industry at the Treasury, and Douglas Hogg, who is Head of the Private Finance Unit.

365. Thank you. I wonder if I could begin by putting some questions to you, Mr Hogg. You now combine the role of Head of the PFI Executive and Head of the Treasury's Private Finance Initiative Unit. Do you think there are any dangers in combining the roles of what I would call the policy promoter, who wants to meet quantitative funding targets, and that of guardian of the public purse, who wants to ensure that value for money is not sacrificed?

(Mr Hogg) If you look at the role of each, first my role as Chief Executive of the Private Finance Panel, I am there to do a job of managing a team currently of 23 executives who are to act, if you like, as facilitators, catalysts, in helping the client departments deliver individual projects, and that is a role which, for this purpose perhaps, can be split into two parts. The first is giving advice where helpful in the way to structure projects and bring them forward, and the second is a post box or receptacle of best practice, of establishing precedents, and for that purpose we have a vehicle for spreading those precedents and best practice, which is the training course. In that role we are very much independent and involved where we can be of help and are invited. So far as the role within the Treasury is concerned, that is where the policy itself is defined resulting very much from the practical experience of projects. In that role I report to Steve Robson. In terms of the way in which the policy is developed, or I should say refined because at this stage we know what we are trying to do, which is essentially to deliver projects under two criteria, the first being risk transfer and the second value for money, I should stress that whilst we issue guidance it is very difficult to issue any

thing that encapsulates everything. We are trying as much as possible to approach projects on a case-by-case basis. For that purpose I am not the guardian of the public purse. That is the responsibility of the accounting officers in the client departments.

366. So you do not really see any conflict?

(Mr Hogg) Not in that way, no.

367. The build-up of PFI expenditure has been criticised by some people as having been slow. Do you think that overall the level of publicly sponsored capital expenditure has been higher or lower than it would have been if the PFI had not been launched?

(Mr Hogg) So far as my own role as the head of the Private Finance Unit is concerned, I confine myself to the process of delivery of projects in terms of helping people address issues that are effectively barriers to that. I see myself in a role with the Unit as helping in that practical process.

368. There has been a certain amount of controversy, I think, about the Skye Bridge. Has the fact that some projects were regarded as suitable for the PFI led them to being taken ahead of their priority in terms of expected net benefits?

(Mr Hogg) I think where we are today is at a point in time where we can now say that a lot of people have now heard of PFI and a lot of people are really beginning to understand it. I think in the three years to date there has been a lot of misunderstanding and the evangelistic role that has been carried out by the Treasury and others has been to help people understand what a PFI project might look like. We are now engaged in the process of actually delivering them. Inevitably what will happen is that what people thought might have been a suitable PFI project is not. Obviously those projects either will not go ahead or will go ahead other than through PFI.

369. Some very large benefits have been claimed from the adoption of PFI projects. What evidence

24 January 1996]

MR ANDREW LIKIERMAN, MR STEVE ROBSON and
MR DOUGLAS HOGG

[Continued]

[Chairman Contd]

can you provide to the Committee about projects which have been completed so far?

(*Mr Hogg*) If by "completed" you mean actually built, there are relatively few. If by "completed" you mean signed, then I think we can go through those: first of all, the national insurance recording system. That is a project for Andersen Consulting to undertake the function of essentially processing national insurance contribution records. The savings on that project are something approaching 50 per cent of what we estimated would be the cost of providing the equivalent service in the public sector over the life of that contract. So first of all, there are very considerable savings. Secondly, there is the possibility in that contract that things do not go according to plan, by which I mean the service is not provided at all or there are interruptions or the quality of the performance of the service is less than we expected. What we have been able to do in that contract, which we have done in others, is to specify what we see as acceptable service standards. So we actually have a clear idea of what we want and we have a means of measuring it and in the event that that service is not delivered, we will penalise the service provider. If that service is not provided at all, there are very substantial penalties. Those are structured in a way which ensures that we are able to continue to provide the service as well as incentivising the operator to continue to provide the service. Characteristically, I would say that if you look at any PFI project you can look at the benefits perhaps in three ways. The first is savings, the second is that you actually have certain protections in the delivery, and thirdly, you will have at least as good, if not better, quality of performance. For example, in relation to the Northern Line trains we have warranties on reliability that are four times better than any other service on London Underground.

370. I wonder if I could put a question to all three of you and I do not mind who answers, but it is a question which has come up at previous hearings and it will not surprise you in the least that I think we ought to go over the ground again today, and it is simply this: is PFI additional or substitutional?

(*Mr Robson*) Chairman, I will take a crack at answering that, if not in a very helpful fashion. I think when something starts it is quite easy to say whether what then happens is additional or not because you are pretty clear about what was going to happen otherwise. So in the early days of PFI it was pretty clear to me that the projects that were going forward were additional in some sense. When something is established, it is much harder to say whether it is additional because it is very speculative to know what would have happened if it had not been there. If you look at the figures in the Red Book at the moment this is projecting capital investment under PFI this financial year that is coming to an end of about £0.5 billion, in the next two financial years in the area of £2 to £3 billion. When something is happening at that level—

admittedly not a big figure in the total of either Government capital spending or obviously total budget expenditure but it is still quite significant—it is very hard, I think, in fact, I am not sure one can make a sensible stab at answering the question of what would it have been otherwise and, therefore, whether or not it is additional. The main point I would draw out—and it follows on from your last question—is that we are seeing on these early deals really quite significant improvements in value for money by comparison with the traditional way of procurement, and if the taxpayer's pound can be made to go further in this way, then more can be obtained with it.

Chairman: Before I call Mr Betts, Mr Forman would like to put a supplementary to you, Mr Robson, on this point.

Mr Forman

371. It is actually to Mr Hogg. I thought your simple schematic division between savings advantages, delivery advantages and quality advantages was helpful to the Committee, but can I be sure I understand what those headline terms imply. So far as savings are concerned, it really is to do with life-time costs, is it not, in the case of PFI? That is the great advantage, is it not?

(*Mr Hogg*) That is one way of looking at it. The life-time cost assumes the life of the asset. Frequently the length of the concession or franchise or service contract may or may not be the same as the length of the life of the asset. The appraisal that is carried out will be for the period of the contract that extends beyond that.

372. Is it your ulterior motive, as it were, to try, wherever possible, to get the contractual period coterminous with the life of the asset that is created?

(*Mr Hogg*) In terms of what is proposed, the way in which we go about completing these projects is to try and suggest a period of time that we think is the optimum period of time.

373. From what point of view?

(*Mr Hogg*) From the point of view of the asset and the service we are talking about. But having said that, we must not forget that the private sector are coming back to us with their design and proposition for the delivery of the service and it is, therefore, important for them to be given the opportunity to bid on terms, one of which is the length of the contract. We have a number of different lengths of concession proposed. For example, in relation to CTRL it is 999 years, Croydon Tramlink, it is 99, roads, it is 30 and so on. So it can vary enormously, of course.

374. And then on the delivery point, you really mean the old traditional desire of any procurer of an asset or a service, the idea that it should be done to time and to cost, in other words, it should have a high level of predictability in it?

(*Mr Hogg*) Under a normal capital procurement you would normally expect to pay over the

24 January 1996]

MR ANDREW LIKIERMAN, MR STEVE ROBSON and
MR DOUGLAS HOGG

[Continued]

[Mr Forman Contd]

construction period. You, the public sector, are therefore parting with money and you will find during that period there may be delays for a variety of different reasons and cost overruns. Under a PFI proposition we do not pay a cent until the service starts and that means that it has started and that what you are being provided with meets your criteria for acceptance. So by definition you are forcing the private sector to take the risks of delivery to time.

375. I was going to say that is the essence of the transfer of risk really, is it not?

(Mr Hogg) So far as that risk is concerned, absolutely, and part of the key to structuring these transactions is to identify the revenue streams that are payable by the public sector to the private sector, to link them to elements of the service and then to have fluctuating levels, which may vary, for example, on performance and quality.

376. Then on the final point of quality, let me be clear. It is quality of service to the users that you are principally interested in, is it, or is it quality from the Treasury's point of view of, as it were, quality of public spending?

(Mr Hogg) These projects can differ enormously in terms of who is actually receiving the service at the point of delivery. For a hospital it is taxpayers; for roads it is taxpayers. It may actually be a service which is to the public sector itself.

377. Such as?

(Mr Hogg) For example, prisons and the national insurance recording system. Those are examples of services that are for taxpayers but to the public sector. What I mean in that context by "quality of service" is to the users. In the case of the national insurance recording system, it is ensuring that it can handle a number of transactions within the period of time, within certain timeframes, to certain levels of quality of performance.

378. So if the user were another government department that would not matter; it would still score as quality?

(Mr Hogg) Exactly.

Chairman

379. Mr Robson, in the light of your answer to my question about additionality, which was a very helpful answer, if I may say so, could I put to you the question I put to Mr Hogg earlier, and that is whether or not you think that overall the level of publicly sponsored capital expenditure has been higher or lower than it would have been if the PFI had not been launched?

(Mr Robson) Again, I think, Mr Chairman, it is very hard to answer that when this is a reasonably established initiative because one is increasingly speculating as to what might have happened otherwise. I think the main point I would emphasise is that if, as we are, we are spending the taxpayer's pound more effectively, that means more can be done with that pound, and I think that is the heart

of the "doing more" as this initiative gets better established.

Chairman: Thank you for that. Mr Betts?

Mr Betts

380. Can I ask one or two questions about the issue of the control of public expenditure. This is analogous with family budgets and I know Lady Thatcher used to like to use these rather a lot but if you liken PFI to family budgets for Christmas presents, in straitened circumstances instead of being able to spend £200 you can only spend £100, but if at the same time you had a credit card that would give you £1,000, they all have a wonderful Christmas and a few months later they cannot pay the rent. Are the Treasury actually worried that they are losing some degree of control over public expenditure in this process?

(Mr Robson) I think the first thing I would emphasise is that whenever the Government creates an asset, whether it is by PFI or by some traditional method of procurement, it is *de facto* entering into a stream of obligations because it will usually want to keep that asset working. If it builds a hospital, it wants to keep the hospital working; if it builds a prison, it wants to keep the prison working. It will not have entered into a contract with its workforce to keep it working, but *de facto* there is a pretty certain commitment that it is going to carry on using people to run that facility for the life of the facility. When you move into the PFI that *de facto* commitment becomes a legal commitment to the PFI supplier, so there is that change, an important change, but one has to measure it by what would have happened under a traditional procurement and it is not totally novel in that sense. At the same time one is servicing the capital invested in the project. In some ways that is akin to repaying the borrowing if you financed it through public sector borrowing. The main thing that is happening so far, and our key test in PFI, is that we are doing it on a better value-for-money basis. So to go back to your analogy, if the family is spending its money and getting better value for spending it, it should be a happier family.

381. Surely the difference is that under the system of accounting for projects which are funded by traditional methods, the Treasury is going to want to see the cash value of that project, the construction costs, in the budget immediately. It is not prepared to see the value of those come as costs for renting the building built in whatever form you described it throughout the period of the life of the building? It is a different way of accounting surely? Did it not impose a greater discipline on departments which they are now more free from?

(Mr Robson) As I said, in part that department would have entered into a stream of *de facto* liabilities to operate that facility.

382. But aside from the operation, the up-front costs of providing the building?

(Mr Robson) Yes, the up-front costs will be returned over a period of years, and that is some-

24 January 1996]

MR ANDREW LIKIERMAN, MR STEVE ROBSON and
MR DOUGLAS HOGG

[Continued]

[Mr Betts Contd]

thing that we are putting in place arrangements to monitor. We have to monitor that liability.

383. So there are longer life engagements under the PFI downstream than there would be under the traditionally funded project?

(Mr Robson) There would be more, yes.

384. Can I pick you up on the point you raised about putting in place systems to monitor. Does that mean there are not any in place at present?

(Mr Robson) There are none in place to monitor forward commitments in a systematised way of any sort across government departments, whether it is my pension, a defence project or the PFI. The PFI has brought a focus on to this. We are responding to it and putting those in place.

385. They do not exist now?

(Mr Robson) No.

386. But the commitments are being entered into?

(Mr Robson) But the commitments are being entered into.

387. When Sir Christopher Bland came to see us the other day he made the very same point, that his concern was not merely that within government centrally, the Treasury, there was not any real system of monitoring commitments within departments, but in many cases, because departments were operating PFI on a decentralised basis themselves, the departments themselves had not really got any system of monitoring commitments within their own departments. Is that your experience as well?

(Mr Robson) I think departments are starting to focus on that issue but Sir Christopher—

388. Starting to focus on them?

(Mr Robson) That is right. Sir Christopher was right in that sense.

389. Why did the Government start off then on the PFI initiative? Why did the Treasury accept this approach, which clearly was creating more downstream commitments than traditional projects, without getting the monitoring in place first?

(Mr Robson) As I said, this is not something that is restricted to PFI. There are downstream commitments in large areas of Government which are not systematically monitored at the moment.

390. The Treasury accepted a system of PFI coming in which created more downstream commitments without putting monitoring in place first. Why?

(Mr Robson) I think the simple answer to that is that we were concerned to put the effort initially into getting this initiative established and working. Now that it is starting to work we want to put in place the monitoring. It is a question of which comes first.

391. How long will it take to establish the monitoring on a comprehensive basis?

(Mr Robson) We intend to get it in place in the next six months.

(Mr Hogg) May I add to that that I think the department that has really got PFI under way in terms of entering into commitments is Health and Health have for, I think, roughly a year to 18 months now had a system established on a subcontracted basis to a consultancy to actually monitor commitments, and very recently the Higher Education and Further Education Councils, one of them has put one in place and the other one is looking at it. Characteristically, what we are seeing in departments in terms of their approach to monitoring these commitments is that they go through a first stage which, if you like, is understanding what this is all about, what does a PFI project look like. The second stage is beginning to identify it and exploring the potential for PFI in relation to those projects. The third is beginning to make them happen, at which point there is a process of, how do we track them, how do we keep an eye on them. Most departments, virtually all departments, have their own private finance units, which are the early warning system, the way in which these sorts of commitments and knowledge of them is centralised within departments, and I think we can expect to see departments set up similar sorts of databases. That is certainly happening and well-advanced in Health and, indeed, the consultancy which was responsible for doing that in the NHS publish a regular bulletin updating people on how many commitments have been entered into and so on, giving them information.

392. That is very interesting because I recently asked some questions of various government ministers, including Health, and it was very interesting that, particularly in Health, Education and the Environment, the answers I got back about future commitments were really that the department did not have any information because it operated itself on a decentralised basis and bodies like hospital trusts were independent and, therefore, whatever they did they did and the department did not have any collective information about it. Do you think this is a problem?

(Mr Hogg) If you just talk about the job which has been done by Newchurch in the Health Service, the way in which that database works is that it is very much market-driven, in that trusts are encouraged to register, but I am not aware that they are actually required to or there is a means to require them. If you look at that database what you have is something between 500 and 1,000 projects—I do not know what the number is—actually registered on it. If you look at the experience of the Further Education Funding Council, they recently published themselves a list of something like 480-odd projects—I cannot remember the exact number—with a capital value of something like £650 million. Not all of those are PFI projects and one of the big problems we have is actually establishing whether these requirements for capital

24 January 1996]

MR ANDREW LIKIERMAN, MR STEVE ROBSON and
MR DOUGLAS HOGG

[Continued]

[Mr Betts Contd]

expenditure are all PFI. So the process, I think, for departments of setting up these databases is one that goes wider than just PFI in terms of, as it were, putting these commitments on paper and then following them, those that are PFI and those that might be, for example, straight operating leases or finance leases, which are obviously not PFI.

393. So trusts can still decide they do not actually want to register?

(Mr Hogg) Absolutely. What I am trying to explain is the process as it exists today in terms of the way we are going.

394. I wonder whether you would be able to give the Committee a clear indication, perhaps not now but in a note later, of what the monitoring system is that will be set up now, both within the Treasury and what is going on in departments, and also indicate those areas of spending where there is no requirement to register into the monitoring system?

(Mr Hogg) I should emphasise that these initiatives are very much the departments' own initiatives.

395. There is a central unit, otherwise we will be getting some information from departments. Is it possible to give us what the monitoring arrangements for the Government are within the Treasury and what you are aware of happens within departments and also where the holes are in it, where spending can take place without any monitoring of that expenditure being able to take place, if trusts, for example, choose not to register?

(Mr Hogg) So far as the Private Finance Unit in the Treasury is concerned, it does not have a role. It is even more remote than, say, the NHS Executive from trusts in relation to the monitoring of obligations that are entered into or are anticipated as being entered into by trusts. I simply volunteer to you my distant knowledge of what is going on in the Health Service, as I believe that is the process that many departments are going through when they feel they have a critical mass of projects coming forward, but it is very much the responsibility of departments and they are the ones that are informed as to the arrangements that they are entering into for monitoring those commitments, and some of these are as small as a few hundred thousand pounds.

396. You can give us a note on the issue of monitoring?

(Mr Hogg) I can certainly provide you with a note as to the role that the Private Finance Unit has and what it is aware of in relation to what is being done.

397. And what is being done in the Unit now?

(Mr Hogg) I can give you a note which spells out exactly what the Private Finance Unit's role is in relation to monitoring and what we are aware is being done, but that has to be caveated with the fact that we are even more remote from some of

these databases than, say, the NHS is from its own trusts.¹

(Mr Likierman) Chairman, if I may, I would like to clarify an earlier question. The PFI does not give rise to new accounting principles as far as the Government is concerned. To confirm what Mr Robson says, the Government enters into many commitments for the future, of which this is one kind. So we are not in new territory here as far as the way in which the accounting system works. I just wanted to clarify that.

398. We might have slightly different views on that. We will come on to another issue, the issue of confidentiality, which again I think we raised in the Budget hearings with you, Mr Hogg, back on 5 December. You almost have a season ticket to our hearings! On that occasion, you raised the issue of commercial confidentiality and the difficulty that raised for ourselves as Members being able to have any feel for what was going on, particularly on individual projects but also sometimes in terms of real commitments that had been entered into, because the departments say the information is something that is between them and the contractor. Is that not something of a concern? How does the Treasury pick up on each of these contracts? Presumably you do not have the problem of commercial confidentiality in terms of access to the information. Is there any guidance to departments on how they should treat this issue because otherwise departments could decide they are not going to release information?

(Mr Hogg) So far as guidance is concerned, we provided a note on the practice which is adopted in relation to contracting out.² Is there anything further that we can provide you? So far as PFI contracts are concerned, I think the issue in terms of what is kept out of the public domain is surely a matter for the departments and the contracting party and what they feel should be done but respecting, however, the fact that, for example, the NAO or others or yourselves have got to make due enquiries.

399. While the NAO can come in and look at contracts after they have been signed and after the project is in being, looking at the situation afterwards is different to having a view about the commitments that are being entered into before they are entered into and there is no way for Members to get any proper understanding of the comparative analysis and decisions that have been made before they are actually taken.

(Mr Hogg) So far as the responsibility for that is concerned, that lies with the relevant accounting officers and departments; in other words, the due and proper process of a PFI procurement, like any capital commitment, is the responsibility of the accounting officer and his concern will be to ensure value for money through a competitive process. So far as their concerns are concerned, I would have thought so long as there is a level playing field, there is the competitive process, there is

¹ See Appendix 18.

² See Third Report, Session 1995-96, HC 79, Appendix 8.

24 January 1996]

MR ANDREW LIKIERMAN, MR STEVE ROBSON and
MR DOUGLAS HOGG

[Continued]

[Mr Betts Contd]

therefore the mechanism in place to ensure value for money.

Mr Betts: It is about the aggregate of those and how you look at future commitments that we are most concerned.

Mr Carrington

400. Just going on from what Mr Betts was saying, you gave an answer, Mr Hogg, which said that the PFI was quite clearly distinct to operating leases and financial leases. I can understand why they are distinct from financial leases. Can you give me a definition as to why they are distinct from operating leases?

(Mr Hogg) So far as finance leases are concerned, they will quite clearly be capitalised and they will be recorded in their own particular way in government accounts. So far as operating leases are concerned, they are very much an animal which in character is something that is more to do with asset financing than the provision of a service. My view is that if in order to ensure that we get the best value out of PFI type structures we went around trying to sell a modified form of leasing we would end up with a whole load of commitments that are more to do with financing and funding issues than really what we are after, which is an operating agreement with clear service provisions and funding behind it because at the end of the day what is absolutely critical is that there is a substantial element of what I would loosely describe as responsibility, operation and control of the asset by the private sector. The difference, though grey, between a PFI project and an operating lease is that I think in relation to an operating lease you begin to muddy the water on the issues of responsibility, control and service provision so far as the supplier is concerned.

401. I am a little confused about that because—and I do not want to pursue this point to destruction because I suspect the difference between the PFI and an operating lease gets rather hazy on the edges—if you are looking at something like the Northern line trains where clearly an asset is being provided on a term basis, where the owner of the asset is responsible for ensuring the asset is available for use against certain criteria, I do not really see that that is not an operating lease.

(Mr Hogg) So far as that transaction is concerned, that actually started life as a finance lease proposal from a specific contractor. It then became what I would loosely describe as an operating lease in that the focus of the transaction was very much around the asset. It then evolved into pure service provisions in the sense that we succeeded in getting much more, if you like, control and responsibility with the private sector supplier. You are absolutely right when you say that the edges are fuzzy and it may be even more than that. I am sure that you can look at these things from a financing point of view which is very much a characteristic of the finance and operating lease. We try and look at it entirely differently which is why I always seek to

make the distinction which is really about service provision and an operating agreement that relates not to an asset, which is really with the connotation of a lease, but to a service in order to get away from this concept of it is all about the asset.

402. One of the projects that has been awarded under the PFI by the Department of Transport has been a new road between Newcastle-Upon-Tyne and Carlisle, as I understand it, called the Haltwhistle by-pass. When the Secretary of State announced this he refused to disclose the cost of this scheme to the Government on the basis of commercial confidentiality which is entirely understandable. The slight concern that I have about that is that there are going to be relatively few of these projects. Ought we not to be worried that if commercial confidentiality applies to one of the major projects it will clearly apply to all major projects and, therefore, because there will be a small number of them we will not get realistic numbers in total either because there will be a danger they could be broken down project by project? In other words, commercial confidentiality would stop the global figures being released because the global figures would be sufficiently close to the individual projects and, indeed, break down given the commercial league table figures as well. Is that a risk?

(Mr Robson) I think it depends on what level of aggregation one has for the figures. It is clearly not going to be the case that this is going to be allowed to distort aggregate public spending figures. If somebody asked for a level of aggregation which was relatively small and carried the risk that you describe then maybe there could be a problem. Usually there are enough ways of putting things together in the public accounts to avoid that and certainly we would not let the aggregate figures be corrupted by such considerations.

403. Regardless of commercial confidentiality, it is right, is it not, that the commercial details of each of these transactions would be available, say, to the PAC or whoever it is wishes to audit them on behalf of the House of Commons?

(Mr Robson) They will certainly be available for the National Audit Office to look at and to satisfy itself that the accounting officer has entered into a transaction that represents value for money for the taxpayer.

404. So commercial confidentiality will not be used as a shield against public accountability?

(Mr Robson) Absolutely not.

405. When that particular project was looked at, was it compared against a public sector comparator?

(Mr Robson) The road?

406. The Haltwhistle by-pass.

(Mr Robson) Yes.

407. What was the result of it?

24 January 1996]

MR ANDREW LIKIERMAN, MR STEVE ROBSON and
MR DOUGLAS HOGG

[Continued]

[Mr Carrington Contd]

(Mr Robson) I cannot say what the result was in detail simply because I do not know it. What I do know is that the accounting officer was satisfied that it was value for money to adopt the PFI solution.

408. But you do not know whether it did so by a wide margin or a narrow margin or anything like that?

(Mr Robson) I do not know.

409. One of the things that slightly concerns us is under what circumstances the public sector comparator is not used. Are there any circumstances where a project might not be compared to a public sector comparator and, if so, what would happen in those circumstances?

(Mr Robson) Maybe it would be helpful to the Committee if I took a moment to describe what our guidance on this matter says. The guidance distinguishes two categories of PFI project. The first category of such projects are cases where the output of the project is being sold to a third party, and the Government is entering into a joint venture with a private sector company or consortium to supply that output and the Government is contributing to that consortium through assets or cash or whatever. The Channel Tunnel Rail Link would be a classic example of that type of project. What our guidance to the department says in that case is that the department does not have to look at the option of building that facility wholly in the public sector. It has to satisfy itself that the money or the assets it is contributing to that project represent value for money by comparison with the other ways it might deploy those assets or money. That is the first type of project. The second type of project is one where the output is sold entirely or substantially to the public sector. A prison, as Mr Hogg said earlier on, would be an example of that. The guidance says that that should be compared with a wholly public sector solution, if one is realistically available, in a similar timescale. If one is not realistically available in a similar timescale then one has to compare it with whatever is available, including the option of doing nothing. What we are trying to do in all of this is to make the comparisons real. I think one of the criticisms that existed at the time of the Ryrie rules was that like was not being compared with like, that the private sector would come up with a proposal for a project and a department would compare it with a wholly public sector solution which it had no intention of undertaking for the foreseeable future. We have tried to get away from that which seemed to be a rather false concept.

410. It does seem rather difficult to be able to judge best value for money in those circumstances, does it not?

(Mr Robson) I am not sure it is any more difficult than it has traditionally been in the public sector. We have done traditional procurement for the past 40 odd years where if someone came along and said, "I want to build a road in a traditional man-

ner", it was not compared with some other way of building that road. It was simply looked at in its own right, assessed against some not very explicit absolute sense of what represented value and by implication was compared with doing nothing. Here for the majority of cases we have advanced the cause because we are now comparing that with a PFI solution so in a sense the comparison has become more meaningful.

411. What is the credibility of the public sector comparator? Presumably what happens, say, in the Department of Transport or in the Home Office or the Department of Health is that they do their own sums and they decide what their public sector comparator is, which is quite a complex calculation in itself. They then compare it to the PFI bids that they have in, which again are going to be quite complex to analyse. They are going to be under enormous pressure in each of these departments to accept the PFI bids because that is the way the whole thing is going and if they do not accept the PFI bids they may not get their project in any case, so they are going to want to make sure that the public sector comparator is favourable to the PFI bid, in other words the public sector comparator is always going to be top dollar if they possibly can. Who polices the analysis?

(Mr Robson) There are some very important issues here. On the last point you raised, I sometimes wish, "If only it were so". Sitting where I sit one gets the main sense that there are plenty of people in departments who are busy trying to find ways to let the traditional way win rather than the new way because doing things in a new way is risky and they would much prefer to stick with tried and tested methods. Often I feel the dynamic in the department is in the other direction. Going back to the other aspect of your question, there are some very difficult issues here. One issue is the whole area of risk. In the public sector there has traditionally been a tendency not to address risk actively when looking at a traditional project and at the start of that project. Risk has tended to be a thing where you used to explain why the outcome differed from what was expected, not something that you seek to identify in advance and to manage effectively. If one compares a PFI solution with a traditional solution this can tip the playing field against the PFI project because the PFI project does cost risk at the outset because the private sector costs the risk in the bid. If you compare that with a traditional solution where people have not sought to identify and cost the risk of handling it in a traditional way you have got an unequal comparison and an important part of the work that we have been doing, in particular the work Mr Hogg has been doing, has been to get public sector sponsors to accept the need to identify risk *ex ante*, to put a value on that risk which is often quite easily done by looking at past experience of their projects and therefore making a comparison of like with like in that sense. The other aspect that you raise, which is also very important, is the change in the nature of the decision when the bids come in. The

24 January 1996]

MR ANDREW LIKIERMAN, MR STEVE ROBSON and
MR DOUGLAS HOGG

[Continued]

[Mr Carrington Contd]

traditional public sector way of doing this sort of business, as you know as well as I do, is to put a specification out in tremendous detail to the private sector to do whatever it is, build a road, build a hospital, put it out to maybe five firms and get back five bids. You will get back five very similar bids because the specification was so rigid there is hardly any room for manoeuvre, so the decision at that point is very simple, "Which is the cheapest?". By comparison, when the PFI bid comes back the specification that will have been sent out will be much more open, will specify the outputs it has sought and left it to the private sector to come back with solutions to that, solutions which will usually have a number of variant bids in them with different degrees of risk transfer, so that instead of a simple, "The cheapest must be best solution", you have then got a number of bids with a combination of price and risk transfer to deliver the output and you compare it with the traditional way of doing things where hopefully you have identified and costed the risk of that solution *ex ante*. So from a very simple decision you have produced a more complex decision, a more subjective decision, but I think a more sensible decision. That decision is much more evidently a judgment call than a decision at the end of the traditional procurement route. I do not think one should make any apologies for that because it is a more realistic decision, a decision that has got to face that project as it really is rather than the rather hopeful way that projects tended to be addressed in the past. These issues of identifying and costing risk at the beginning, of having a more complex decision at the end, are real and important and ones that we have got to try and address and provide guidance on to help people address in coming to a judgement about what is the best value for the taxpayer.

412. Thank you for that very detailed answer. Coming back to the final part of my previous question, with this extraordinary complex bidding process and comparative process who then polices the judgment as to whether the right decision has been taken, indeed the right methodology has been used and the right risk put into the calculation?

(Mr Robson) We in the Treasury and Mr Hogg's Executive Unit provide help, advice and guidance, but the responsibility—and we have made this very clear indeed—is the responsibility of the accounting officer of that department accountable to the Public Accounts Committee.

413. And the National Audit Office has agreed the whole process and is happy that the public funds are properly protected and that the transparency of accounting on these meets their general requirements and that they indeed understand the risk assessments that are being made in a position to be able to sign off on the accounts for the accounting officer for the department?

(Mr Robson) The National Audit Office do not give generic ticks of that sort. They will look at the position on individual projects and properly so. We have talked with the National Audit Office,

explained it to them and Mr Hogg has taken them through case studies. I think they have a good understanding of what the PFI is. I think they have a good understanding of the sort of issues that I have just been describing and I am sure that they will police it rigorously in the context of individual projects.

Mr Forman

414. I think we ought to bring Mr Likierman in because otherwise he will be a wasted resource for the public sector! Could I pursue with you a little bit the relationship between the PFI and resource accounting. I believe you are very closely involved in the latter subject. In the Treasury publication put out in November of last year which I have referred to before, and other Members have, called *Private Opportunity, Public Benefit* there is a paragraph which you are probably familiar with because you may have written it yourself and it is paragraph 3.60 which baldly says: "Resource budgeting will mean a more level playing field between resource costs using the PFI route or conventional procurement." Could you just elaborate, for the benefit of the Committee, on what lies behind that statement?

(Mr Likierman) There are three different dimensions to that in terms of the notion of a level playing field. First of all, if one thinks about the way in which the public and private sectors plan and report, the PFI, through the resource accounting mechanism, provides a way by which public and private sectors will indeed be reporting on a comparable basis. Resource accounting will help to make the position more transparent. The second dimension is in relation to the comparison with conventional procurement. If one looks at the way in which conventional procurement will take place under resource accounting and the way in which the PFI projects are planned, again there will be greater comparability between the two because the introduction of capital charges will provide the basis for a clearer definition of the costs of projects. Thirdly, in terms of the remuneration of capital, at the moment we have a position where the private sector generally, but not always, will seek to remunerate its capital in its projects. That is not so at the moment in the public sector and we will therefore have comparability there in the need to remunerate capital in both public and private sectors. Those are the three ways.

415. In relation to capital charges in particular, it would not depend on a fortuitous accident for a department to incur equivalent charges for identical publicly and privately financed assets?

(Mr Likierman) Fortuitous? The capital charging mechanism will be operated within the public sector on one set of rules. It is up to the private sector to decide what it takes for its own cost of capital and the way in which it seeks to bring that into its own calculations.

416. What about the whole question of public expenditure control. Can you identify any ways in

24 January 1996]

MR ANDREW LIKIERMAN, MR STEVE ROBSON and
MR DOUGLAS HOGG

[Continued]

[Mr Forman Contd]

which largescale recourse to the PFI might actually undermine public expenditure control or are you confident that that will not happen?

(Mr Likierman) The answers given earlier about the way in which future commitments in general are monitored are applicable. As Mr Hogg has indicated, work is at the moment going forward to try and make sure that the monitoring of expenditure over extended periods is improved. As you have heard, we are very aware of the need to make sure that that takes place.

417. The Red Book looks at the accounts three years ahead. Obviously in traditional capital expenditure procurement in the public sector it would be a much longer period than that. It has been lengthened still further, has it, as a consequence of the PFI extending into more and more departments?

(Mr Likierman) Coming back to the question of the principles of appraisal here, at the moment in a nonPFI position there is an obligation to secure value for money and to make sure for departments that they are offering value for money regardless of whether it is a PFI deal or not. In that sense, therefore, the arrival of the PFI provides no change to that principle in terms of the need to provide value for money. Value for money will mean looking at the whole life of the project and not just at the three years of the Survey.

418. As I think Mr Hogg alluded to earlier. Can I ask one question on a matter which is only slightly connected with that and that is the impact of the European Union, if any, upon these questions which we have been questioning you about. At Annex C in the document I referred you to there is a heading "EC Procurement Rules" and in paragraph 15 there is a fairly clear paragraph which says, "When undertaking negotiations"—that means with the private sector—"the purchaser must observe the following principles: transparency; objectivity; nondiscrimination; equality of treatment; measurability." If I have understood this right those principles derive from the thrust of opinion on these matters within the European Union. Have we reached a stage where any regulations or directives emanating from Brussels might affect the success or otherwise with which we pursue our own initiatives?

(Mr Robson) I think the answer to that is no. The sort of criteria that you describe are really ones that one cannot take exception to. The European directives allow for a thing called "negotiated procedures" which means entering into contracts with the private sector through a process of negotiation with bidders and this meets the requirements of the PFI quite satisfactorily.

419. I believe one of your other responsibilities is regulation within the Treasury so there is no equivalent in this area yet of the Capital Adequacy Directives?

(Mr Robson) There are EU Procurement Directives which do bite on this but they have procedures within them which accommodate the PFI approach.

420. So it is sufficiently elastic to allow us to carry this forward without feeling that we are inhibited in any way by the European view?

(Mr Robson) We have not hit our head against any problems there yet.

Mr Bruce

421. I was wryly commenting to my colleague there that it is a pity you did not think of all of this when you had nationalised industries because you were claiming that you could not get access to the public sector and that was the reason you had to privatise them. Given that you are setting this in motion, how are you going to present to us in future the spread of repayments? If more and more projects are going to the PFI, how is it going to be presented to Parliament that publicly sponsored projects are being financed?

(Mr Robson) As I was saying earlier on in relation to Mr Betts' questions, we are putting in place a system to monitor these forward liabilities and in the course of that we will seek to develop ways which are satisfactory to you and to Parliament in reporting them to you.

422. Will that include the possibility of transferring existing capital assets that have been conventionally established to the PFI and then changing the basis of payment in future?

(Mr Robson) No. Existing capital assets which have been procured under existing methods remain in that particular box. PFI projects which have the nature of forward commitments, like Mr Betts was talking about, will be the ones that we will be putting in place in the monitoring system.

423. On the roads budget, for example, if you were to transfer a road or roads to the private sector with the shadow tolls and so forth that would be an existing capital asset transferred to a private operator from which the private operator would derive an income from Government. Presumably that income needs to be presented forward as a charge on the public purse?

(Mr Robson) The PFI does not involve transferring existing assets to the private sector in isolation. That sounds a bit like privatisation to me. It may be that they will in another way. For example, it is not inconceivable that one might have a project to widen an existing road so that traffic on the widened part of the existing road formed a PFI project and in that case the shadow toll associated with that project would fall within the monitoring system that you have talked about.

424. Can you see the difficulty we have as these projects expand in that—obviously they are new projects and not existing assets transferred—we are told that much of the information is not available because it is commercial and confidential? How

24 January 1996]

MR ANDREW LIKIERMAN, MR STEVE ROBSON and
MR DOUGLAS HOGG

[Continued]

[Mr Bruce Contd]

fast can we be sure that your political masters against your very sound advice may not be tempted by the idea at the end of a Parliament to enter into a number of PFI projects which would enable them to start physically to get things in place knowing in reality that the cost to the taxpayer over the life of that project could be significantly higher than doing it by the conventional method? What assurance can you give us that there is a mechanism in place either to prevent it from happening or, if it is happening, to make it apparent to the public at large and Members of Parliament that it is happening?

(Mr Robson) I think the protection that is available for those cases is the protection that is traditionally available to protect the public purse which is the responsibility of the departmental accounting officer and his ability to send formal memoranda to his Secretary of State if he feels that a transaction which is not in the interests of the taxpayer is being entered into. That applies as much to the PFI projects as to any other activity and it has proved, as we have seen in the recent past, to be a fairly effective method.

425. But it is an internal mechanism.

(Mr Robson) No. If this situation arises, the National Audit Office gets to know about it as a matter of course and will no doubt, if it sees it right and proper, investigate it, so that there is really what is a very important check in the system at that point. The proposition that you raise that people may enter into PFI projects in the late stage of a parliament applies to almost any project because quite a lot of the expenditure is never going to come home to roost that fast, so the concern you have, it could materialise anywhere, but this same check is there.

426. I do not quite follow that given the rather simplistic way we treat borrowing at the moment where mainly capital and current are not really very significantly distinguished. They are shown separately, but not distinguished.

(Mr Robson) Sorry, but the point I was making was that someone could start a project now and the expenditure, even with a traditional project, it would not be very large in the course of the next 15 months, so, shall we say, the publicity effect of starting it would be apparent and the commercial chickens would not really come home to roost. The check in that case is the same check, the responsibility and the accountability of that accounting officer.

427. Given that we are used to that method of accounting, the forward implications are fairly clear, but the difficulty some of us have is understanding how, given so much information is being treated confidentially and is not available, we can be sure that the alternative method is equally comparable and transparent. We have had difficulty getting basic information about what is happening at all, so at the moment it is difficult for us to see

how we can do our job, never mind the Public Accounts Committee.

(Mr Robson) The degree of commercial confidentiality here is no more than any other area of government where contracts are involved. There are not new boundaries being erected. The point about commercial confidentiality exists in many other areas as well. The ultimate guardianship of the accountability to Parliament does work through the NAO, the PAC in those areas and will work in the PFI area as well. As I was saying earlier on in relation to Mr Carrington's question, one of the things the PFI does is actually erect an alternative traditional way of doing things and a stronger challenge in terms of getting value for money for the taxpayer than has existed to date.

428. I understand that argument. I do not think across the political divide there is anybody who is against the principle of having good PFI initiatives. Whatever your politics are, if it is going to enable you to do more things effectively, then clearly that is of interest to everybody. That is not the point at issue, but what the point of concern is when you change the method of accounting that you do not get yourself into a situation where in the short run effectively you go on a spending spree, a bit like Mr Betts was saying of a family going on a hire purchase spending spree where you get an awful lot going and the bills come home to roost and in five, ten or 15 years you build up a substantially bigger repayment. If I can quote the late Harold Macmillan talking about privatisation as selling off the family silver at somewhat distressed prices, are we not now in danger of buying replacement silver at rather expensive prices?

(Mr Robson) I do not think we are. When we sold the family silver, we did not actually compare it with other ways of getting rid of it. Today we are for the first time comparing traditional procurement with a real alternative. Now, the point about the forward commitments is an important one, as I have said in relation to the answers to Mr Betts. We are determined that we have in place a system that monitors those. We will try to ensure that the information that the House seeks about knowledge of those forward commitments is provided. The issue of commercial confidentiality is there, but, as I say, it is an issue that arises in many other areas of government as well and it does not of itself create a new borderline.

429. I think from my point of view you are making a statement, an assertion that it will not cause a problem, but I am not sure you have convinced me why.

(Mr Robson) The only other thing I would say is that as the person at official level in government charged with the responsibility of driving this initiative forward, it does not feel to me like people are rushing to exploit it. It does not feel to me like people are rushing to do anything very much and that is one of my great problems.

Mr Bruce: Perhaps they are right!

24 January 1996]

MR ANDREW LIKIERMAN, MR STEVE ROBSON and
MR DOUGLAS HOGG

[Continued]

Chairman

430. Mr Likierman, is there anything else you wish to say or Mr Robson or Mr Hogg?

(Mr Likierman) No, thank you very much, Chairman.

Chairman: Well, I think this has been a very useful session, so thank you very much indeed for joining us this afternoon. We are really most grateful.

Examination of Witnesses

MR MICHAEL JACK, a Member of the House, Financial Secretary to the Treasury, and MR STEVE ROBSON, Director, Financial Regulation and Industry, HM Treasury, examined.

Chairman

431. Well, thank you very much for coming before us today. For the record, can you just remind us of your particular responsibility so far as the PFI is concerned?

(Mr Jack) I am, Sir Tom, the Minister responsible for the Private Finance Initiative.

432. Now, the PFI was launched in 1992. So far as you are concerned, how has the initiative evolved since its launch and in what areas so far do you feel that it is proving most successful?

(Mr Jack) I think inevitably with something which represents such a major change in the way that government departments can procure their services, it has evolved slowly and I think inevitably there is a caution amongst spending departments about wholeheartedly embracing the initiative and so it has been a question of finding their way. I think without doubt the area which has shown the greatest progress has been in the area of health and I think that was particularly marked out by virtue of the fact that the Under Secretary in that Department, Tom Sackville, was prepared effectively to issue an endorsement to the project which invited all who were concerned with the procurement of services and particularly those with a heavy capital bias to see the Private Finance Initiative as the first and foremost area to be examined before coming to a conclusion on which way a service should be procured. I think without doubt too transport has shown the way forward. There have been some significant successes and, although not directly encapsulated in the current Private Finance Initiative, the Second Dartford Crossing has certainly been a very useful example to draw on to illustrate to people with some clarity what the whole concept of the Private Finance Initiative is about.

433. If you had to make a judgment now about the relative inadequacy of the Ryrie rules, what would you say?

(Mr Jack) I would put it simply that they were one of the major inhibiting factors in allowing a proper relationship to develop between the private sector and government in the provision of services. Certainly there was a lot of representation coming from the private sector prior to the changing of the Ryrie rules which showed the private sector wished to be more involved in the provision of services to government, particularly where there was a large-scale capital element and that those rules prevented

that relationship from evolving properly and the easement that was made by the present Prime Minister to enable the door to be opened I think has opened the door to a new dawn in the way in which services to the public sector can be procured.

434. I recognise that the following question is perhaps slightly unfair because you were not in the room when I put the question to Mr Robson, but I think I ought to put the question to you as well, not least because we have put it to other witnesses in earlier hearings, but really to have the benefit of your answer because undoubtedly we shall want one or more paragraphs in the report on this issue, and that is whether you regard the Private Finance Initiative as additional or substitutional?

(Mr Jack) The answer, I suppose, which most people may have given you is that it is additional at the time that it occurs because clearly you are seeing private funding coming in to help the Government procure services and, therefore, if the Government has a particular amount of money to spend and it, therefore, wishes to see services procured, then the additionality is the arrival of the private project with its capital to enable that particular project to take place. Where I think though more popularly people have asked the question is certainly in the current spending round where there has been a deletion against previous capital plans of certain sums which the Government have planned to spend because the Private Finance Initiative can be seen to provide an alternative way of procuring those services and it shows up in the capital base-line, and some have indicated that that is a cut in activity, but I think what impresses me is that if you add into that analysis the question of value for money, because that must be the starting point as to whether a project is Private Finance Initiative or not, then clearly if resources can be freed up by adopting that particular route of preferred procurement of services, then it is clearly available to the spending department. I think when the Secretary of State for Health was before this Committee, he indicated quite clearly in his case that resources so freed could be devoted, for example, to additional patient care.

Mr Bruce

435. Mr Jack, can you tell me first of all whose responsibility is it to check the bona fides of those people bidding from the private sector? Mr Robson said before that this was not moving for-

24 January 1996]

MR MICHAEL JACK, MP and MR STEVE ROBSON

[Continued]

[Mr Bruce Contd]

ward all that fast because it is a new venture, but who is responsible for determining that the bidders are suitable, acceptable, safe? Is it the departments or is it you and does the Treasury cross-check?

(Mr Jack) I think the most important point to make is that the starting point in any chain of responsibility is the departments'. The accounting officer in any spending department is ultimately responsible for what he does and what he agrees to and it must be for the department where the department of course is in the lead because one of the aspects of the Private Finance Initiative is that it effectively is a devolved initiative and if you take the field of health, then there are many hospital trusts, other similar bodies who themselves will be responsible for using Private Finance Initiative. The field of higher and further education will be another example of where not directly at departmental level, but at a devolved level it will be those organisations who will take the responsibility for ensuring the bona fides of a series perhaps of partners who come together, perhaps in a consortium, to do a particular project, but I do not see in the sense of the way that perhaps you ask your question that one should differentiate that from the very proper need, whether it be public procurement in the traditional sense or Private Finance Initiative, for the right level of responsibility to determine whether the partners in any project are going to be appropriate to do the job. That is part of good order and good procedure.

436. Are you satisfied, with the very substantial cut-backs there have been in the mainstream Civil Service and especially in the Treasury, that you have the resources in-house to satisfy yourself that the private bids that are coming forward are, if I can use the term, "safe", and I do not mean just because the companies are safe? What comes forward to me is that almost every bid that is put forward is different, it is original, a different package. How do you test whether that will work?

(Mr Jack) If you had asked me that question in July when I first came into post, I think I would have had to have said to you that I could not be safe in giving you an answer in saying that we were adequately sourced or resourced to check on the stream of projects and one of the things that happened in fact as a result, in fairness, of comments by Sir Alastair Morton prior to his departure and the arrival of Sir Christopher Bland, a very clear statement from both of them, was that if we were going to get deals done, and getting deals done means picking the right partners to make it happen, we had to improve the resource at the disposal of certainly the Private Finance Executive whose, as you may have gathered from earlier evidence, particular task is to act, to use a modern term, at the interface, the point of relationship between the department and the private sector to make certain that the proper deal can be negotiated, to make certain at that level they receive additional resource both in terms of manpower and money. We responded to that by increasing their budget to some £2½ million to ensure that the

panel of executives could be enlarged to its current size of 24 and that we had that body of expertise. People, by and large, from a financial/City background who had been used to the private sector to do the type of deal that we are talking about, so if we are looking for an element of street-wise people to be alongside those in the departments, then we have taken a first and important step there in bolstering that. The second thing where again if you had asked me that question in July, I would have had to have admitted that there were areas for improvement was within departments themselves and one of the things we are about to launch is a very substantial training programme indeed which has been done on a good Private Finance Initiative basis with Price Waterhouse where, and I hope it is not too ambitious, but it has got to be of this order, some 5,000 to 10,000 civil servants will be put through an intensive training programme to ensure that they are properly exposed to the culture that is involved in the Private Finance Initiative. Part and parcel of that will be how do you make the judgments which lie at the heart of your particular question. Certainly we do not omit the Treasury from that because I am determined that they will be as strong in being able to make those judgments as the departments, so I think we have recognised there is need to strengthen the assessment and, in the ways that I have described, I think we have made some important steps forward.

437. Can I quote a specific example of which I do not expect you to be aware of the details, but nevertheless it is controversial in my own area which is the proposed private bid for a new community hospital in Stonehaven which is obviously under the auspices of the Scottish Office. The bid list was published yesterday and there were three bidders, one including the local healthcare trust and two others who, in their CV, if you like, attached to the press release, made no reference to their ability to provide clinical services, even though this is the first community hospital in which clinical services are being privatised. Therefore, the public are saying, "We have three bidders. One is the local trust which appears to have private backing plus the clinical resource and two others who are entirely private, have no clinical resource, bidding for a hospital which includes an accident and emergency unit". So the first question which arises is: how does this add up? Can I also say that today I have been advised that one of the bidders, which is Westminster Health, which is 42 per cent owned by an American company called NME, has been the subject of some controversy inasmuch as its parent company has a terrible record of fraud within the United States system. I gather that a £670,000 out-of-court settlement on a fraud allegation by the State of Texas has been paid; they have admitted liability for the death of a 13-year-old girl in their care; there are 150 allegations of patient abuse under their care; and they have paid out over £250 million in fines for fraud in the United States. Now, this company has three

24 January 1996]

MR MICHAEL JACK, MP and MR STEVE ROBSON

[Continued]

[Mr Bruce Contd]

non-executive directors on the board of Westminster Health which is one of the three bidders for this hospital. Now, I am not asking you to answer all those things. What I am asking you is who will test the bona fides of that subsidiary company? Will the Treasury in those circumstances interest itself in that or is it entirely a matter for the Scottish Office to determine?

(Mr Jack) You have asked implicit in that a great number of questions. Let me see if I can boil that down to some comment which will be more generally applicable. The first and most important thing is the terms upon which the services that anybody indulging in a Private Finance Initiative project are going to proceed, whether it be health, roads, computers or whatever. The definition of what is to be procured is absolutely crucial and that is why, listening to your description, I was rather surprised that for what appears to be a provision of a range of healthcare services that the procurement specification that you describe in your example meant that some clearly were not responding as others were doing, so if you said to me what was I going to do about being presented with that story, my first question would be, "What was the specification for the services to be procured?" because clarity in there is absolutely crucial. There are clearly going to be, when you get back the bids following the tendering process, the responses and part and parcel of the Private Finance Initiative is a clear ability to demonstrate that people have got their finance in order and that they are effectively companies of good probity and part and parcel of checking up whether somebody can actually deliver is to make appropriate enquiries and that is why I lay emphasis on having people who, in the nicest sense, were street-wise to the types of deals that we were talking about which is where the executive can give guidance to government departments if they are in the lead as far as a procurement exercise is concerned. One of the other parts of any Private Finance Initiative exercise is the whole question of how do you analyse the risks that are involved because again what you have described is a series of risks and you adverted to the fact that part of the record of the enterprise that you referred to might be deemed as risky in terms of could they actually do the job. In terms again of laying down a detailed specification of what is required, I would say that it was very important indeed to ensure that the right questions are asked in order to ensure that you can quantify the risks that may be involved in determining how somebody is actually going to do the projects, so all of these factors have to be looked at very carefully indeed.

438. But that is by the Scottish Office in this context.

(Mr Jack) Well, I think it must be in your case because of where the ultimate responsibility lies for the provision of healthcare services.

439. One of your ministerial colleagues, and it is on the record so I will name him, George Kynoch,

who is the Parliamentary Under Secretary to the Scottish Office, is effectively on the record as saying that what he hopes will come out of that is a sharpened pencil by the trust and that the trust will win the contract. Well, when that is stated, it makes one wonder why anyone else bothered to bid and what the public are asking is, "Is this a genuine, real competitive exercise or is it in fact a means of putting pressure on a trust to put in a better performance than the original specification that was drawn up a year or so ago?" It may be a legitimate position, but it leaves people confused as to what the real objective is.

(Mr Jack) If I may say to you, I think this is one of the important things that is coming out now which is a much closer debate which has happened certainly as it has become evident to a wide range of service providers that the Government takes the Private Finance Initiative very seriously indeed. Part of the process you have described in fact is a two-way process of education because a number of people on, for example, projects in the transport sphere have written me letters saying, "I am not quite certain why this particular procedure was followed" in the context of a particular project, and I think that it is very important that the procedures that are going to be involved in any process of tendering are made entirely clear to those who are involved in it because some may be relatively new to this type of work and, by definition, most will be because they have not been in since the beginning, but that is precisely the point as to why we want to strengthen the way that we operate both in terms of Civil Service awareness, the strengthening of the panel and the strengthening of the Treasury which is a repository of advice and review on particular projects, but, as I made clear, the ultimate responsibility lies elsewhere, because there may well be problems because the initiative effectively is only three years old, as the Chairman indicated in his opening questions. I certainly would not want to sit before any body like this and claim that every problem was sorted out, but we are recognising, if you like, where our weaknesses are so that we can in fact realise the strengths of what the Private Finance Initiative has to offer. So I acknowledge there may be problems in terms of the particular example you quoted, but, if I can summarise, we are working very hard to further sharpen up our act, but good dialogue with private sector partners is very important if both sides are to learn the best way of doing these deals. One of the things where again I think you made a very important point is when you illustrated the fact that each deal up to now is very much a bespoke affair and having sat with members of the construction industry and had them carry out an exercise of compare and contrast between, for example, the contractual arrangements which they can currently enjoy because there are standard form contracts for many of the major public procurement projects they are involved in, they can pluck that off the shelf, but, on the other hand, they are saying, "We have to design, if you like, a contractual arrangement for this project", one of the things

24 January 1996]

MR MICHAEL JACK, MP and MR STEVE ROBSON

[Continued]

[Mr Bruce Contd]

that arises out of the action plan which I issued a short while ago is the need to bring forward revised procurement rules which address that problem and try to enable, where it is appropriate, more standard form parts to be included in tendering and contractual documents and in so doing perhaps cut down some of the difficulty which I do understand from your question can come at this stage when there are so many bespoke projects.

Chairman

440. How much of your own time is taken up currently on PFI and PFI-related work?

(Mr Jack) Well, at this very moment, Sir Tom, not as much as I would like because I think it is very important that ministers both in the Treasury and in departments spend time getting behind it and showing their commitment. The reason I give you that answer is, as you are probably aware, we have just embarked on the Finance Bill, so most of my time not unnaturally is going on that, but just let me give you an idea of how I am re-ordering my time to raise the priority. I shall be embarking on a series of regional visits once the Finance Bill is out of the way to take the Private Finance Initiative around the major regional centres to promote it. I am doing that partly because I think it is a good idea, but partly because an awful lot of people are writing to me and saying will I go and talk about it, so I would imagine that probably something like 20 per cent or more of my time is going to end up by being spent on that very properly indeed because it is an area which requires further intense work and support and, as the Minister responsible for it, I think I would be derelict in my duty if I did not do it.

Mr Betts

441. Could I summarise what you said in reply to an earlier question about the substitutionality or additionality. What you were saying to us was that it had reduced the provision in the Red Book figures for traditional capital spending and that you now hope that PFI schemes would come along which would be additional and act as a substitute as well for those schemes that had been reduced in the Red Book, but is there not a danger that having already made those reductions in the hope that PFI schemes may come along, they may not come along and there may be a total reduction in the capital spend which is undertaken?

(Mr Jack) I think there are a number of points in your question. I always think it is better to travel in hope than not to travel at all, but I am confident of the estimate which was in the Budget announcement that we would have agreed by the end of this financial year some £5 billion worth of projects, but I think it would be very wrong, if I may say, to concentrate wholly and solely on the capital impact of the Private Finance Initiative. It is not just about a different way of substituting capital. I have, if you like, disciplined myself to get away from that point because when I first arrived and I was learning more about it because I had seen it from the standpoint of a spending depart-

ment in the Ministry of Agriculture, Fisheries and Food, and it certainly seemed as if capital was what was at the heart of it, having examined it more closely, I think the most important starting point is to say that it is about procuring services and to get those services may involve initially upfront for the provider of the service a substantial capital element and, you are absolutely right, the Red Book looks at PFI in terms of approaching capital spending in a way which, if you like, perhaps focuses the mind because of the Red Book or the very nature of it on the capital spend. The reason why I have confidence in it is that departments will want to procure services. They have in their running costs the ability to procure those services and they look then to private finance to find a way of doing that because, you are quite right, if their capital base-line has been cut back and they still have the ability to procure the service they want to provide, then the Private Finance Initiative is the right way to go.

442. But if the PFI does not deliver there will be a shortfall.

(Mr Jack) In the sense that people who agree private finance deals agree things to be delivered. There are indeed complexities in any project like this where you have to go through the necessary negotiations and because of that very complexity you cannot always guarantee precisely that you are going to get to a particular point in time where you say a thing is happening. On the other hand, if you have a need for either roads, hospitals, new computer services or new Northern Line trains you start out on that with a clearly identified need. You look at the Private Finance Initiative as you would do the public sector route as to which is better in terms of value for money in deciding to go down that way. If at the same time you are facing the fact that your capital baseline has been reduced but you still have a need for those services by definition the Private Finance Initiative gives you an opportunity to acquire the service against a background where your capital baseline may well have been reduced.

443. If the PFI schemes came out as giving worse value for money you would have a fewer number of projects?

(Mr Jack) There is that aspect of it in terms of value for money, that is perfectly true. In most of the areas we have looked at what we have seen is that the Private Finance Initiative has been able to give substantially better value for money.

(Mr Robson) Can I add a point in relation to Mr Betts' question and that is that this table, table 6.5, is a table of figures from departments. They are not figures that the Treasury dreamt up; they are figures which the departments put together. They know our enthusiasm for PFI and they will tend to underestimate so they could over-achieve in our eyes.

444. Could I come back to a point we were raising with your officials before: as a Treasury

24 January 1996]

MR MICHAEL JACK, MP and MR STEVE ROBSON

[Continued]

[Mr Betts Contd]

Minister can you justify the fact that the PFI has no monitoring procedures in place at all?

(Mr Jack) Given what I said to Sir Thomas in answer to the first question, we certainly started out with this initiative having changed the rules to enable a closer relationship to be established with the private sector. As always, you learn as you go along. I have inherited this initiative at a time when we were further evolving our monitoring rules. I do not think it has ever been the case to say there are no monitoring rules. Obviously every department is subject to scrutiny whether it be by this House and our procedures, by the National Audit Office or the Public Accounts Committee. So there always has been the ability to monitor and scrutinise the spending of a department.

445. I was thinking of monitoring of future commitments rather than anything else.

(Mr Jack) The work carried out by this House, by the PAC and by the NAO is monitoring current activity.

446. At the present time Members cannot find out from departments what future PFI commitments are.

(Mr Jack) I think you are asking a slightly different question than your first words suggested. What you are actually talking about is how can you analyse, having agreed a private finance deal, what the forward spending consequences are in terms of a department, in terms of actually procuring—

447. Officials told us there was no system in the Treasury for monitoring departments.

(Mr Jack) If that was the question it was not entirely clear from your first line of enquiry that is where you wanted to go. I would agree with you to the extent that that is an area we are currently working on because there are some important aspects, but I think our first priority was to get some of these deals going. I know the Committee has been supplied with some of the forecasts as to the possible implications in terms of spending. The figure at the end of the PES period, which I think is about £460 million works out as 0.14 per cent of total government spending. I think that puts it in its perspective. I would not in any way wish to diminish the importance of the question you are asking but in terms of the overall spend as the project develops, the consequences over that period are relatively small. We are looking very carefully at that because clearly what departments are signing up to is a continuing series of obligations they are going to have to meet having started on the Private Finance Initiative. If there had been no Private Finance Initiative then those departments, having committed themselves to a continuing stream of payments for particular services—remember I am answering this from the perspective of no Private Finance Initiative—the best we could have seen under old ways of analysing government spending was an analysis of a rolling three-year public expenditure survey. Yet the obligations to

provide monies for on-going services by definition would have stretched ahead to some way in the future. I think the essential difference is this: if you take something like a road under conventional activity the government of the day can move up or down on the timing of, for example, a major refurbishment of a particular road. Under the Private Finance Initiative you are making continuing payments where the refurbishment or maintenance is down to the supplier but there is an inescapable commitment to meet those expenditure targets. We are conscious of that and we are working hard within the Treasury and the departments to find a way that we can analyse the forward effects. It is not without parallel in any department where under conventional procurement it has long-term future commitments.

448. Can I ask a question on efficiency and value for money which you raise. You said it was buying a service rather than a construction project. It seems to me that the argument right the way through on the PFI and the justification for it has been that you also link in the effects of any construction in terms of the downstream cost of maintaining the project. You tie it into one contract with one organisation and so there is a general presumption in the document that is produced by the Treasury that the PFI will give value for money savings. On the other hand we have been told repeatedly—Mr Hogg gave us some figures when he came to give evidence on the Budget inquiry—that the range of increased financing cost was around two to four per cent. Why does the Treasury not find a way, given that many of these assets remain owned in the public sector, of getting a design build and operate contract with a private operator but getting public funding for it to get the best of both worlds?

(Mr Jack) Can I pick you up on some important words in your question. You said there was a “general presumption”. That, if I may say, is not the way the thing is gone about.

449. It is paragraph 3.30.

(Mr Jack) As far as the adoption by departments of the PFI route is concerned, it happens after a very careful analysis of the question of value for money because one of the points that we have made is that they must prepare good quality business cases before they put their project out to the private sector for their interest and part of this is to make sure you are going to get better value for money. The reason I mention that is to address the second point that was mentioned. If you were to use the government as a banker, which is really what lies at the heart of your question, it is perfectly true in borrowing terms the government can borrow money cheaper than anybody else but part of the development of the response to the risk transfer which the Private Finance Initiative involves is that the private sector partner has got their money at risk. It concentrates the mind to be able to win the contract in such a way that the overall full life costs can come out once the evalua-

24 January 1996]

MR MICHAEL JACK, MP and MR STEVE ROBSON

[Continued]

[Mr Betts Contd]

tion has been done to give a lower cost than in terms of public sector procurement.

450. The private sector can still take the risk on the project and borrow from the government for what is a government asset and pay the government back the same as they could to a private banker. Is the real government objection to this idea not the macro-economic impact of the government borrowing money rather than the private sector borrowing money?

(Mr Jack) No, what we are doing is procuring a service so there is no need by definition in the Private Finance Initiative to have public money involved. If that means that you can reduce the use of public capital, if it means that monies can be deployed elsewhere then so be it, but as far as the public sector is concerned it is used to managing risk. One of the key risks is financial risk and that helps to concentrate the mind on producing a good quality project.

451. This raises the issue of how you make sure there are proper controls over what is being done. I think it is a very important point. You said in an answer that there is a defined project and we have got to make sure the contract specifications are right. Is not one of the problems with PFI schemes—it may be very good that it happens but it is also a problem—that there is an incentive for the private designer/builder/operator to come forward with new ideas? Because of the issues you raise on intellectual property rights there is naturally a presumption that those ideas can be passed on to the competitor who will compete on the basis of the ideas they have. Sometimes you will not be comparing like with like. You will be comparing a new idea from one operator against an artificial idea of how to do something from another operator. It is not simply a test of how much money is involved. I suggest to you there are worrying possibilities in this. I would like to know what the government is doing about it. If you reflect back to when we had all the Polson problems a few years ago, one of the real difficulties of that exercise was that Polson and his company was offering a new product that could not be compared to existing products and therefore it left scope for subjectivity and within that the corruption that followed from this. I am not saying corruption has to come, but do you not have to tighten it up because of this incentive to the operator to find new ways of doing things?

(Mr Jack) Particularly where technology is involved there may be a risk in the innovative solution but that is a question of weighing up all the risks because every risk within a project can be identified and you can put a weighting on it in coming to your conclusions. You can also put a money value on it because if somebody came up with a wholly novel idea then we have to ask how we score that risk and ask whether it is worth taking the chance. You have got to use your knowledge of the area in which you are operating to come to a judgement. It must be the same problem

which faces, for example, every Defence Secretary of State when they are looking at some new piece of technology before going into a particular project. The government generally is used to weighing up that balance. It is no different in the sense of looking at technological risk than if government was doing it by its normal traditional route where it has to make a decision as to whether to go into that particular area. Inevitably one learns from previous experience and that is why the blending together of the experience of the private and public sector is helpful in developing schemes and identifying where risk may be greatest. You identified the question of technological risk. Quite clearly if you take something like the project with the Northern Line trains the technical specification there has been so upgraded and designed to give a factor of four in terms of improvement over the best alternative options and when you are looking at the quality of the company, their track record, as well as the financial case, then I think you weigh all of those factors after a proper risk assessment in coming to a conclusion as to whether you are going to award a particular project to that particular bidder. I think all of those factors are taken into account but you have to balance to a certain extent the risk to value for money, and that is the same in any kind of procurement exercise.

Mr Forman

452. Mr Jack, I would like to ask you a few questions about this transfer of risk you have already been talking about. Before I do I would like to try and get a point out of you which your official Mr Robson mentioned earlier on. He was looking ahead to the way in which the PFI might benefit the public purse over a longer period and one of the things he said was that he thought it would move the process towards a position where the specifications for capital requirements could be less tightly defined. In other words, you would not have to say in minute detail exactly what you were expecting from people bidding for a particular project. This might develop into a statement of the desired outcomes and an indication to the private sector firm involved and it might suggest competing ways of meeting the objectives specified in the tender document of value for money. That sounds rather interesting but will it not take the PFI into the realm of policy options and mean it will have much greater impact on the policymaking process? In case that sounds abstract let me give two examples to illustrate it. In the sphere of health the policy objective might be to reduce the most common cause of illness and death in men, namely prostate cancer. You can intervene surgically to deal with that problem; you can intervene with drug treatment ahead of time to try and cure the problem; or you can induce changes in human behaviour well in advance in such a way that the problem does not arise on such a largescale in the first place. Could it not be that with the PFI in a few years time that private sector operators who were responsible for a package of services and as it were controlling the whole consortium might say, "The

24 January 1996]

MR MICHAEL JACK, MP and MR STEVE ROBSON

[Continued]

[Mr Forman Contd]

right approach to this, Minister, is following . . .", and they might suggest some radical policy departure which was at least implicit in their package. Would that be something which you or your predecessors would *a priori* rule out?

(Mr Jack) I think anybody who listens to the Radio 4 programme *Medicine Now* will be tempted by the many novel and interesting ideas which come forward from practitioners, suppliers and innovators as to how medical conditions can be dealt with. As we have seen, there is a big difference between the discovery of some new approach and its general adoption within the National Health Service and the reason for that is what we are looking at in the Private Finance Initiative is the question of specifying the output. When I am talking about procuring a particular service I am talking about what you want out of what it is that you are going to buy. And so it is for the policy maker, whether it be the Secretary of State for Health or whether it be a hospital trust, to determine what the output is and then to seek good quality innovative ideas to achieve it. However, I certainly do not think in a world where innovation and new technical development is the order of day that we shall stop seeing interesting ideas coming forward. I do not see the Private Finance Initiative in quite the way you describe it as being a shop window where perhaps untried and novel ideas will be put forward in the hope of tempting the policy maker down the route to buy the service. It is up to the policy maker, as I say the hospital trust or the Secretary of State, to specify the output they want based on their best judgement of how to specify that and for the private sector partner then to provide that. If you have a look at private opportunity and public benefit you may have an answer to that question. There is an interesting little box in there which talks about the provision of dialysis facilities under the control of clinicians but the provision of those via the Private Finance Initiative. It might be helpful to reexamine that as a way of illustrating the point I am making.

453. It is interesting the way in which the PFI could spill over into the sort of work now done by consultants working for government. Consultants are often given a remit by government departments to look at a wider range of policy options than would be conventional in Whitehall departments' ordinary methods of operation. To give you another example to clarify what I am getting at: transport. In the modern world it could well be that commuter needs, for which there is an obvious requirement in the public sector, could be met by further road building or improvements in roads on the one hand, by better train services using existing technology or new technology such as light rail systems, or thirdly, and very importantly, by telecommunications or in other words people not moving at all. Somebody has come up with the brainwave why not move the information to the people (which has been happening now with the Internet) rather than the people to the sources of

information. Am I being fanciful in asking this question or might the PFI have this effect over a five or ten year period?

(Mr Jack) Innovation is part and parcel of helping to achieve good value for money and it might be that innovative developments could stimulate further thinking. We live in a world, as you clearly illustrated in your question, where there are all kinds of potential interactions. If one takes the question of either moving people or moving information, if there were a government locus in that particular argument, then it would be for the relevant department to decide what its policy initiative was going to be and then if it felt that there was a project that was associated with it to determine how best it could specify the output that it wanted. If you are asking me whether the PFI represents a tail that can wag the policy dog then I would answer that for the foreseeable future I think the dog will be in charge of wagging its own tail.

454. You will be aware that several representations made to us by private sector organisations have raised doubts about the allocation of risk. The private sector is being asked sometimes by departments to assume risk over which it has little or no control. Is that a valid objection in your view on the part of those who get involved in bidding processes or is it something over which you cannot expect to have control otherwise it ceases to be risk.

(Mr Jack) I think it is a very valid comment at this stage in the development of Private Finance Initiatives because the allocation of risk is crucial in procuring best value for money. When I began to probe this I started asking questions about projects to relieve traffic in Birmingham (which has become something of a *cause célèbre* in illustrating the question of risk transfer because, as I understand it, Trafalgar House has incurred many millions of pounds, in terms of the difficulties they have experienced over planning in the context of that road) and I think it illustrates quite clearly, without going into the detail of that particular project, if outline planning permission were an issue it is arguably the case that the government is in a better position to assist in passing that particular risk to the private sector. There are no specific rules to identify this but it is important to find the right balance in terms of how you share out the risks in any particular project. It is a question of identifying where the strengths lie. In terms of securing maximum value for money, the private sector is best able to deal with risks such as, for example, cost-overrun and specification difficulties and if you give them the right package of risk they are going to provide a better value for money project than if they are asked to bear the long range. I very much welcome people probing and asking questions because it is part and parcel of how we refine the process of the PFI to make certain that we do maximise the value for money that is available from this initiative.

24 January 1996]

MR MICHAEL JACK, MP and MR STEVE ROBSON

[Continued]

[Mr Forman Contd]

455. It is not just a crude transfer of risk in order to get the risks off the public sector books? It is to try and achieve, difficult though it might be, the optimum proportion of risk—

(Mr Jack) I faced this question as part of my own learning process and I concocted for my own benefit extremes of whether you would look at the Private Finance Initiative (because I think you have to look at the extremes) and the extreme is perhaps a main battle tank where it would be unusual if the Minister of Defence were to go down the PFI route because the risk in that particular project is very great indeed because of the nature of the end use of the project. On the other hand, something like a hospital, of which there have been many examples, the risk is far more easily transferable into the private sector (with outline planning permission, if it was relevant, being difficult to achieve) and being something that might stay in the private sector. I think it is important to continue to explore this to make certain that we refine as much as we can the question of risk because that risk transfer does lie at the heart of getting best value for money.

456. One of the confidence building aspects of this for both sides is the fact that this whole thing is becoming contractual in its nature. What assurances are there for the private sector, if I can look at it from the other end, against possibly vexatious and quite gratuitous cancellation of projects and ideas once contracts have been entered into on specifically political grounds. We all know the historical examples—TSR 2 comes to mind some years ago and there are many other examples—where people have gone ahead with considerable investment before the days of PFI and then found they were subjected to a quite unreasonable degree of political u-turn or political risk.

(Mr Jack) Many of my constituents continue to remind me of the down side of TSR 2 and I share your concerns about that. Let me pick up on that though; it does come back to this question of the specification of the project. When we were talking about how we were improving training and strengthening private finance units in departments I spoke about the role of the panel under Sir Christopher Bland and the role of the Executive under Douglas Hogg. I said that all of these are factoring in on departments to make certain that, bluntly, they do not waste the private sector's time, money, efforts or resources. If too much money is spent on poor quality poorly specified Private Finance Initiatives, if for example too many bidders are invited in, eventually the private sector will quite justifiably say, "Enough is enough. We are not interested in this. We are going to seek our business opportunities elsewhere." If we are to make this thing the success that I believe it can be then the quality of the specification and the resolute commitment to seeing it through once you have decided what you want is absolutely crucial.

457. Can one administration commit a subsequent administration on such a matter as a PFI which is set to stretch for 15 years?

(Mr Jack) The government as a collective does not renege on contracts entered into. I take some comfort from the generally welcoming noises from members of the Opposition. One or two have claimed authorship of this initiative but I shall not indulge in that debate here this afternoon. Quite clearly there is a growing appreciation from all sides of the House about the benefits that can come from greater private sector involvement in the provision and procurement of services and output. Where perhaps there will be healthy debate is on how that partnership actually operates. I do not think there is any dispute that once an arrangement has been entered into there is a commitment. I have not heard anybody suggesting that it would be subject to a political whim. Far from it. I think there is a welcome for the services being provided and a recognition that once the government of the day has committed itself to a particular project then it is committed to it.

Chairman

458. These are proper contracts and therefore enforceable?

(Mr Jack) Clearly once you have signed the deal they are proper contracts. I believe it is very clear that people would not sign these contracts, as they have done, if they had doubts over whether they were going to get their money because that is what it boils down to at the end of the day.

Mr Forman: For the record I was thinking of a subsequent Tory administration.

Mr Betts

459. In 30 or 40 years' time!

(Mr Jack) Mr Betts has just indicated that we will be here for a long time; I do not think there is a problem.

Mr Carrington

460. I only have a couple of fairly straightforward and simple questions. When I was talking to Mr Robson earlier we were discussing the responsibility for evaluating PFI projects and clearly the ultimate responsibility lies with the accounting officer in the department where the PFI project is being undertaken. What we have established with the analysis of these projects and the comparison of the bids one to the other and the comparison against the public sector comparator is a complex and highly technical matter involving presumably quite sophisticated calculations but also a lot of judgemental input as well. The Treasury has a role in advising on those calculations. Does it have a role in monitoring these calculations?

(Mr Jack) I think it is quite difficult to distinguish between advice and monitoring because clearly before a department signs off a particular contract it will involve the spending teams in the Treasury which will help to evaluate and have an input into the department's consideration. They will offer their advice but ultimately the responsibility for such things is that of the department. It is important to come back to what I said to a

24 January 1996]

MR MICHAEL JACK, MP and MR STEVE ROBSON

[Continued]

[Mr Carrington Contd]

question earlier; that is the key role of the Private Finance Executive. It can assist departments because many of the people in the Executive are used to operating in an environment where they have to assess the types of risks involved in this type of project and its task is to make certain the civil servants can properly evaluate the risks that are the subject of the comparative exercise. If you are asking me whether the Treasury is ultimately the gatekeeper or whistle blower the response I gave to earlier questions I think illustrates where the responsibility lies ultimately. It lies ultimately with the department and its accounting officer. You could have a situation where somebody might not heed good advice given from other sources and go ahead with the project but ultimately that person knows where the responsibility lies. They know that they will be the subject of investigation by the NAO and by the Public Accounts Committee so I do not see perhaps the tension of that reply you gave a moment ago working in the real world. What people do is gather together all the sources of information and weigh everything up in terms of working out the risk. I agree with you that they are complex calculations but they have to be done to ensure a proper comparator can be achieved and a proper comparison between different private sector alternatives can be evaluated.

461. My concern is that if a department was very keen to go ahead with a project and it knew it could only go ahead if one of the PFI bids was acceptable, because the calculations are complex and indeed judgemental it might be tempted to skew some of its assumptions so as to provide the answer it wanted. Clearly, the PFI Executive would look at that but when it comes down to it it is going to be a judgemental decision as to whether the department has got it right or the Treasury's concerns are justified or not. The pressure would be to underwrite what the department has said. In those circumstances where the Executive has a real concern and it is a judgemental concern, they would go to the accounting officer and take his decision and eventually it would go to the NAO and PAC—but that is has a long way down the road and in any case it is too late. Knuckles are going to get rapped but "It's judgemental, isn't it, and nobody is going to get fired are they?"—but if the accounting officer says that the Executive was wrong for going ahead, does the Executive then have the ability to go to somebody else like the Chancellor and say, "This is all getting completely messed up. Somebody has got to go in and sort these guys out."

(Mr Jack) Perhaps one person you missed out in your list of those who would be involved is the Secretary of State of the department that wishes to acquire the service because clearly he is not going to simply allow a free flow of information to carry on between all the other partners you mentioned without the Secretary of State being involved. Ministerial involvement in each department is very important indeed in ensuring that you do not have the type of scenario you are talking about. Obviously Ministers are accountable in many ways

very properly to Parliament for what goes on in their departments. Good quality advice is probably one of the most important safeguards that any Minister relies on. The strength of the Private Finance Initiative is there is more than one source. If ultimately they are uncertain as to the information clearly they have recourse to various forms of action. They can say no. They can consult with their accounting officer. If they felt uncertain they could certainly take advice from the Treasury. The heart of your question is can you ensure you do not in some way bias the result for a department that may feel under pressure because of the squeeze on its capital budget to achieve a private finance outcome. I would say there are sufficient checks and balances in the system to prevent that occurring.

462. And the National Audit Office is up and running and perfectly able to control this and monitor this and has signed off on its procedure to be able to do so?

(Mr Jack) Yes. In fact I have taken an interest in the National Audit Office because as the Financial Secretary I find myself a member of the Public Accounts Committee. I wanted to refresh my memory because it is many years since I went to the NAO to learn about what they were doing as the watch dog on the spending of departments, so I went back for a refresher course and my last presentation with Sir John and his staff was on the subject of value for money. I have agreed to go back to look specifically at how they are tackling their procedures and the monitoring of the Private Finance Initiative. Not only are they commenting *ex post* they are the repository of knowledge on value for money and do have a role in a consultancy position to give an indication on the types of factor that have to be taken into account. Departments can refer to the NAO for guidance as to whether they might consider a particular project as being good value for money and there is strength in that. Certainly the last conversation I had with Sir John—I hope I do not quote him out of context—showed an enthusiasm to not only pick up this particular challenge to be involved but at the same time endorsing what an important initiative PFI was. The NAO welcomed the value for money gains that can be made from the initiative. If somebody like that welcomes the Private Finance Initiative, given all the proper probing you have done whether you can make certain you get good deals out of it, I hope that is an element of particular reassurance.

Chairman

463. Are you, and Mr Robson, in effect the guardians of principles in all this?

(Mr Jack) Yes, I think we are the guardians of principles but clearly ultimately I report to the Chancellor and if there were concerns over principle I would report to him and seek his views.

464. If you see something in the Department of Transport or Department of Health which you do not like the look of you can, and do, intervene?

24 January 1996]

MR MICHAEL JACK, MP and MR STEVE ROBSON

[Continued]

[Chairman Contd]

(Mr Jack) The Treasury in many ways will give its advice and response; it has to. Ultimately we come back to the where does the buck stop? The buck stops with the Secretary of State and the accounting officer within the department which seeks to procure the services.

Mr Timms

465. In the latest issue of the *Parliamentary Review* there is an article under your name which says: "Our aim is to make the PFI the procurement route of choice for all projects." Is not the implication of part of what you are saying today that there needs to be a weeding out process and part of what needs to be done through the training you describe is to identify projects which the PFI is not the procurement route of choice in order to avoid wasting a lot of people's time. Can I ask you about one particular kind of project we have not discussed yet. At the end of last year the government dropped proposals for PFI in the courts' administration. That followed pressure from the trade unions and the judiciary as well as the Opposition. There are obvious sensibilities about extremely sensitive data being handed over from the public sector to a private organisation. Does the Government's change of mind about that to some extent suggest that there are some sensitive strategic areas where PFI is not the route of choice?

(Mr Jack) When using words like "procurement route of choice" what we are trying to do is concentrate departments' minds that in general terms the Private Finance Initiative can yield substantial value for money gains and can relieve some of the pressure on the public purse in terms of the capital content of those particular projects. Instead of seeing the Private Finance Initiative as an option what we are saying to people is make certain it has proper status in terms of your department's decision-making and prioritisation. As capital becomes a scarcer item as far as government expenditure is concerned the imperative of those words concentrates the minds of the Secretaries of State to look at things because, by and large, departments want to make things happen and if the conventional route of funding is not available but they can service the costs of the services that they want to produce then clearly the private finances initiative is available to them. You asked the question as to whether the sensitivity of the provision of service is one which, if you like, determines the use of the Private Finance Initiative. I suppose some would argue that the provision of health services because it is involved in life or death decisions is amongst the most sensitive areas but in that context it is the National Health Service that is providing the service of the health care and it is the private sector that is providing the facility to actually deal with the place where the health care is provided. In that context you can have a sensitive service provided in the context of a Private Finance Initiative. If you look at the area of defence, another sensitive area, there are a number of projects there where it is proper

for Private Finance Initiatives to become involved. You come down ultimately in testing out the project in terms of its value for money as to whether the private sector can properly deal with that area. We discussed the other determining factor, namely the question of risk transfer. I am not familiar precisely with the courts service but obviously if there are risks which are better borne in the public sector, having evaluated that, you may say that is where the chosen course of procurement should remain. It is a question of evaluating risk. The private sector is well capable of dealing with the handling of so called confidential information when it is delivering services to the public sector. Some of the examples of contractualisation have illustrated how successfully that can be done.

466. Can I emphasise the point of strategic outsourcing in certain core areas of public service. You do not know the details and I do not know the full details of the courts administration either but, as I understand it, there is now a scaled down proposal which involves putting out to PFI some of the computer systems that support the work of the courts. Lord Justice Wolff in his report last June on access to justice said that it raises the question of whether the IT structure of the civil justice system should be run by the private sector. He said that the possible implications of this need to be appreciated and that ultimately the Lord Chancellor's Department will be able to take control over issues of policy and strategy in the development of court systems. He said that that needs to be considered and this may be difficult to achieve when there are powerful and capable service providers running the IT infrastructure. That touches a chord with quite a lot of people that something like the justice system is essential to our national life and it is essential that public confidence in the core of the system is maintained. Is there not potentially a problem about handing over to the private sector in this particular and are there not serious worries?

(Mr Jack) I am a little worried about your question because it shows almost that there is a fundamental distrust in your mind about what the private sector is capable of doing when handling confidential information. It is interesting that Lord Justice Wolff raises that question because one of the major providers of legal advice to members of the public dealing with some of their innermost and intimate details are private solicitors. It strikes me that the legal profession can have confidence in private solicitors and barristers in dealing with intimate private details but a question is raised in the context of the court. It may well be a proper question in that context so let me address it. That comes down to the person specifying the output for a project in deciding precisely what it is they think the Private Finance Initiative should be about. It may well be that they say in the case of an information technology system we are confident that that makes a good private finance deal. You could have one in terms of the provision of a system, the software backup and the maintenance of

24 January 1996]

MR MICHAEL JACK, MP and MR STEVE ROBSON

[Continued]

[Mr Timms Contd]

the facilities. You might decide in terms of the output to say, "No, we want there to be public sector involvement with that." The Revenue, for example, have engaged the services of EDS, one of the major players in complex IT systems, to assist in the further development of the computerisation of the Inland Revenue and it is perfectly true that EDS employees are involved in access to confidential information, but they are used to doing that and they have contractual arrangements with penalties if they break the clauses of confidentiality that are imposed upon them. They know what will happen both to individuals and their business if they were seen to breach that code of confidentiality. We have been prepared to accept them as a provider of IT using the PFI principle because we can see there are very considerable gains to be made in terms of the operation of an IT intensive activity, namely that of the Inland Revenue. I think if we see a world where the private sector is

going to be increasingly involved with the public sector we have to express confidence in the private sector's ability to keep confidential information. When I worked for Procter & Gamble when I started my working career I had to sign a declaration to forget everything I had remembered because they did not wish me to promulgate to their competitors private and confidential information which was very sensitive to them in terms of the types of developments they had in mind at that particular time. To think the private sector is in some way secure from dealing with private personal confidential information is perhaps to miss what is happening in the real world.

Chairman: Thank you very much indeed for joining us this afternoon, Mr Jack. Can I also thank Mr Robson not least for his patience because he has been with us throughout the proceedings.

MONDAY 4 MARCH 1996

Members present:

Sir Thomas Arnold, in the Chair

Ms Diane Abbott

Mr Brian Sedgemore

Mr Clive Betts

Mr Stephen Timms

Mr Matthew Carrington

Examination of Witnesses

MR GERRY GREEN, Chief Executive, The Royal Hospitals NHS Trust, examined.

Chairman

467. Mr Green, thank you very much for joining the Committee this afternoon. Could you introduce yourself for the record.

(Mr Green) My name is Gerry Green and I am the Chief Executive of the Royal Hospitals NHS Trust.

Chairman: Thank you. Mr Sedgemore?

Mr Sedgemore

468. Mr Green, I wonder if I could ask you a question about the issue of consultation and your ability to listen. Would it be fair to say that you are not very good at consulting with the public and not very good at listening to the doctors? Am I right that on 25 January 1995 the Barts Medical Council passed a motion of no confidence in you and in the Chairman, Sir Derek Boorman, of the Royal Hospitals Trust?

(Mr Green) That is quite correct, Mr Sedgemore, they did.

469. What was that about?

(Mr Green) That was about the closure of the Barts A&E department and basically they believed that we were not taking steps which they could agree with.

470. And one consultant who was present at the meeting said, "Our anger goes back over the last year over how we were promised there would be a level playing field between consultants on different sites. We have suffered and patients have suffered because beds have been closed and services drained away before anything is ready in London to replace them. There has been huge secrecy over what their plans are and most of our information has come from reading newspapers. It has got to the point where it is impossible for us to trust either of these two men any more." That is not a very good CV for you, is it?

(Mr Green) Perhaps, Mr Sedgemore, I could expand a little bit. Firstly, I would refute that we had behaved to any degree with secrecy. In fact, our plans had been openly discussed with medical and other clinical staff as well as support staff. Whether or not people agreed with them is

another matter altogether, of course, and people are entitled to have their views about that. The second point I would make is that the Barts Medical Council is one of three representative councils that existed at that stage. My understanding is that at that meeting there were about 80 consultants present and we have round about 400 in the Trust.

471. I am told from people who were actually at the meeting that there were 85 consultants present and the motion was passed *nem con*. That is a heavily attended meeting for the Barts Medical Council. That represented their overwhelming view, did it not?

(Mr Green) Of those present.

472. You are not trying to decry the fact that 85 consultants turned up to a meeting of Barts Medical Council and 81 of them actually voted to sack you and the other four just left their hands down? That is a thundering vote of no confidence. Come on, Mr Green.

(Mr Green) That was certainly the representative view of that meeting but I would argue, and I did argue at the time, that there was a large number of other consultants within the Trust who fully supported the direction of travel which the Trust was embarked upon.

473. One of the things that they were concerned about was the suggestion that behind their backs you had facilitated a press conference with some Tory rag to run St Bartholomew's hospital down.

(Mr Green) Quite untrue.

474. Quite untrue, is it? So where did they get their information from then? They read it in the press, did they not?

(Mr Green) They must have speculated on how that happened.

475. I see. First of all, could I put this to you: I have been talking to some consultants since we decided to call you and a couple of them who have got grave reservations about this PFI said that they would not come and give evidence because although they might not go back and be sacked

4 March 1996]

MR GERRY GREEN

[Continued]

[Mr Sedgemore Contd]

they would be eased out. That hardly suggests the position of a happy ship, does it, that people will not come to Parliament to give evidence because they feel that you or Sir Derek Boorman will actually ease them out?

(Mr Green) That is arrant nonsense, I am afraid.

476. Have they not signed contracts that they are not to talk about it?

(Mr Green) No.

477. They have not signed contracts that they cannot talk about the affairs of your hospital? That is not true, is it? Have they not all signed a contract saying that?

(Mr Green) All of the consultants to whom you are referring have carried over the contracts they had prior to the Trust's formation. We have not changed their contracts.

478. You would be quite happy for them to come here?

(Mr Green) Absolutely. Indeed, if I could remind you, or perhaps you are not aware, a number of them did come to a meeting here in the House to which I was also invited to put their view point.

479. I was talking to one of them who is not averse to private finance who is actually working on it—clearly I cannot tell you his name or I will not tell you his name—and he was saying that there are no actualities at the moment, just options and concepts, there is nothing firm and yet you are hoping to sign a contract by October 1996.

(Mr Green) By the end of 1996.

480. It is not October?

(Mr Green) No, that is when we would make the selection of the preferred bidder under the time-table which we are operating.

481. Where are you at the moment?

(Mr Green) We have just finished receiving expressions of interest which we did on Friday and within the next month we will be selecting the people we believe we ought to short-list who will then work up the proposals in partnership with us. By the end of October we will move towards a preferred bidder.

482. Who are "we"?

(Mr Green) Well, the Trust.

483. The whole board?

(Mr Green) Yes.

484. The PFI, as I understand it, is based on a business case which you have published. Is that right?

(Mr Green) That is right.

485. That business case is for a possible 750-bed hospital?

(Mr Green) Yes.

486. The purchaser does not think that you would be able to interest the private bidders on the basis of a 750-bed hospital. The purchaser told one of our Members that it does not think on its projections that you can sensibly interest a private bidder to carry out this scheme because the margins of error and the actual potential profit is so small on a hospital of 750 beds. Have you discussed that?

(Mr Green) Not that specific point. All I can say to you is that we have had considerable interest so far. That clearly needs to be translated into specific expressions of interest in the sense of being worked up into proposals but certainly on the evidence we have so far a large number of companies and consortia are interested in our scheme.

487. They do not know what you are offering them, do they? They do not know very much about what they are being asked to do? They are being asked to express an interest in some vague concept of the PFI in relation to a hospital.

(Mr Green) No, they are being asked to express an interest in a scheme based on the outline business case which has been heavily discussed.

488. Based on the whole £250 million?

(Mr Green) Yes.

489. But they are not going to run the clinical services, are they?

(Mr Green) No.

490. Do you have a definition, by the way, of "clinical services"?

(Mr Green) Perhaps I can turn that round, the services which we are asking the private sector to express an interest in are the non-clinical support services which would include the maintenance of the buildings, the cleaning of the buildings, the cooking of the meals and that sort of service which has traditionally been subject to competitive tendering.

491. And the building of the hospital?

(Mr Green) And the building of the hospital, indeed.

492. The consultant I was talking to last week said that the people concerned with this PFI were "re-visiting the size of the hospital", which is another way of saying that they were questioning whether or not there should be a substantially different sized hospital and questioning whether it should be a 1,020-bed hospital.

(Mr Green) The work that we have been doing, which is the work which re-visits the outline business case to check that our assumptions remain as robust as they were when the outline business case was approved, is going on and has been going on ever since the outline business case was completed.

493. My question was have you been discussing whether there should be a hospital of the size of 1,020 beds?

4 March 1996]

MR GERRY GREEN

[Continued]

[Mr Sedgemore Contd]

(*Mr Green*) We have been discussing whether or not we can raise the expectations by garnering further expressions of support.

494. Does that mean that you have been discussing a larger hospital? Can you put that in English.

(*Mr Green*) I am putting it in English.

495. The word "garnering" seems to come out of a sociology book.

(*Mr Green*) No it does not; I am not a sociologist.

496. Are you talking about a larger hospital?

(*Mr Green*) We are looking at whether or not we could expand the size of the hospital given our expectations of our ability to get further work in. What we have at the moment is a business case based on what purchasers will purchase from us from now until after the hospital is built.

497. If you were going to have a 1,020-bed hospital instead of a 750-bed hospital a) you would have to have a completely different business case and b) you would be obliged to go back to consultation with the public on this new plan.

(*Mr Green*) No, because what we are saying is that basically the guaranteed income flows will support the size of hospital which is described in the outline business case. If I can convince the private sector (and this is the beauty of the PFI proposal) that it is worth their taking the risk because we think we might be able to get additional work in and they are prepared to take that risk, we might well end up with a hospital which is larger than that for which we can guarantee income.

498. For a hospital that has 300 beds more it is a different proposition altogether.

(*Mr Green*) If it were that size.

499. It would require all kinds of capital, capital reconstruction and different revenue flows and what you are saying is that you can avoid the consultation you have already had by doing it after you have signed the contract. Is that your evidence to the Committee?

(*Mr Green*) No.

500. That is what it sounds like to me.

(*Mr Green*) That may be but that is precisely what my evidence does not mean.

501. What does it mean then?

(*Mr Green*) We are required to test all the assumptions on which we based the outline business case. That is what we are doing and that is the bench mark against which the PFI proposal, once it is fully worked up, will be judged against. What I need to do now is test whether those assumptions are correct. That is what we are doing with the purchasers. We are also doing that by looking at what the clinicians, the people who are actually

going to be providing the service, believe they might have in the way of demand.

502. The current PFI is based on a capital expenditure of roughly £250 million and revenue savings of £9 million per annum. Am I right in thinking that the robustness of those revenue savings has been questioned by the very prestigious York Health Economics Consortium?

(*Mr Green*) The comparator that you are using, Mr Sedgemore, is the comparator between the dual-site option that we looked at and the single-site option. The revenue savings from the "do nothing" position, which is the bench mark against which we judge these things, is in fact £30 million.

503. Let us look at the comparator between the dual and single site options since that is a politically explosive matter and millions of members of the public think you are taking the wrong step. You assume that there will be a £9 million extra revenue saving on £250 million capital. I put my question again: am I right in thinking that the prestigious group, the York Health Economics Consortium, actually questioned the robustness of those figures?

(*Mr Green*) They did but quite a lot of their report was supportive of our own conclusions, as I think you are aware.

504. I do not think you want to get into real hot water because in the judicial review Mr Justice Sedley deemed the press release that you put out about their report was rather damnable, did he not?

(*Mr Green*) I do not know because I was not involved.

505. I put it to you that that was the case. Presumably you read their report and you studied it carefully?

(*Mr Green*) Indeed I did.

506. Do you remember reading this: "In February 1995 the York Health Economics Consortium expressed doubts about the capital and revenue estimates." This comes from another report about which I will ask you in a moment. And it quotes the York report as saying: "The preferred option generates an additional saving of £9 million at the cost of almost £100 million in additional capital spending. For this additional capital cost to be justified, the revenue benefits of the incremental spend must be reasonably secure. We believe that there is sufficient uncertainty around the estimates of net revenue savings (which are central to the appraisal) that the magnitude of the assumed difference in costs between the options is extremely sensitive. Since this difference is, in any case, relatively small in relation to the total revenue expenditure of the Trust (£190 million to £200 million) further evidence is needed before the additional capital expenditure of £100 million required to move from a do minimum to a single site solution can be justified on a purely financial

4 March 1996]

MR GERRY GREEN

[Continued]

[Mr Sedgemore Contd]

basis." That seems to me to be a fairly clear-cut query about the relationship between your revenue and capital figures, is it not?

(*Mr Green*) All I would say, Mr Sedgemore, is that our outline business case was subjected to an enormous amount of external scrutiny, not just by York and CASPE but by others, and it passed all the sensitivity tests that could be thrown at it and, indeed, has been approved.

507. It did not pass the test of these distinguished experts who know as much about health financing, I would have thought, as anybody in Britain.

(*Mr Green*) They are experts amongst others. We had two or three other people go through our report.

508. Let us have a look at some others. This whole plan to close Barts and build it on a single site came from the Tomlinson Report which got its basic data from the King's Fund, did it not?

(*Mr Green*) Amongst others.

509. The King's Fund has produced what you call this CASPE report. That report also questions the robustness of your figures in relation to capital expenditure and revenue savings on the single site, does it not?

(*Mr Green*) In fact, Mr Sedgemore, the author of that report, with whom I have spent many hours discussing it, supports our conclusions save in one respect and that is that he makes a fundamental assumption that the Barts site once surplus to requirements has a negative equity and would therefore rely on support from the public sector for its continued existence. That is an assumption upon which that report is based and it is from that assumption that it draws its conclusions. In point of fact, if the site has a positive value then the whole thesis on which the CASPE report is based falls. That is what the author himself says.

510. Let me use the report as I have not been privy to private conversations but I have got the report here. It says: "Business people are used to taking risks, but of a calculated sort. The Trust is expecting to start negotiations with Private Finance Consortia soon. Even on the figures in the outline business case it would appear wise for any of the possible consortia to check whether the CASPE Consulting's St Bartholomew's Foundation option incorporating new partnerships would not produce better returns and do so much more quickly. After all, the new build requirement would be less; the need to relocate services would be less; the condition of the St Bartholomew's estate is good; minimising the amount of new hospital building at Whitechapel should produce some earning occupancy for Private Finance Initiative partners more quickly; the restrictions on the use of the St Bartholomew's site for other purposes than health care are very severe; the site is an historic one and deserves special consideration; and the public and the City have given great evidence of their commitment to keep 'Barts' as a hospital."

Then it says: "However, even the preliminary work undertaken to date suggests that a complete reconsideration and development of a new Foundation option, incorporating the service proposals of both NHS and non-NHS partners, would be wise and would be likely to produce a better solution for the NHS." That seems to be a pretty robust criticism. Is that another criticism that you just toss aside like the York Health Economic Consortium?

(*Mr Green*) No, Mr Sedgemore, but what I can say to you is that what the CASPE report completely ignores is the strategic context within which Barts is situated and within which the decisions were taken. It makes no mention of the impact of that solution on the development of the hospital in Hackney at the Homerton and the further development of that hospital. It makes no mention of the development of services at University College Hospital. If I could remind you the services which that report suggests ought to be on the Barts site are cardiac and cancer principally, which are regional specialties which draw their flows from a wide area of the population.

511. Come on, Mr Green. I have read this report from cover to cover and it says a lot more than that. It is a thumping great report. It does not just talk about cardiac and cancer services on the site, for God's sake. That is a blatant misrepresentation of the report. It is a massive report about a private sector hospital, about a public sector hospital, about a charitable foundation and it has got all the City services that currently the City wants on it and you are telling me it is about cardiac and cancer. That is a nonsense.

(*Mr Green*) The major services on that site are cardiac and cancer. The others, if I can enumerate them, are the community hospital that is being proposed. There are the proposals to move orthopaedic services up, to have one medical ward, one surgical ward, a private hospital, if I remember correctly, some Aids and HIV beds and endocrinology.

512. "Category 1: There will be a fluctuating range of temporarily decanted NHS activities from the Royal London Hospital. There will also be some St Bartholomew's services waiting to transfer to their ultimate location in the new or refurbished facilities at the Royal London Hospital at Whitechapel. Category 2: There will be carefully chosen elective services caring for the regional or wider populations which will remain permanently at the hospital. These will include Cardiac and Chest Medicine and Surgery, AIDS/Immunology, Endocrinology and Medical Digestive Disorders, Renal Dialysis, Orthopaedic and Vascular Surgery. Category 3: There will be NHS services particularly for the local population, which again will be permanently accommodated. These will incorporate those services proposed by the City Corporation and Royal Hospitals Trust, including the new minor injuries service, a care and rehabilitation unit for older people, a GUM clinic, an occupational health service and a health centre for

4 March 1996]

MR GERRY GREEN

[Continued]

[Mr Sedgemore Contd]

GPs, but will also provide two wards for GP heralded admissions." That is rather bigger than cardiac and cancer services.

(Mr Green) And includes, Mr Sedgemore, precisely the services that I have just enumerated.

513. Why did you try and minimise it when you first answered the question?

(Mr Green) Because the principal services, the large critical mass of services, would be formulated by cardiac and cancer. If you recall, what the report suggests is in fact that all cardiac sciences currently provided at both Barts and the London Chest Hospital would be transferred to Barts. That is a very large critical mass of services. Cancer services, similarly, is a very large critical mass as proposed.

514. This contract is going to be for how many years?

(Mr Green) 25.

515. 25 years. Who is accountable if this experiment in health care goes wrong in five to ten years' time? Particularly, who is accountable if all GPs become fundholders? Who is accountable for what you are doing?

(Mr Green) We, the Trust, remain accountable for providing the clinical services.

516. You are not accountable to the public, are you; you are an independent trust.

(Mr Green) No, we are accountable to the public.

517. You are not accountable at all. You do not have to take a blind bit of notice, in fact you have not taken a blind bit of notice of the public. A million people signed a petition and you did not take the slightest bit of notice. You told them to, "Get stuffed", did you not?

(Mr Green) That was subject to the judicial review, as you well know.

518. The Royal Hospitals Trust was the prime mover. You were the people who pushed it to the purchasers and the purchasers pushed it to the public. We all know that, Mr Green, because all your documents were leaked to me on the way. What I am getting at is that the hospital service is likely to change over the next five to ten years. You are signing 25-year contracts. If all GPs did become fundholders, there would be no need for a health authority. Who would be responsible? There would not be a purchaser. There would not be a health authority to whom you were responsible. It would be Wimpey or whoever these people who have got these interests are.

(Mr Green) No, of course it would not because the Trust would still be responsible for providing the services. Perhaps it is worth reflecting that any major development of hospital services will be, of course, subject to the same sorts of changes that all health services are facing however that development is funded. Therefore whether or not a hospi-

tal constructed today is precisely right for the conditions in 25 years' time is a moot point whichever funding route you take. What we are trying to do, and that is why we are re-visiting all the assumptions, is to make absolutely certain that we have the best possible focus on the changes that are going to happen.

519. Tell me this, suppose you sign a contract with somebody to run the administration of a hospital and the administration presumably would include the finance officer and you sign this contract and the finance was being run by this outside body which was not, in effect, part of the health service but this company whoever it is, Costains, Wimpey or the companies which seem particularly interested in hospital care, the finance officer in ten years' time is looking at the figures and he says, "We are going to have to stop using the operating theatre." That, in theory, is a clinical decision but if the finance officer is outside the Health Service and is arguing that and he has got to produce a rate of return and there are knock-on effects between the relationships, as there are bound to be over time, between non-clinical and clinical matters, what the hell happens?

(Mr Green) You are making the assumption that the finance officer of the Trust is not an employee of the Trust. That is a new departure to me.

520. I thought letting other people run the administration was one thing you lot were quite anxious to do.

(Mr Green) Yes, but that does not mean that we will not be accountable for the performance of the Trust as Chief Executive, Director of Finance, Medical Director and so on.

521. You can see the kind of conflict that might arise between public and private. You can see why the Labour Party is not very keen on this kind of thing.

(Mr Green) The kind of stresses and strains on the Health Service that you are just describing exist now.

522. But they are all resolved within the public sector whereas they are going to be resolved within the private sector. That is what is worrying us.

(Mr Green) Surely they are not, Mr Sedgemore.

523. I thought it was axiomatic. Do you read *The Lancet*?

(Mr Green) Occasionally.

524. I was reading *The Lancet*, A M Pollock, 9 September 1995 and he said: "The NHS will be placed at the mercy of its landlords and there is no reason to suppose they will settle for less than the 25 per cent profits currently expected by the private residential care sector. Quality of care and terms and conditions of staff are unlikely to be accepted in the newly privatised services. The expe-

4 March 1996]

MR GERRY GREEN

[Continued]

[Mr Sedgemore Contd]

rience of compulsory competitive tendering is that both have been detrimentally affected and shareholders may well trade quality of care for efficiency gains." That is going to happen, is it not?

(Mr Green) I doubt it very much, firstly because the clinical staff are going to be employed in the National Health Service and, secondly, there is a key difference between compulsory competitive tendering and what we are now talking about. We are talking about time-scales which do not have a three-year life but are likely to have a 25-plus year life. The interests therefore of any private person investing in this are to make sure that the contract operates properly and effectively for the whole period.

525. To pay high wages?

(Mr Green) Potentially. You would be interested to know that some of the people who have talked to us about our scheme—

526. —think your wages are too low.

(Mr Green) Yes, absolutely.

Ms Abbott

527. How many companies have indicated an interest in this contract?

(Mr Green) 34, from memory.

528. What form did the public sector comparator take?

(Mr Green) What form did it take? The public sector comparator is the outline business case.

529. Over the life of the project how much money do you expect to save compared to a publicly-funded project of this nature?

(Mr Green) The outline business case envisages a £30 million revenue saving.

530. Is that relative to what you view as a "do nothing" option?

(Mr Green) Yes, that is right.

531. That is not a realistic comparison. What I am asking you is if the same project was publicly funded, how much money would you be saving compared to that? Have you looked at that?

(Mr Green) We have not yet got detailed private sector bids in so we have no comparator to be able to do that. That is later down the track.

532. At some point will you be able to compare how much money you are saving, assuming you are saving money, than had you done this whole thing with the public sector?

(Mr Green) Yes because that is the acid test and without that we do not move forward.

533. How precisely is this project going to improve the quality of health care compared to a publicly-funded alternative?

(Mr Green) As a minimum it has to realise exactly the same benefits but it should actually realise more benefits in terms of value for money

and risk transfer. The benefits that the publicly-funded option has already described, which is the centralisation of services in Whitechapel, will be realised and we anticipate and we hope by building in that additional flexibility we will be able to realise more, but that remains to be seen and cannot be seen until we have detailed bids.

534. Will this improve the quality of health care? It ought to improve the balance sheet, this we understand, but what about the quality of health care?

(Mr Green) You do not embark on this type of project without a fundamental belief that what you are doing is going to improve the quality of health care.

535. That is what we are querying on this Committee. We think PFI is about numbers and not about quality of health care.

(Mr Green) I do not agree with that statement. I understand the view but I do not agree with the statement.

536. One of the problems people have with PFI is the extent to which the private sector will be involved with health care. You have made the point that PFI will only involve non-clinical support services but some of those so-called non-clinical support services do bear very much on the patient such as catering, administration, portering and security. The problem that some of us have with PFI is that there is an overlap between the building and the care of the patient. One of the problems some of us have with PFI is where you do have this overlap and where you have elements such as catering that do bear on the service to the patient, then it will be about maximising profit for the private shareholders as opposed to maximising the quality of care.

(Mr Green) That presumes that private sector companies are only interested in profit and not interested in quality of care.

537. It is a long time since I studied economics, but I always imagined that was the main purpose of them.

(Mr Green) Is it not also central to the proposition that you only retain your customers if you provide a good-quality service?

538. Yes, but we are going to be locked into a 25-year contract.

(Mr Green) Yes, but with regular value for money checks throughout that period.

539. You referred to the possibility of private facilities. Will any public money be used to finance that?

(Mr Green) No.

Ms Abbott: Thank you.

Mr Timms

540. Can I go back to the point you made to Mr Sedgemore about the number of beds in the

4 March 1996]

MR GERRY GREEN

[Continued]

[Mr Timms Contd]

hospital. You have got 750 in the outline business case. That is the "do nothing" option; that is carrying on as it is?

(Mr Green) That is the centralisation option.

541. 750 is the number of beds.

(Mr Green) That does not include intensive care beds or neo-natal intensive care.

542. You are looking at the possibility of increasing that to over 1,000?

(Mr Green) No, what we are doing is we are testing—that number has been arrived at because that is the number which we know we can finance on the basis of what purchasers will purchase from us long-term. We are re-visiting those assumptions basically as we speak and will continue to do so throughout the period until the close of this process because what we want to be absolutely certain of is that we can maximise the capacity of the hospital. What I am really trying to do is get the private sector to take additional risk to put up increasingly flexible facilities which we could not do under the publicly funded option. The publicly-funded option would require us to build precisely that number of beds. What this process allows us to do is to test those assumptions more rigorously.

543. Does the project work as a PFI bid on 750 beds?

(Mr Green) Yes.

544. You do not need to increase things?

(Mr Green) Not looking at it from that perspective, no.

545. From what perspective would you want to look at it differently?

(Mr Green) I think Mr Sedgemore made the point that over a period of 25 years health services are going to change and that is a given. What we want to do is try and ensure that what we build has a flexibility built into it that will allow us to accommodate that change without a major further rebuild later on down the track. One of the problems with the old procurement route was that in a sense the Health Service tended to take 15 years from conception to construction. That meant inevitably that you were building hospitals which were ten or 15 years out of date by the time they opened.

546. Where would you envisage the additional demands coming from?

(Mr Green) Largely around the areas of the specialties, the cancers, cardiacs and renals, where we believe that we are particularly strong as a Trust and we can make a good case for attracting work over and above that which has already been signed up.

547. Is this attracting from other NHS hospitals?

(Mr Green) Potentially, yes, because we are creating the critical mass by the centralisation process that allows us to sub-specialise in a way that we could not if we retained many smaller units.

Ms Abbott

548. These are Barts specialties anyway.

(Mr Green) Specialties that were at the Royal London and at the London Chest Hospital in the case of cardiac as well.

Mr Timms

549. Are you expecting a number of private patients to be attracted?

(Mr Green) As Ms Abbott said, potentially what we are proposing is to put a private unit on to the Whitechapel site. We do not have that at the moment. That will be funded separately.

550. Is that within the 750 beds?

(Mr Green) No.

551. It is not within the 1,000 either, it is entirely separate. It sounds to me as though there is still a fair amount of uncertainty about the dimensions of the project. How realistic is the end of year deadline?

(Mr Green) I think it is very realistic. It is something we thought about long and hard. There is an enormous amount of work going on, as you can imagine, to re-test the assumptions we started out with in the way that I have described and also to work with both clinical and other staff internally and indeed with the private sector in due course. Over the coming months we will be spending a lot of time with people who are interested in the scheme. Part of the beauty of this process is that they can develop their own approach to the kind of outline that we have put up. We know what we want and we have been able to describe the floor, if you like, below which we believe we should not go. What we are now able to do is to test with them other possibilities that allow us potentially to build more flexibility into the ultimate building that we build.

Mr Sedgemore

552. The consultants I have talked to think the deadline is driven by political considerations and that Sir Derek Boorman is desperate to get this out of the way before the next General Election.

(Mr Green) It is news to me, Mr Sedgemore.

Mr Sedgemore: I would have thought that is what is happening. The whole thing is going at a manic pace, is it not, and there is every conceivable uncertainty. You do not know what you are contracting out and yet you are talking about signing a contract by December.

Chairman: Mr Green, thank you very much for helping the Committee this afternoon. We are most grateful.

4 March 1996]

[Continued

Letter from the Central Sheffield University Hospitals NHS Trust**PRIVATE FINANCE INITIATIVE (PFI)**

The initiative started when we sought expressions of interest from the private sector in assisting us with the provision of new and refurbished facilities for the provision of Obstetrics, Gynaecology and Neonatal Services. This follows a strategic review of hospital services within Sheffield resulting in a decision to provide these three clinical specialities exclusively from hospitals within the Central Sheffield University Hospitals.

The advertisement was placed in the European Journal, on 8 September 1995 with a closing date of 16 October 1995 for expressions of interest.

Four appropriate private organisations expressed interest and all were seen on 22 and 23 November 1995 by way of clarification of the Information Memorandum which they had been supplied with as part of the progress. A copy of this document is enclosed.¹ These organisations were:

W S Atkins Building Management Ltd
Healthcare Group (Northcroft) Ltd
Trafalgar House Construction (Regions) Ltd
Transcare Ltd

Further presentations of a more formal nature were arranged for 6 December 1995. By this time Transcare had withdrawn from the process but the other three organisations, following a structural presentation and question/answer session, were all short-listed by the Trust for the remainder of the process.

We are planning to meet the three organisations again on 28 February to hand-over the Provider Specification. A full three months will then be allowed for the preparation of tenders which will lead to the selection of one preferred partner by the end of June. A Full Business Case will then be prepared making a recommendation between the solution offered by the preferred partner and the Treasury Finance Alternative produced by this Trust. We are aiming to submit this case by September of this year.

Details of the scheme are as follows:

- Provision of Facilities in which to provide Obstetric, Gynaecology and Neonatal Services for the whole of Sheffield; scheme value £244.8 million. It is expected that this will be mainly in a new building adjacent to the Royal Hallamshire Hospital with a major refurbishment of two floors within the Royal Hallamshire Hospital for Gynaecology.

This could be extended/modified to include the provision of a Private Patients Facility on the basis that it would generate income which would benefit the NHS, and possibly, the provision of a patients hotel in existing space which would facilitate a change towards shorter lengths of stay.

- Provision of Services to the whole Trust. Following the initial meetings with the private sector companies, the Board agreed to include within the Specification, the provision by the private sector to the Trust a range of clinical and non-clinical support services: These are:

Clinical

Pathology Laboratories
Diagnostic Imaging
Sterile Services

Non-Clinical:

Car Parking/Traffic Control
Non-Emergency Transport
Residential Accommodation
Laundry and Linen Services
Portering/Distribution
Security
Document Imaging

Catering
Domestic
Energy and Waste Management
Estate Maintenance (new building)
Telecommunications
Information Technology
Staff Creche

It is the view of this Trust that whilst the above services are essential they do not represent core business of a NHS Trust and that the expertise of the Private sector could bring about both economic and quality benefits. It is also our view that constraints on NHS capital make it almost inevitable that the replacement and development of assets will require private sector collaboration if we are to maintain a secure and safe environment. We are, of course, also required to follow the guidance on market testing.

¹ Not printed.

4 March 1996]

[Continued

- Disposal of the site and buildings of Jessop Hospital for Women for redevelopment by, or in collaboration with, the private sector.

We are taking expert advice on the process.

Newchurch & Company (Commercial and Financial Bevan Ashford (Legal))

21 February 1996

Examination of Witnesses

MR DAVID WHITNEY, Chief Executive and MR CHRIS LINACRE, Director of Corporate Strategy and Deputy Chief Executive, the Central Sheffield University Hospitals NHS Trust, examined.

Chairman

553. Thank you very much for joining the Committee this afternoon. I wonder if you could introduce yourselves?

(*Mr Whitney*) Yes, indeed. My name is David Whitney, Chief Executive of the Central Sheffield University Hospitals NHS Trust and this is my deputy, Chris Linacre.

Mr Betts

554. Mr Whitney, could you inform us of the nature of the project. Also, could you tell us what difficulties you have had to date in dealing with it, particularly with regard to PFI and to what extent that has extended the timescale in terms of the amount of time you have had to develop the PFI itself?

(*Mr Whitney*) The nature of the project is the new women's hospital for Sheffield of about 240 beds. It is to replace one of the existing hospitals, the Jessop Hospital for Women in Sheffield which was built in 1880 and is long past its obsolescent date in terms of physical environment. The project was in a sense ready to go out to tender, indeed would have gone out to tender in October 1993 but for a review of acute services in Sheffield which forced us to delay the letting of the contract for that scheme. The scheme at the time was just to replace the Jessop Hospital for Women in Sheffield. Following a year's discussions about the future acute strategy for Sheffield, the scheme has now been extended to meet obstetric, gynaecology and neonatal services for the whole of Sheffield so a new women's hospital for Sheffield. The scheme is going to be on the site of the Royal Hallamshire Hospital, a big acute hospital in our trust. The Hallamshire was built in 1978 and it will be on the back of that. The project itself is of the order of £25 million much less than the London Hospital scheme we have just heard about but includes, as I say, 240 beds and certainly will provide services for women both in South Yorkshire and Sheffield. In terms of the difficulties, I suppose one of the most frustrating issues to date has been the fact that our original scheme to replace the Jessop Hospital had to be halted just at the point where we were about to start building in the light of the health authority's review of their strategy for acute services and that was in October 1993, as I said. When the decision on the future strategy for women's health in Sheffield became clear, we

could not use the Treasury funded money that was available in the region's capital programme for that development because we were required then to go out and test the new scheme, if you like, against the private finance option. The money that was available in the region's capital programme as at October 1993, whilst it might still be available in principle, and hopefully in practice, is not immediately available until we have gone through the process of testing the public option against the private financing.

555. If we had been with the old public system the work could have been underway by now?

(*Mr Whitney*) It would have been a slightly different scheme in the sense it would have been the Jessop Hospital for Women replacement now we are talking about a slightly larger scheme for the whole of women's obstetric, gynaecology and neonatal services in Sheffield. Certainly the scheme would have been on site in October 1993, November 1993.

556. You talk then about the traditional way of funding in the health service that would have been available in October 1993 that is not available any longer but presumably you have to have a public sector comparator to judge the PFI schemes against?

(*Mr Whitney*) Yes.

557. Is that effectively a ghost comparator in that the money is not going to be there for the public sector and you are testing against a hypothetical situation or have you been made aware that if the PFI scheme comes out more expensive then public sector money would be available to it?

(*Mr Whitney*) I think two points on that. First of all, we are absolutely clear that we must have the back stop of public finance available if the private financing option is not available and does not pass the test of comparability. This scheme is absolutely crucial to the strategy for Sheffield and any delay from having this scheme in use on 1st April 1999 will cause major problems in Sheffield about a much wider reconfiguration of health care. Certainly we have been reassured, to date, by the Department of Health that the Treasury funded support would be available as an underwriting, if you like, if the private sector funding alternatives do not prove to be viable. Clearly one of the issues

4 March 1996]

MR DAVID WHITNEY and MR CHRIS LINACRE

[Continued]

[Mr Betts Contd]

that we are here to debate is the viability of such a scheme against the public funded option. Clearly we have done an enormous amount of work in the outline business case which sets out both the capital and revenue implications for publicly funded options and we have taken publicly funded options through to detailed planning. We have a good comparator against which to test it but we have no provision at this stage about what private financing options will measure up against that comparator.

558. Is the objective to try and find cost savings to improve the care and the level of service people will receive from the project when it is eventually completed?

(Mr Whitney) Hopefully in terms of the last point I would hope that there is no difference between the relative benefits in terms of clinical care between a publicly and private financed solution. We require and will require the same standards from both in terms of maintaining and hopefully developing the high quality of clinical care that we expect. In terms of the financial situation relating to that, we do not see substantial savings necessarily from this scheme, it is revenue neutral anyway as far as we are concerned. This scheme fits into a wider strategy in Sheffield which is intended to save £9 million between now and the year 2000. So in a sense this scheme in itself will not bring any financial benefits that we see today, although clearly one issue for us is that with the complexity of the NHS financing framework, as of now, there is an issue of capital charges. One issue, for example, is the Jessop Hospital for Women has well depreciated past its acceptable life expectancy of 80 years and therefore any new scheme would bring with it capital charges, investment costs and a new development.

559. You do not expect to find any revenue savings then?

(Mr Whitney) The public sector scheme at the moment is essentially revenue neutral because you have an old hospital which is past its depreciation date, any new scheme, including a publicly financed scheme, with the complex capital charge relationships in the NHS would cost us more because you have to pay interest on the capital but that would be offset by savings of bringing the site on to the main Royal Hallamshire site where you would make some revenue, certainly revenue neutral. How that would configure once we have a private financing option if that is the way forward in many respects—this is my comment—we would transfer some of the risks of the capital charges to a financing partner so that is still to be tested.

560. Could you explain the sorts of risks you are looking at transferring and what difficulty that has given you in terms of identifying the risks that should be transferred and how are going to do it to make the private sector pick them up?

(Mr Linacre) The risk transfer really falls into a number of headings. The first one surrounds the risks associated with financing the construction

project itself on time and to the standards necessary by the timescale of April 1999. The second risk concerns the ownership of the building beyond the contract period we have in mind which is 25 years like the previous submission. Another risk concerns the extent to which services provided alongside the facilities will be managed against a submitted price over that same timescale.

561. Could I pick one point up and this is the issue of the lifespan of the project. It has given us some cause for concern when we have looked at a number of PFI projects. What does happen at the end of the project, have you worked that one out yet, the end of the contract period?

(Mr Linacre) There are a number of facets. The initial part is a granting by the trust to the private sector of an 80 year lease to use the land which we hope to put the new hospital on and then a lease back by the private sector over 25 years for use of that facility. We are exploring with the private sector a number of break periods along the way to see what the cost consequences would be to our serving notice within a 25 year period. At the end of it there is an absolute right for the Trust to renew that period as long as it wishes to.

562. You have leased the land to the contractor for 80 years?

(Mr Whitney) We would do.

563. Does that not cause a problem if you decide to have another contractor at the end of 25 years?

(Mr Linacre) It has a break clause.

564. Why go for 80 years?

(Mr Linacre) It is a reasonable period for any lease of ground for a development of that magnitude.

565. Why not go for 25 years if it is possible to extend it rather than have a break clause in an 80 year period?

(Mr Linacre) The legal advice we have received from our expert advisor is to go for a grant of that duration.

566. Could I pick up one issue again which came up and Mr Sedgemore mentioned it before. You are contracting for a service over 25 years during which time the health service and the development could change. What happens if you have to shut a ward in that period of time, do you carry on paying for the heating and maintenance and the cleaning of that ward?

(Mr Whitney) The contract would be adjusted depending on the service content of the scheme. Obviously it is within the context of a much wider set of financial issues of the trust as a whole. Obviously the purchaser purchasing the health care cannot be immune from that particular problem.

567. There would be more costs for you as a trust than if you had complete control of that situ-

4 March 1996]

MR DAVID WHITNEY and MR CHRIS LINACRE

[Continued]

[Mr Betts Contd]

ation? You could shut a ward down and switch all the services off?

(Mr Linacre) It depends really because in any event the problems are the same. If there was a need to close down part of our facility, however it was financed there would be a financial problem there for someone. The contracts will be sufficiently flexible to address that sensibly. Hopefully that is one of the risks that will be transferred to the private sector.

568. Do flexible contracts not give the opportunity to contractors to get their pen out as well and adjust things to suit themselves?

(Mr Linacre) Yes.

569. Is that an issue you have fully sorted out yet?

(Mr Linacre) The contractual framework is drawn up in outline. The suggested heads of terms are now written and have gone out as part of the specification. Within a tender review period any problems that the private sector have with that contractual framework can be raised.

570. Can I come on to the issue of the effect on the rest of the trust. You are putting the PFI bid out. I understand you are under an obligation with the PFI partners to ensure that the designer and builder of the facility is also the manager of things like the maintenance and caretaking and cleaning services. That is part of the deal, is it not?

(Mr Whitney) It is, in fact. Whether we are under an obligation or not, I suppose in discussions with the potential PFI partners it became clear that the reality of any coherent viable bid seemed that it would have to be linked to a substantial facilities management type arrangement. There is also a land sale opportunity in this deal which is part of that as well.

571. Did you look then at just giving the support services of the new project over to the private sector but leaving those services which are currently operated by yourselves in the main part of the hospital as they are?

(Mr Whitney) We looked at that but obviously the whole aim of bringing the new hospital on to the main capital is to try and get the cost benefits of bringing some of those hotel support services together under one organised integrated management because the two hospitals will be linked together and therefore part of a whole. It would be difficult to separate those out in terms of the way that this is going to be organised from 1 April 1999.

572. So in order to ensure that the PFI scheme can go ahead with the terms which the contractors, and indeed as far as we can gather the Government, require it to go ahead, which is support services being run by them as well as them designing and building the new facility, all the support services for the main part of the hospital have to be handed over to the private sector as well?

(Mr Linacre) That is not quite true. The document as it stands, or the specification as it stands, is an invitation to negotiate and the submissions will be looked at as a series of compartments. If any of those compartments are attractive to the trust in the overall deal they will be accepted, if not they will be rejected. We will be able to compare submissions which relate purely to the campus scheme itself and those elements which also relate to the provision of services and negotiation will follow as to which package can be accepted.

573. You indicated before that you did not really see how, in bringing on board this new development on to a site to create one overall hospital, it was realistic to run the support services in two different ways on the same site. If within the new facility they are going to be run by the private sector surely by definition, therefore, they are going to be run by the private sector on the whole site?

(Mr Linacre) It follows that you are probably correct in that assumption but until we see the detailed submissions it is difficult to judge.

574. But that is the likely outcome, is it not, that several of these support services are likely to go to the private sector on the whole of the site?

(Mr Linacre) They will be tested for whether that is an accepted view. If the deal is attractive to the trust and to the private sector it will be seriously considered. If you take into account the benefits of the land sale or the land development of the old Jessop Hospital site, the capital scheme could possibly be financed purely through that and the benefits of raising intelligent buildings. We do not know.

(Mr Whitney) There are two separate issues here. There are 20 potential services that are in the service specification which we have put to the three potential PFI contractors which are cross-trust services and then within that we can negotiate, depending what their response is, a broad range of those services within a final deal. Then there is the whole issue as to whether in fact the trust, and indeed the PFI people, want to put in any of those services in any event because it is a complex deal which has a land sale opportunity with it as well.

575. But if they do and they say: "This is part of our bid, we want these non-clinical services in the new facility" then you have got no choice if you want to have a comprehensive approach on site, you have to transfer the lot?

(Mr Whitney) Certainly it would be nonsensical to have two different management facilities for domestic services, for other hotel services. The whole concept of this is to bring it together on to one site with two hospitals but joined together so they get the benefits of the economies of scale.

576. To some extent the nature of the management of those issues will be determined by the nature of the PFI bid that you eventually get?

(Mr Whitney) That is right. We have left ourselves, we hope, flexibility within that to negotiate.

4 March 1996]

MR DAVID WHITNEY and MR CHRIS LINACRE

[Continued]

[Mr Betts Contd]

Obviously a lot will depend on what the financial equation is for any of the PFI partners including facilities management and potential land sale opportunities.

577. Could I raise two other issues. One is within that list of services that you are providing to the private sector to look at clearly there are clinical services, the pathology laboratories, diagnostic imaging and sterile services, is that not somewhat against the advice of the Department of Health? When the Secretary of State was with us before he was saying: "It is not clinical services. We are definitely not about transferring the control and running of clinical services to the private sector", but you are.

(Mr Whitney) No. In reality this leaves some flexibility. We see clinical services being medical direct patient care services. Within the laboratories, diagnostic imaging, there are a number of elements there that we want to explore. One is the replacement of equipment clearly which is very important. A lot of our equipment, both in laboratories and radiology, diagnostic imaging, is becoming obsolete. It was put in new in 1979 when the hospital opened and now needs replacement, so the PFI has to engage and address those potential major capital equipment replacement problems.

578. That is a way of getting extra capital you could not otherwise get?

(Mr Whitney) That is right. We perceive there is very little opportunity now with a 16.6 per cent reduction in the capital budget for engaging in, without testing at the very least, opportunities for getting new laboratory and radiology equipment into the organisation. A lot of it is becoming obsolete pretty much at the same time. Chris will comment on the staffing side.

(Mr Linacre) It is interesting to note that clinicians and to some extent the scientific staff involved have a certain healthy curiosity about this. They see the need above all else to replace some of these very expensive assets with modern replacement equipment which would not be available through the conventional route. They wish to see the proposals which we will discuss with them when they come back in and they are reserving judgment until they see them, which is a very healthy attitude towards it. We are not in any shape or form contemplating the contracting out of clinical services, that is specifically written out. These are clinical support services, services which support the clinical processes.

(Mr Whitney) By that we mean technical support for laboratories and radiology rather than medical support.

579. You mentioned staff. They have now got a big question mark hanging over their future, have they not, not merely the ones in the new facility but those who work in the existing hospital?

(Mr Whitney) I have to say that there are from our perception some positives and some potential real problems around PFI and one of them relates to the industrial relations issues which we spent a

lot of time in building. In the extreme situation there are perhaps over 1,000 staff who might be affected by this facilities management contract. Clearly to date we have experience of market testing and unconventional financing options but never at the same time have we actually engaged in such a large scale facilities management option which involves a quarter of our staff. Within that, of course, those organisations that might be skilled in managing those 20 different services will not be the same company so you potentially have three or four, indeed more, organisations within that. I think we have to be alive that we are on a major steep learning curve here but we have to be alive to some of the industrial relations and organisational issues within our own trust that we have not contemplated.

580. And no guarantees for staff?

(Mr Whitney) There is TUPE, transfer of undertakings and protection of employment, which we have had some experience of. Again, we are learning. I think we are into potential uncharted territory here.

(Mr Linacre) I think there is a degree of protection in the fact that the skills associated with services like pathology and diagnostic imaging are scarce resources and any private sector partner will be looking to the trust to provide those resources.

581. But car parking and portering and catering are the people who have had their wages and conditions cut by CCT, are they not?

(Mr Whitney) Yes. Other concerns we have are in relation to the fact that we have actually moved forward as a trust in multi-skilling some of our staff. The domestic housekeeper is a key part of the clinical team. How do you engage that service from a non-NHS employer, if you like, whilst making sure they remain as a core part of the clinical team? When you talk to patients on the ward the housekeeper is a key part of that team.

582. So it is not simply a matter of division between clinical and non-clinical, it is a problem of integrating the PFI involving clinical with non-clinical?

(Mr Whitney) Absolutely. This is something we are learning as we go. We have not got any experience of that to date. We have actually market tested domestic services. Beyond that time obviously we have the multi-skills of some of our housekeeping staff. For example, in one of our directorates they take blood, they are phlebotomists.

Chairman

583. Are you finding it necessary to take advice on any of the thornier questions that are arising if you say there are difficulties and you are having to learn as you go along?

(Mr Whitney) I think, Chairman, we look to examples elsewhere and we are trying to find out where good examples do exist in the country. I think we are at the front edge of the learning

4 March 1996]

MR DAVID WHITNEY and MR CHRIS LINACRE

[Continued]

[Chairman Contd]

curve. We are looking to the other big PFI options that are going around the country and indeed taking advice from our colleagues in the Department of Health clearly. I think the reality is we are probably as far ahead as most in our PFI testing and there is not much experience out there to learn from.

584. If you go back a couple of questions to the question Mr Betts was asking about introducing the PFI on equipment I think.

(Mr Whitney) Indeed.

585. Which was one of the points that you made, how far have you got with your thinking on that for example?

(Mr Whitney) The equipment side is probably one of the more straight forward elements because we have experience already of leasing major radiological equipment: MRI, magnetic resonance scanning, CT scanning equipment, all going into unconventional financing arrangements, for example with the university. In a sense that is not the bit that concerns us too much. Also, we acknowledge that within the context of scarcer capital in the NHS there are some well trodden paths with companies who are prepared to lease that sort of equipment to us, medical equipment.

586. It is the development of a freedom which in a sense you have had already?

(Mr Whitney) Yes, to a limited degree that is what it is. The market testing has been there, unconventional financing has been there, this is what I would call a major extension of that and because of its size and complexity we are moving into uncharted territory because of the size of it. 1000 of your staff out of an organisation with 4,500 staff who are potentially in the frame for facilities management contract, albeit by three or four different consortia partners, is new territory for us.

Mr Timms

587. Can I ask one question, you said there are a number of downsides from your point of view of the PFI.

(Mr Whitney) Potential, I mean I said we are learning as we go. I think the industrial relations' issue we have to manage our way through, as of now, and we are only just beginning to share with all our staff the reality of these options.

588. Is that the biggest one?

(Mr Whitney) We have a very good industrial relations' climate in our organisation and with the greatest respect getting this across to staff who have experienced some of the problems of market testing, TUPE and all that is not easy. Potentially in a city where there is major strategic organisational change already in place it is going to be an issue. The other issue which is a significant one is the potential for delay. We had a scheme, as we say, that was ready for public financing two years ago. Whilst we acknowledge we had to adjust that scheme to some extent certainly at the front end of

PFI there was a delay in my perspective in getting on to site at the front end. Hopefully we will be reassured in practice by the fact that the back end of the scheme will catch that up but I would like to see the reality of that. Perhaps slightly differently from other trusts, we have an absolute deadline on this scheme which is 1 April 1999 for in-use and so we are building an end point date into the service specification for any potential PFI contractor. It is a bit unclear at the moment as to whether as we move through 1996—we are not going to let a contract, if one exists, with a private financing partner until November 1996—we are going to deliver that key date which is not just key for us but for the city as a whole.

(Mr Linacre) The reassuring part of that for is that each of the companies with whom we are exploring this project all of them are absolutely confident that they can deliver it by that date. They express no sign of stress about that timescale.

Mr Betts

589. Is three companies a very large number, nobody else was interested?

(Mr Whitney) In the OJEC advertisement that we placed in the European Journal we had I think 40 odd responses from firms but I suspect a lot of those were putting in a marker basically. Out of those, four potentially legitimate companies emerged, of which we short listed that to three. We felt three was the minimum we should explore to make sure we had a reasonable number—a minimum number—of companies who we could take forward.

590. You still do not know whether they can come up with the project?

(Mr Whitney) They received this very detailed specification on 28 February and have now got three months to make of it what they will, obviously in close relationship with us, with a response by the end of May. The trust will clearly consider during June which of the PFI partners is the preferred one, if any, that is assuming one of them. Then we have three months or thereabouts to have this tested against the public option which is again an unknown territory.

591. Is this private sector likely to influence the nature of the project very significantly?

(Mr Whitney) Very much so. Dare I say this, the other major concern that we have—I am not saying it is an overwhelming issue—is that clearly we had a footprint for a scheme already because it was already planned, we had taken exhaustive steps to go through the planning processes in the city to get that agreed with wide consultation but one option for a private financing partner is to go back to square one and look for a radical redesign. Obviously we will do all we can to make sure they sustain the blueprint and the footprint of the existing design but I guess none of that can be guaranteed at this stage.

592. You mean you will have to go out to consultation again presumably?

4 March 1996]

MR DAVID WHITNEY and MR CHRIS LINACRE

[Continued]

[Mr Betts Contd]

(Mr Whitney) Well, I think this is part of the process. The original scheme having been in gestation now for 12 years we do not look with enthusiasm for that and I am sure you do not.

(Mr Linacre) Again, because of the antecedents of the scheme the general receipt of such detailed documentation is not usual for a scheme at this

stage. They are very receptive to what is in this document and they say it will save them a great deal of time.

Chairman: Mr Linacre, Mr Whitney, thank you very much indeed for helping the Committee this afternoon.

Supplementary Memorandum submitted by the Department of Health

APPLICATION OF PFI AT THE ROYAL LONDON HOSPITAL, WHITECHAPEL

This memorandum provides a brief commentary on the progress of the Royal Hospitals NHS Trust's private finance project for the redevelopment of the Whitechapel site. The procurement process for Private Finance Initiative (PFI) projects is described in detail in "Private Finance and Capital Investment Projects", issued to the NHS as HSG(95)15.

1. THE TRUST'S OUTLINE BUSINESS CASE

HSG(95)15 states that no procurement under the PFI will be undertaken until approval is given by the relevant Regional Office of the NHS Executive to the Trust's Outline Business Case (OBC). The OBC is designed to present the case for capital investment, regardless of the eventual funding sources (ie public or private finance). The key steps in the development of the Royal Hospitals Trust's OBC were:

- a clear definition of the objectives of the investment;
- a clear description and understanding of the strategic context within which the NHS Trust will operate now and into the future;
- a clear demonstration of the case for change;
- an objective non-financial and financial appraisal of available options.

The North Thames Regional Office approved the Royal Hospitals Trust's OBC in March 1995. Approval was given and the Trust began to develop plans for the next major stage of the procurement process. This involved exploring potential PFI options and then developing a Full Business Case (FBC).

2. THE PFI PROCUREMENT PROCESS

HSG(95) 15 describes the main stages of the procurement process to be followed by NHS Trusts when commissioning health care facilities. Figure 1 sets out the main stages of this process.

3. PREPARATION FOR PROCUREMENT

For a development of the nature and dimensions of the redevelopment of the Whitechapel site, a substantial amount of pre-procurement preparation and planning needs to be undertaken. The main tasks during this period are:

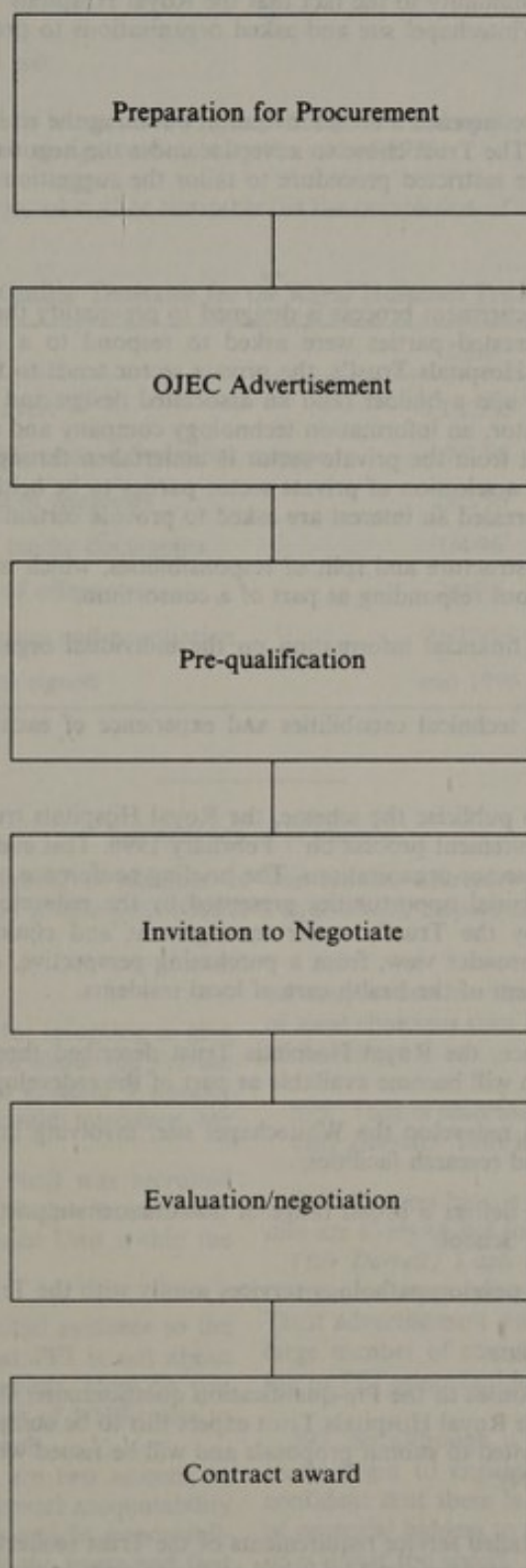
- appointment of health care planning, financial and legal advisers;
- initial work on the planning and development of detailed output specifications (including the objectives, outputs, performance standards and quality standards required of different services);
- development of a contractual framework (including consideration, for example, of contract duration, risk allocation and payment mechanisms).

Much of this pre-procurement planning was undertaken between March 1995, when the OBC was approved, and December 1995. Newchurch, Hambros and Herbert Smith were appointed respectively as health care planning, financial and legal advisers.

The Royal Hospitals Trust proceeded extremely cautiously with procurement itself. This cautious pace was deliberate so that the Trust would not prejudice the results of the outstanding judicial review concerning the public consultation process on the associated health care changes undertaken by East London and the City Health Authority (ELCHA). The judicial review was heard in late January 1996 with the judgement being given on 2 February 1996. The application was dismissed, on the grounds that there was no basis on which the consultation process could be said to be flawed.

4 March 1996]

[Continued]

Figure 1—PFI Procurement in the NHS

*4 March 1996]**[Continued]*

3.1 The OJEC Advertisement

The PFI procurement process was launched formally by the placing of an advertisement in the Official Journal of the European Union (OJEC) on 13 December 1995. The OJEC advertisement alerted organisations in the European Community to the fact that the Royal Hospitals Trust is seeking to commission the redevelopment of the Whitechapel site and asked organisations to provide expressions of interest in receiving further details.

The OJEC advertisement comprises a broad invitation outlining the size and nature of the opportunity in the very broadest terms. The Trust chose to advertise under the negotiated procedure. This allows the Trust greater scope than the restricted procedure to tailor the suggestions of the private sector through negotiation and agreement.

3.2 Pre-Qualification

The next stage of the procurement process is designed to pre-qualify the interested parties for entering into negotiations. The interested parties were asked to respond to a questionnaire. For most large schemes such as the Royal Hospitals Trust's, the private sector tends to form into consortia. Each consortium might include *inter alia* a builder (and an associated design and architectural team), a bank, a facilities management operator, an information technology company and a medical equipment manufacturer. The sifting of interest from the private sector is undertaken through evaluation of expressions of interest and interviews with a selection of private sector parties to be held in March 1996. Private sector organisations who have expressed an interest are asked to provide certain information including:

- the organisational structure and split of responsibilities, which is especially relevant in the case of those organisations responding as part of a consortium;
- detailed published financial information on the individual organisations which comprise each consortium;
- a summary of the technical capabilities and experience of each organisation in their relevant fields of expertise.

As part of the process to publicise the scheme, the Royal Hospitals trust organised a formal briefing conference on the PFI procurement process on 7 February 1996. This event was attended by representatives from over 100 private sector organisations. The briefing conference comprised a presentation on the nature and size of the potential opportunities presented by the redevelopment of the Royal Hospitals Trust's Whitechapel site by the Trust's senior management and clinicians. The Chief Executive of ELCHA also presented a broader view, from a purchasing perspective, of how the redevelopment will contribute to the improvement of the health care of local residents.

At this briefing conference, the Royal Hospitals Trust described three discrete but inter-dependent opportunities for PFI which will become available as part of the redevelopment. These were:

- the opportunity to redevelop the Whitechapel site, involving intensive new build for medical, dental, teaching and research facilities;
- the opportunity to deliver a broad range of non-clinical support services for the Trust and the associated Medical School;
- the opportunity to develop pathology services jointly with the Trust and the College.

3.3 The Invitation to Negotiate

Following receipt of responses to the Pre-qualification questionnaire, the Trust will determine a short-list of interested parties. The Royal Hospitals Trust expect this to be completed by 29 March 1996. These interested parties will be invited to submit proposals and will be issued with documentation known as an Invitation to Negotiate (ITN).

The ITN contains the detailed service requirements of the Trust (collected into a series of output specifications) against which the tenderers will be asked to design and develop their physical and operational solutions. As well as making the ITN available, the Royal Hospitals Trust will make senior management, clinicians and operational staff available to each tenderer, on a structured basis, so that further details can be provided as designs are worked up. The response to the ITN is the most time-consuming part of the procurement process and the Royal Hospitals Trust expect to receive final worked-up and costed design and operational solutions by 2 September 1996. The Trust has then allowed a two month period to 31 October 1996 for clarification and negotiation with tenderers following which a preferred partner will be identified.

4 March 1996]

[Continued]

4. THE FULL BUSINESS CASE

As part of the FBC, the Trust will seek to compare the preferred PFI solution with the detailed publicly funded option and will make a judgement as to which is the preferred option on the basis of:

- value for money;
- transfer of substantial risk.

If the PFI solution is judged to be superior to the publicly financed option, the Royal Hospitals Trust would expect to be in a position to sign contracts by the end of 1996.

Figure 2 summarises the projected outline timetable for the completion of the PFI procurement process for the Royal Hospitals Trust.

Figure 2—Projected Outline Timetable for the Royal Hospitals Trust PFI Procurement

Stage	Date
● OJEC advert	13/12/95
● Pre-qualification submissions returned	29/2/96
● Selection of tenderers	29/3/96
● Issue of tender documents	1/4/96
● Receipt of offers	2/9/96
● Clarification and negotiation	31/10/96
● Contracts signed	end 1996

28 February 1996

Examination of Witnesses

THE RT HON STEPHEN DORRELL, a Member of the House, Secretary of State for Health, and MR ANDREW NEILL, Private Finance Unit (Grade 3 equivalent), Department of Health, examined.

Chairman

593. Thank you very much for returning to give the Committee further evidence about the Private Finance Initiative, we are most grateful. I wonder if, just for the record, you could introduce Mr Neill?

(Mr Dorrell) Mr Andrew Neill was recruited from the private sector as a short-term civil servant to head the Private Finance Unit within the Department of Health.

594. Thank you. In your initial evidence to the Committee you were clear that PFI is not about the privatisation of clinical services. How do you intend to monitor the operations of NHS trusts to ensure that this does not happen?

(Mr Dorrell) I think there are two answers to that. The first is that in the normal accountability process we obviously take an oversight responsibility for what is going on within the trusts and that clearly will continue whether or not there is a Private Finance Initiative project in a particular trust. The second element of it is that I have said explicitly if a proposal comes to me for approval, comes to the Department for approval as a PFI project, and the viability of that PFI project depends upon the privatisation of clinical or clinical

support services that does not have the consent of local clinicians then it would not get departmental backing.

595. That is enshrined as departmental policy? (Mr Dorrell) That is departmental policy, yes.

596. Do you have a sense of how many companies are likely to bid for large PFI projects?

(Mr Dorrell) I can tell you that the number of companies responding to the Royal Hospitals Trust advertisement was over 100 or so. There is a large number of companies interested in responding to PFI opportunities.

597. So although it is still early days, if many trusts begin to engage in large projects you feel confident that there is a sufficiently high number of potential bidders to ensure effective competition or is it just too soon?

(Mr Dorrell) I am absolutely confident that there are enough bidders to guarantee that it is a competitive marketplace and I am equally confident that as the PFI approach to the provision of health care facilities takes off as a mainstream provider of capital stock of the health service that this will become a well established sector and that

4 March 1996]

THE RT HON STEPHEN DORRELL MP and MR ANDREW NEILL

[Continued]

[Chairman Contd]

it will be an attractive one and there will therefore be plenty of competition within it.

598. Now, in a recent newspaper report it was announced that you were reviewing the closure of hospitals, including Barts in London. What implications, if any, will this review have for the PFI projects set in train by the Royal Hospitals NHS Trust to redevelop Whitechapel?

(Mr Dorrell) The answer to the precise question, the second half concerning Barts, is none. The reason for that is that the report that you quote was, if I may put it this way, slightly overwritten. What is in process is a recognition, not a formal review process as such but certainly a recognition, that we need as the health service develops into the next century to ensure that we provide health care as locally as is clinically safe and economically sensible. I think as we look forward we can see a developing role for some community hospitals. It does not often happen that a Health Secretary is able to open two brand new hospitals on the same day but I was able to do that a fortnight ago in the South West where I opened two brand new community hospitals, cottage hospitals if you prefer the phrase, reflecting the fact that that type of facility is something that very definitely does find a place in the future of the health service.

Mr Sedgemore

599. Secretary of State, would I be right in thinking that the Private Finance Initiative is in effect your flagship scheme for the Conservative Party and the Department and that you have been brought in from the Treasury, a financial giant amongst pygmies in the Cabinet, to quietly and seamlessly hand over to private contractors the running of NHS hospitals?

(Mr Dorrell) I think there are several aspects of Mr Sedgemore's question with which I would disagree. First of all I would disagree with the proposition that this is my flagship—singular—policy. It certainly is an important aspect of my approach to the health service, I would not wish to deny that for one moment, but there are plenty of other flagships. It is a fleet with many capital ships in it is the answer to the first question. As regards the suggestion that bringing private capital into the health service represents handing over the management of the health service to the private sector, I very strongly disagree with that and I imagine Mr Sedgemore's own party leader does since I understand he agrees with the policy.

600. Let us explore this, it is not for me to answer your questions at this particular stage! Would I be right in thinking that if an NHS trust goes bust or is in some way or other dissolved then at the moment it could be that the private contractor would be responsible for its liabilities and would the reason for that be that you would want the private contractor to take the risk?

(Mr Dorrell) I think Mr Sedgemore may be referring to a Bill which was published last week

which addresses a lacuna in NHS legislation that has existed since 1948. If there is a political responsibility for this it is broadly shared. The lacuna is that in the event of a health body being dissolved the Secretary of State has the power to deal with the liabilities of that body but he does not have the duty to deal with it. It seems to me reasonable, not just to PFI partners but, as I like to put it, to the supplier of potatoes to Southend Hospital, that if there is a reorganisation of the structure of any health body undertaken that no creditor of that body should be the loser as a consequence. Ever since 1948 the understanding has been that the taxpayer stands behind the liabilities of the health service and that remains true.

601. Sorry, I have obviously got this the wrong way round. You have got this health service, it has worked happily since 1948, no Bill has had to come forward, and now you are going out to the private sector to transfer the risk and you are not telling me that you want the risk transferred back to the public sector.

(Mr Dorrell) Mr Sedgemore is right, he has got it the wrong way round.

602. That is the great benefit, is it, of private sector finance, that you transfer risk back to the public sector if the trust is dissolved?

(Mr Dorrell) Let me be precise. When the health service signs an agreement with a private sector supplier of goods or services that health service body has the power to sign with a taxpayer guarantee, that has always been understood to be the position. It has not been the position, in fact, within the standing statutes, but we intend to make it the position reflecting what has always been understood by governments of all political complexions. The purpose of the PFI is not to say that the health service does not stand behind its liabilities, it is to say that when a particular project is in prospect that does not involve clinical or clinical support services but does involve the improvement of the facilities available to allow NHS clinicians to deliver health care, where that kind of project is in prospect, we look for private sector partners where the private sector carries its own project risk but the health service continues to meet its own liabilities and to deliver its obligation to deliver free health care to the patients.

603. What if these liabilities are accrued by the operations of the private sector, then you are asking the Treasury to sign a blank cheque for the private sector if something goes disastrously wrong and the hospital is wound up?

(Mr Dorrell) The virtue of a risk sharing arrangement with the private sector is that whereas in traditional structures the NHS has signed up to build a big new project using public capital, in that model the NHS accepts all the risks associated with the development of a big capital project. If the same project is done under the PFI then some at least of the risk associated with a big project is borne by the partner and the health service and therefore the taxpayer has a clearer idea at the

4 March 1996]

THE RT HON STEPHEN DORRELL MP and MR ANDREW NEILL

[Continued]

[Mr Sedgemore Contd]

beginning of the project what are the obligations that the health service and therefore the taxpayer are undertaking. Those obligations that the health service and therefore the taxpayer sign up to will be met.

604. I think you are skirting around my questions, if you will forgive me, Secretary of State. Let us be a bit more specific. Currently as I understand what you are saying, you have a discretion under the legislation to pick up the liabilities and you are now rushing forward with an emergency Bill to turn that discretion into what you call a duty so that you must pick up the liabilities if a hospital is dissolved or ceases to exist—ceases to exist is the word—you must pick them up in the future.

(Mr Dorrell) Yes. Can I pick up that concept because it is quite true that under this Bill our obligation is made clear, most of us thought we already had it anyway, that is if a hospital trust is reorganised the taxpayer will pick up the liabilities the trust had taken on. If the private sector partner had other liabilities that were not projected at the time that the agreement was signed then those are for the private sector partner, they cannot be transferred to the health service.

605. What about if the private sector did some reckless borrowing or found itself with a bill for massive compensation or did not perform part of its contract and the purchaser thought: "Blow this for a lark, we are going to withdraw our funds". There is a lot of liability which builds up as a direct result of what the private contractor had done. You are saying the Treasury is going to foot the bill for that, that does not seem to me like risk taking, it seems to me like bailing incompetence out?

(Mr Dorrell) I am seeking to draw a distinction between two parallel cases: a big project built on the traditional public sector needs and a big project built under the PFI. We all know that there are risks of big projects overrunning, risks that they will not deliver what we hoped they would deliver at the time the projects were undertaken. Under the traditional model, all of those risks are borne by the taxpayer. Under the PFI model, the taxpayer knows at the beginning of the project the scale of the risk that he is subject to because it is clearly set out in the contract. If the underlying investment overruns in a way that these projects often though not always have in the past, that risk is borne by the private sector partner. The liabilities that Mr Sedgemore is talking about are the liabilities of the consortium, they are not the liabilities of the trust.

606. When you say they are the liabilities of the consortium, it is the National Health Service. You take over the liabilities and you are saying you can entirely separate out the liabilities of the consortium, even if the consortium causes the liabilities to the trust the taxpayer pays. The consortium by its activities can make an awful bog of this and cause a lot of liabilities to the trust and you are saying the taxpayer pays.

(Mr Dorrell) That is precisely what I am not saying, with great respect.

607. That is what you are trying to avoid saying. That is the effect of the Bill I have in front of me.

(Mr Dorrell) I look forward to the Second Reading of this Bill when we shall be able to make it clear that the ironic position is indeed that the Government is in favour of the taxpayer standing behind the NHS and it appears that some of the Opposition are not in favour of the taxpayer standing behind the NHS.

608. Is not the problem that you have actually, despite all your brilliant financial acumen, made a bog of it? You have an emergency Bill here. You phoned up the Shadow Secretary of State in the middle of the night at her home. You faxed her through the stuff. You asked her for special help to get this Bill through. It is published on Thursday. You wanted to have the Second Reading tomorrow but Harriet is not having it, you are stuffed.

(Mr Dorrell) I do not regard myself as stuffed. Certainly it is perfectly true that I spoke to Miss Harman the night before the Bill was published in order to tell her that it was coming and said it would be convenient if it could be got through quickly. If it cannot be got through quickly then it cannot be got through quickly.

609. What is this little bit on the top of the Bill: "This Bill was presented under Standing Order number 48". Is that to expedite it?

(Mr Dorrell) I have no idea what Standing Order number 48 tells us.

610. Perhaps you should, you are the Secretary of State, it is your Bill.

(Mr Dorrell) I am sure somebody can find out and write to Mr Sedgemore what is the effect of Standing Order number 48. My interest in this Bill is that the taxpayer stands behind the liabilities of the National Health Service. It appears Mr Sedgemore is not with that proposition.

611. What it is actually, let us be absolutely blunt about it, is the bankers will not sign the Private Finance Initiatives unless you can shunt this Bill through Parliament at top speed and you wanted it through by Easter, did you not?

(Mr Dorrell) I thought I was coming to talk about the Private Finance Initiative, I must say this is a very, very much easier debate, Sir Thomas. This Bill is concerned with one simple question: should the taxpayer stand behind the liabilities of the National Health Service or not? My position is that the taxpayer should. I would be interested to hear Mr Sedgemore explain why he thinks the taxpayer should be able to walk away from the liabilities of the National Health Service.

612. Mr Dorrell you are tempting me to behave like Sir Robin Day and bang the table like an out of work barrister and say: "Answer the question" but I refuse to do that. Can you try and answer the question: is it not the case that some of the bankers want this Bill and—this is one of the hur-

4 March 1996]

THE RT HON STEPHEN DORRELL MP and MR ANDREW NEILL

[Continued]

[Mr Sedgemore Contd]

dles you have to overcome—they are using it as a bargaining chip with you?

(Mr Dorrell) It is perfectly true that in the discussions with partners this lacuna in the law has been pointed up. What is not true is to suggest that this is in some sense special to the Private Finance Initiative, the same problem applies to the potato supplier to Southend Hospital. The potato supplier to Southend Hospital finds himself at risk at this moment of me reorganising the hospital and leaving his bills unpaid. If I sought to do that I think there would be an outcry. None of my predecessors has ever done it but when the health service is taking on longer term liabilities of the kind that are envisaged in the PFI, this question clearly becomes of greater importance.

613. You forgot it, did you? You completely forgot it. There has been this since 1948.

(Mr Dorrell) I and Nye Bevan and all people in between have forgotten it.

614. Since 1948 there has been no need for this Bill and now there is Private Finance Initiative there is a desperate need for this Bill not today but yesterday that is when you wanted it, is it not?

(Mr Dorrell) I am perfectly relaxed about that. Certainly I make no secret of the fact it would be convenient if it could be got through the House quickly but if it cannot be, it cannot be.

Chairman

615. Can I stay with that for a moment: was this discovered by the lawyers?

(Mr Dorrell) It came up in negotiations, Mr Chairman.

Mr Sedgemore

616. The bankers.

(Mr Dorrell) It came up in negotiations because clearly what is envisaged in a PFI project is that the long term finance is being provided to private sector partners of an NHS trust. Therefore, it matters to the private sector partners whether there is going to be a trust for a reasonable period of time to meet the liabilities that the trust is signing up to, liabilities to the private sector partners. Under the present law I have the right to reorganise the trust without providing for its liabilities and that, very understandably, the partners felt was not a reasonable position for them to put themselves in.

617. You want to help the bankers out?

(Mr Dorrell) And the potato suppliers in Southend.

618. Can you tell me, the trusts have the power to borrow, do they not?

(Mr Dorrell) No, that is incorrect.

619. The trusts do not have the power to borrow?

(Mr Dorrell) The trusts do not have the power to borrow.

Mr Sedgemore: "Subject to the provisions of this paragraph and to any limit imposed under the following—"

Ms Abbott

620. Do they have the power to borrow?

(Mr Dorrell) I am open to correction. Mr Neill.

(Mr Neill) Trusts are entitled to borrow but they cannot pledge any assets.

Mr Sedgemore

621. I am coming to that. So here we have a Secretary of State who comes to this room, interrupts me, says that trusts do not have the power to borrow. I have got Schedule 3 of the National Health Service and Community Care Act 1990, which I suggest, Secretary of State, before you come to this Committee again, you read. Section 1(1) of Schedule 3, financial provisions relating to NHS trusts says: "Subject to the provisions of this paragraph and to any limit imposed under the following provisions of this Schedule, for the purposes of its function an NHS trust may borrow both temporarily by their overdraft and longer term from the Secretary of State or from any other person". This Bill is about shoring up things that go wrong with that borrowing, is it not?

(Mr Dorrell) I accept that I have been corrected on the trust's power to borrow. What remains true is that, as Mr Neill says, the trust has no power to pledge its assets and what the Private Finance Initiative allows a trust to do is to achieve direct access to private capital markets to allow the trust to establish a relationship with a partner to modernise the buildings and the facilities within which health care is provided. If you look at the history of the health service since 1948, as I have said many times, it is the history of a service that has failed to achieve the investment that is necessary to allow it to deliver health care in modern purpose built facilities. The history of the health service is littered with examples of investment projects that have fallen foul of short-term capital planning which is the curse of the public sector. What the Private Finance Initiative allows us to do is to form relationships with private sector partners that will deliver modern health care buildings purpose built to meet the needs of a modern health service.

Ms Abbott

622. That is true but also the public purse may end up paying the liabilities of individual trusts which the public have not agreed to. I understand what you are saying about the health service policy terms but as the Treasury Committee the notion of the public standing behind what is a potentially unlimited liability makes us a little nervous.

(Mr Dorrell) Indeed, but the Treasury is not standing behind unlimited liability that is undefined. What the Treasury is standing behind is contracts that are signed up to by health service bodies subject to all the proper appraisal before those contracts are signed.

623. The taxpayer is going to have to stand behind contracts to which the public sector never agreed.

(Mr Dorrell) With respect, I think Ms Abbott is wrong because what happened previously was that the taxpayer agreed to support the development of new hospital buildings which very often

4 March 1996]

THE RT HON STEPHEN DORRELL MP and MR ANDREW NEILL

[Continued]

[Ms Abbott Contd]

overran, so the scale of the risk that the taxpayer underwent may have been less obvious in prospect but it was glaringly obvious very often in retrospect. What happens with the PFI is that the scale of the taxpayer risk is clearer in prospect and when the costs overrun the burden of some of those overruns is borne not by the taxpayer but by the people better placed to manage it, that is to say the managers of the private sector.

Mr Sedgemore

624. But under this Bill, Mr Dorrell, and I have got it in front of me, a trust, if it ceases to exist, you have got to exercise your statutory powers to transfer property rights and liability to the body, the body being the trust.

(Mr Dorrell) That is right.

625. The trust can have liabilities towards the person with whom it contracts. So it actually means that in relation to anything the contractor does—the contractor might actually do something which results in ten people, for example, claiming half a million pounds compensation that might be entirely due to the contractor, not the trust—you are then handing over this open-ended liability caused by the contractor's incompetence to the taxpayer.

(Mr Dorrell) In a case where a contractor was responsible for a service failure that led to a claim by a patient on the trust then I would have thought in most circumstances—Mr Sedgemore is the lawyer, not me—the trust would have a further claim back to the consortium.

626. I do not suppose you can answer this question since you did not know that trusts had the power to borrow but do you have the power to give directions to trusts on borrowing?

(Mr Dorrell) I am told that I can guarantee borrowings but nothing else under the 1990 Act.

627. You cannot stop a trust borrowing?

(Mr Dorrell) I would need to take advice.

(Mr Neill) He cannot stop a trust from borrowing but there are not many lenders who are prepared to lend on an unsecured basis to trusts.

628. Do you know, Mr Dorrell, that under your own Government's legislation the aggregate of borrowing by NHS trusts is up to five billion pounds and—you certainly do not know this—you can make a specific order to take it up to ten billion pounds? That is a lot of liability.

(Mr Dorrell) Indeed. The provisions covering the liabilities of existing NHS trusts are clearly set out in the Act, they are clearly taken into account in the NHS's own cash planning which underlies the annual public expenditure survey process. What the PFI does is to allow the health service more direct access to more flexible private sources of capital. The question is whether the health service should continue to be constrained by the cash planning process that underlies the public expenditure survey or whether the health service should have direct access to private capital markets to allow its investment needs to be met.

Mr Betts: Mr Dorrell, just to pick up one point there. When you were asked by Mr Sedgemore whether you could stop a trust borrowing I think the reply that came back was that of course there are very few in the private sector who would lend because the lending is not secured.

Ms Abbott: It is secured, we are securing it!

Mr Betts

629. The difference in the PFI is that you are not lending in the traditional way, you are actually contracting a range of services. Therefore, you do not have to get any guarantees from the Secretary of State, you are not in the business of having security in the way that borrowing has had to be done in the past from local people who were prepared to lend. Is that not the difference, that with the PFI trusts can enter into agreements for revenue commitments for well into the future incurring liabilities which this Bill will effectively underwrite from the taxpayer where the taxpayer has no say on how that money is spent at all?

(Mr Dorrell) It is not true to say that the public sector accountability system has no say in how they are spent. There are two responses to Mr Betts. The first is that a trust remains a public sector body and the use of resources within the private sector consortium is governed by the contractual relationship between the trust as a public sector body and the consortium. So the use of resources is indeed governed by a public sector accountability process. The second point is that a trust will not get into that contractual relationship anyway if the project has not first passed a value for money test which demonstrates that it is better value than the public sector.

630. But it is still a liability and you cannot stop the trust from entering into that liability, I understand. Indeed I think when you were asked questions before the answer came back that the Department for which you are responsible did not even have in its central monitoring unit clear understanding and information about all the commitments that have been entered into by the various trusts. You have not even got any information.

(Mr Dorrell) What we have got is a clear requirement that trusts cannot enter Private Finance Initiative projects unless it can be shown that they are better value than the public sector alternative, point one. Point two, Mr Betts is making a completely false point. Take the Chelsea and Westminster Hospital as a simple example of a project that overran its original cost estimates.

631. Do you know why that was?

(Mr Dorrell) What I do know is that from the moment the taxpayer signed up to building that project the taxpayer was signed into meeting the cost of the overrun. There was no private sector partner sharing that risk. If a similar project run with a PFI partner, I believe the risks will be better managed because there will be a private sector partner sharing those risks.

632. The difference is—and to take that particular hospital—I understand from Mr Carrington

4 March 1996]

THE RT HON STEPHEN DORRELL MP and MR ANDREW NEILL

[Continued]

[Mr Betts Contd]

who is not with us now but when we had this issue before he explained—and he knows it fairly well—it was not due to the fact the construction costs simply went up out of control but the fact there were new specifications added into the scheme. It was a different project that was eventually built from the one that was initially contracted. That would happen in any contractual arrangement, those costs would increase. The difference is, and the reason why you need the Bill now, first of all you will not get the private sector to enter into these contractual arrangements with trusts unless there is a guarantee that you will pick up the bill in the end if the trust is in some way removed. There is a difference now from the previous situation because previously yes no-one would lend to a trust when it could not use its assets to secure it but under PFI schemes that is different. You are entering into not straight forward borrowing but into a contractual commitment where the trust provides a revenue commitment for future years. That is a different arrangement but it is still one where a liability has been created which you have no control over which you are prepared to underwrite. Is that not the case?

(*Mr Dorrell*) No it is not the case. Firstly I have already explained why it is untrue to say that the trust and the health authority have no control over it, that is simply not correct. Secondly, when any project is entered into, whether in the public or private sector, there are clearly long term implications. Those are better managed through the Private Finance Initiative because there is a private sector risk bearer in the partnership. If the public sector signs up to a project fully publicly capitalised from the beginning then the public sector underwrites all this, known and unknown.

Mr Sedgemore

633. Moving on a bit Secretary of State to an area where there is more joy for you hopefully, can you tell me—I want to know the state of play, as it were—if in relation to the Norfolk and Norwich 700 bed, £100 million project, the trust has signed its agreement with the operator yet?

(*Mr Dorrell*) No, it has not.

634. Can you tell me if the trust in relation to the Carlisle 474 beds has signed its agreement with the operator?

(*Mr Dorrell*) No.

635. Swindon?

(*Mr Dorrell*) It is pretty obvious that none of these has signed up because we have not announced the go ahead for any of them yet. It would be unlikely that we would have signed up contracts when we have not announced whether they are going ahead or not.

636. Have you not been trumpeting these?

(*Mr Dorrell*) No, certainly I have not trumpeted them. I am not sure it is true I have never mentioned them. Certainly I sought to play them down precisely because I have not signed up to any of them.

637. I see looks of astonishment from people sitting behind you. You have sought to play them down? There have been no private briefings, nothing?

(*Mr Dorrell*) I have not sought to play up.

638. You do not want to know. This is something in the infinite future.

(*Mr Dorrell*) Of course. I have not played up and every time I have mentioned them I have always been very careful to say of the ones that Mr Sedgemore listed that these are projects that are coming through, certainly I very much hope from the point of view of residents of those areas that they prove to be viable projects and we are able to make the investments that there are envisaged within them. No decision has yet been taken to go ahead with any of the ones that Mr Sedgemore listed.

639. I have one more question for you, Secretary of State. So it would seem that your flagship project is not so much going along full sail ahead, it is limping along, is it not? It is limping into port before it has gone out of the harbour?

(*Mr Dorrell*) When I spoke on the subject in December I said that I hoped and believed that during the next few months we would be able to announce projects at roughly the rate of one a month. That was three months ago since when we have announced a go ahead at Amersham and High Wycombe, a go ahead at Leeds and a third go ahead: Royal Berks and Battle.

640. Have any of those been signed by the bankers?

(*Mr Dorrell*) I cannot tell you the precise state of negotiations.

641. Can your adviser tell us?

(*Mr Neill*) They are still in negotiation.

642. They are not signed up, the bankers do not want them signed? The bankers are not waiting for this Bill, are they?

(*Mr Dorrell*) We have announced decisions in principle to go ahead with those three projects and we are in the final stages of negotiation. These are complex deals and I think Mr Sedgemore is frankly not being realistic if he thinks that deals of that size can be all signed and sealed in a matter of days.

643. We are at one here. We were just talking about the Royal London Hospitals Trust of £260 million. We were saying precisely your argument, that the December deadline is ridiculous, do you agree with that?

(*Mr Dorrell*) No, I do not agree with that. That project has been going for assessment since it was announced by my predecessor getting on for 12 months ago.

644. Did you know they are still talking about the number of beds, whether it should be 750 or 1,020?

4 March 1996]

THE RT HON STEPHEN DORRELL MP and MR ANDREW NEILL

[Continued]

[Mr Sedgemore Contd]

(Mr Dorrell) I am conscious certainly of the fact that, as is intended, it is one of the purposes of the approach that there should be discussion with the partners on the configuration of the services.

Ms Abbott

645. Mr Dorrell, is it the case that the Government has cut NHS capital programmes by 16.9 per cent from £1.8 billion to just over £1.5 billion?

(Mr Dorrell) It is true that the budget for next year is cut at 12.7 per cent on the current year in real terms. It still represents an increase of roughly 50 per cent on the level we inherited in 1979.

646. The NHS capital programme has been cut. Is it true also that you are dependent therefore on PFI delivering new hospital buildings?

(Mr Dorrell) It seems to me frankly self-evident that if we have an alternative way of financing the capital programme of the health service, which is for a variety of reasons I believe a better way of financing the capital programme of the health service, it does not seem to me unreasonable that the budget that I then get from the taxpayer I should use to treat patients and that is what I am doing.

647. You do not have to be defensive, Mr Dorrell.

(Mr Dorrell) I am simply seeking to explain.

648. I am trying to establish that in practice we are now dependent on PFI delivering new hospital buildings?

(Mr Dorrell) It does not seem to me that it is open to a member of the Labour Party to argue that case, since it is 50 per cent higher than the level that we inherited 15 years ago.

649. Mr Dorrell, it would be helpful if you answered the questions rather than made assertions. In previous evidence to the Committee you suggested that PFI would allow additional spending on health by switching expenditure from the capital to the current project. Can you outline the extent to which this has occurred?

(Mr Dorrell) Yes. In this year's public expenditure survey I announced roughly a 1½ per cent increase in the real terms resources going to current expenditure in the health service. You do not need to have any detailed knowledge of the arithmetic to know that was made possible by a shift from capital into current of the public expenditure.

650. Is not the problem of PFI, Mr Dorrell, that is a kind of glorified HP? Although you may save money in year one by year 25 you have not saved money at all. For all sorts of reasons you can use PFI to save on capital expenditure now but what you are actually doing is building up inescapable future forward commitments resulting in higher scoring of public expenditure in the future?

(Mr Dorrell) I will accept that the PFI is a form of HP when Ms Abbott can produce to me an HP supplier who will offer me terms where it is

cheaper on HP than it is on the basis of finance on the Treasury gilt rate.

651. HP is a very complex financial arrangement.

(Mr Dorrell) No, it is a very simple financial arrangement.

652. You save money in year one but you commit yourself to revenue expenditure over the long term and although you may be saving money in year one over the long term it is not necessarily the case that you are saving money.

(Mr Dorrell) Indeed it is not necessarily the case but it is necessarily the case that in our estimate PFI projects will save us money because if they did not they would not pass the value for money test and they would not go ahead.

653. You say that Mr Dorrell but one of the things that has come through in this inquiry is that PFI is not necessarily appropriate to every single aspect of public sector expenditure. In particular I am not sure that this is appropriate in areas where you do not have an actual revenue flow. Mr Prescott, who has been very vocal about PFI, was talking about transport and roads and railways and one of the reasons we brought you back was we wondered about the application of PFI to the health service.

(Mr Dorrell) I entirely agree with the proposition that there are some aspects of where it may prove that the PFI is not a sensible way of dealing with capital expenditure. That is why I continue to provide a very substantial publicly funded capital programme. I do not agree with the proposition that the health service is in some sense not an ideal application for PFI, I actually think it would be very hard to think of a better one because the truth of the health service is that there is a huge revenue budget donated to the health service quite rightly every year by Parliament but the value we have got for that revenue budget in every year of the health service history going back to 1948 has been sub-optimal because the capital stock of the health service is not as good as it could be. If we bring in private sector partners to improve the quality of the capital stock available to health service clinicians I believe we shall get better value for the taxpayer pounds that are spent on the revenue budget of the health service. That is why I am in favour of it.

654. You would say that, would you not, Mr Dorrell? We have had evidence to this Committee that actually politically sensitive areas like the health service are not ideal for PFI. Let me just ask you something finally; under the Treasury's Resource Accounting and Budgeting initiative, how will the forward commitments to buy from PFI health projects be accounted for?

(Mr Dorrell) I was responsible when I was in the Treasury for resource budgeting but I am not familiar precisely with where current thinking has got to on the implementation of resource budget-

4 March 1996]

THE RT HON STEPHEN DORRELL MP and MR ANDREW NEILL

[Continued]

[Ms Abbott Contd]

ing. In terms of resource accounting, which is a different issue, the health service is already essentially in the system of resource accounting because we already account for the time value of money through the capital charging system.

655. But how will Parliament be kept informed of the future claims on public expenditure which are now arising?

(Mr Dorrell) I do not have current plans to announce specifically the future plans. What I do have is a clear commitment not to sign up to PFI deals that do not pass a value for money test.

656. Mr Dorrell, my point is a different point, it is not about value for money, it is about this: it is about in the interests of allegedly saving money in the short-term you are incurring on the part of the taxpayer a long-term public expenditure commitment and what we are concerned about as the Treasury Committee is how best Parliament can actually monitor that and be apprised of what is happening.

(Mr Dorrell) I am responding to Ms Abbott's question directly because if it is true that each of these projects has first to pass the value for money test then Parliament has the assurance that the contracts that are being signed under PFI will be lower cost contracts than the alternative of voting the money today and raising it in presumably borrowings now in order to finance a publicly funded alternative.

657. They may be value for money but what Parliament needs to know is the aggregate and what are the aggregate commitments going into the future?

(Mr Dorrell) Obviously all Departments in practice have future aggregate commitments. When you sit down to plan the future budget of the Department you need to ensure that there is sufficient flexibility to allow choices to be made in the future. It would be an absurd way of planning public expenditure to insist that we have to take a high cost solution now in order to avoid signing away some of our flexibility for the future and that is the alternative that Ms Abbott is pressing on with.

658. You are deliberately misunderstanding me. The point I am making is the accountancy point. The problem with PFI, and it is a simple point, is that you may save money in year one but you do not necessarily save money by year 25. What Parliament wants to know is how best Parliament can be kept informed and apprised. I see you have now had a chance to read the note your friend has given you and hopefully you can now answer the question.

(Mr Dorrell) You will also have noticed that I wrote something on the note so I am not going to reveal what is the nature of the private correspondence going on between us. What I am going to reassert is the proposition that if I am presented with two ways of building a hospital, one of which is cheaper than the other, it seems to me that it is

incumbent upon me as Secretary of State to choose, if I may shift the concept slightly to one I prefer, the better value solution of the two proposed to me. Since by definition I will only adopt the PFI solution when it does pass the better value test it seems to me perverse to argue then in favour of the publicly funded alternative which would be worse value.

659. I take it from your response that you do not know how Parliament will be kept informed of future claims on public expenditure.

(Mr Dorrell) I will certainly write to the Committee on that subject.¹

Chairman

660. Before I call Mr Betts who wants to put specific questions to you about Sheffield, I wonder if I can just explore a little further the questions that Mr Betts put to you earlier about the relationship between a trust and the Department. Say that a request comes in for permission which is either given or withheld, who gives it? Must it go to ministers?

(Mr Dorrell) The answer is there is a complex series of approval systems. Up to £1 million total capital size the outline and full business case is dealt with by the regional office and full business case is done on a sampling basis. Over £10 million each case is approved by the Treasury. Over £50 million each case has to come to ministers for approval.

661. Where does the accounting officer come in?

(Mr Dorrell) The accounting officer is of course accountable for all these expenditures through the system where the accounting officer for the NHS is Alan Langlands, the Chief Executive, and the accountable officer in each trust is the chief executive of the trust accountable to the accounting officer of the NHS.

662. The reason I put the question is because one of the dimensions to all this which the Committee is exploring, of course, is the relationship between the Treasury and individual departments. We have taken evidence from Mr Jack in which he made it quite clear that while he sees himself together with the Chancellor as being the guardian of the principles, nevertheless in his phrase the buck stops with you and your accounting officer when it comes to specific projects. That is what he told us in oral evidence. So, in fact, when a request comes in on the basis of the figures that you have just given us, in many instances it will actually have to come to ministers for personal approval?

(Mr Dorrell) That is true on the simplified matrix that I have offered to the Committee. I can write and give the full details of that.

663. Would you because it would be very helpful to us in terms of drafting the report.

(Mr Dorrell) It is not at variance with the general approval systems on public expenditure,

¹ See Appendix 23.

4 March 1996]

THE RT HON STEPHEN DORRELL MP and MR ANDREW NEILL

[Continued]

[Chairman Contd]

namely that the accounting officer is responsible for all the expenditure within his accounting officer remit. Ministers are responsible for the expenditure in a policy sense. The Treasury clearly exercises control of the public expenditure but the policy and propriety responsibility rests with the ministers in charge of departments and with their accounting officers.

Chairman: Finally, and this is not a question but for the information of all, I am advised that Standing Order No.48 is not that unusual, that in fact it is used several times in each session as one of the means whereby the House has a procedure whose main object is to create a charge upon the public revenue. Mr Betts.

Mr Betts

664. Thank you. We heard evidence earlier on from The Central Sheffield University Hospitals Trust about a particular project that they are considering under the PFI proposals. One of the issues that is certainly of concern to the people in Sheffield is that while the project changed to some extent because of a review the area health authority carried out there is now a further delay because the PFI assessment has to be gone through on a project which for its most part had been determined in October 1993. Is that not of concern when there is enormous pressure to get a very ancient and fairly dilapidated hospital replaced?

(Mr Dorrell) Quite frankly, I am not seeking to make a party point but I do think it is to turn history on its head to think that the PFI is a new delay in the capital programme.

665. It takes longer.

(Mr Dorrell) With great respect, there are numerous examples through the health service of elements of the capital stock that are antiquated, that need to be renewed, people have wanted to have renewed for a substantial period of time, and where health care is inefficiently delivered as a consequence of being trapped in old capital stock. That has been the experience of all Health Ministers through all governments. When I was a junior Minister in the Department of Health I was responsible for what was then quaintly called "unconventional finance" which I thought was an escape from this straitjacket. In those days it did not work. Since then the Government has changed the rules, in a way I must say that was pressed upon it by almost all independent observers, and we have now created the opportunity for a much more enlightened approach to capital investment in the health service. I do think it would be an extraordinary turn around for the books if this Committee were now to become a friend of the Ryrie Rules, something I think it is true to say the forebears of this Committee were not great praisers of.

Ms Abbott

666. We are friends of financial probity.

(Mr Dorrell) Indeed. I would never have thought otherwise, Ms Abbott.

Mr Betts

667. The chief executive of the trust also indicated that they had to go through this public sector comparator procedure which is one of the tests for the PFI schemes. He also said that because the project was considered to be an important one for the residents of Sheffield that an indication had been given that if the public sector scheme proved to be the cheapest and best value for money then the public sector capital would be made available. Is that the case with all of the schemes that go through a public sector comparator or in many cases is the public sector comparator not real because there is no public money there to fund it if it is the cheapest?

(Mr Dorrell) I clearly cannot commit myself to underwriting every project that fails to achieve PFI, that would be an absurd proposition because it would simply mean that any scheme, however harebrained, if it failed to get PFI I would be caught by a guarantee to fund it. I am certainly not doing that. I make no secret of the fact that my preferred model for the provision of major capital projects in the health service is using the PFI route, provided of course that it can pass value for money tests. I have also made it clear that we retain a very substantial investment, publicly funded investment, programme and we shall use that to deliver the enhancement of the capital stock that cannot be done on good value for money grounds on PFI.

668. I would not like to think, Mr Dorrell, you are actually suggesting that the trusts which you are responsible for appointing actually engage in harebrained schemes under the PFI initiative. I presume most of them set off on what is a very complicated evaluation process because they believe that the project they are trying to find a method of funding for is an important one for their service.

(Mr Dorrell) Of course. I was simply responding to the precise question I was asked: does the public capital programme guarantee to pick up everything that fails the PFI process and the answer to that question is no.

669. So there are schemes which the trusts believe are very important and if they do not get PFI funding will not be funded?

(Mr Dorrell) That follows, it seems to me, from the proposition I advanced in answer to the last question which is that the appeal of the PFI is that it allows us to get out of the excessively constrained circumstances of planning in the health service over the last 40-odd years, it allows us to be more ambitious. It follows from that that there will be more projects coming forward, I hope and intend, than would have been the case under the old regime. It certainly cannot be a sensible position for a Secretary of State to adopt that against the background of that more ambitious capital outlook he guarantees to pick up everything that does not secure PFI backing.

4 March 1996]

THE RT HON STEPHEN DORRELL MP and MR ANDREW NEILL

[Continued]

[Mr Betts Contd]

670. Can I go on to points specifically on the Sheffield scheme which is interesting in some respects. First of all, because the scheme is for the replacement of an existing old mother and baby hospital in Sheffield and associated services are being brought on to a new facility on the Royal Hallamshire Hospital site, do you think that the PFI requires and PFI contractors require that they take over the responsibility for managing support services as well as designing and constructing the project? The hospitals are faced with the almost impossible position that they will have an integrated hospital site in part of which the support services will be managed by the new contractor who will be appointed and partly managed by the trust directly as is the case at present. They are therefore almost being forced into the position of having to effectively hand over the running of all those support services to a private contractor. Is that really a hidden objective of the Government that we are really seeing, privatisation through the back door?

(Mr Dorrell) No, it is not.

671. Are you surprised that is happening?

(Mr Dorrell) What we are seeing is trusts taking the opportunity to form partnerships with the private sector to deliver the support services of the health service more efficiently as a result both of private sector management skills of the support services themselves and also importantly the private sector's access to private capital markets. That seems to me to be an important reinforcement of our commitment to deliver modern health care in modern facilities.

672. But a consequence of that is 1,000 cleaners, porters, caretakers and other support staff of the Royal Hallamshire Hospital in Sheffield now face the prospect of being transferred with no guarantee about terms and conditions or anything else but transferred through a process that they are not really a part of because the PFI process was not directed towards the hospital that they are in. They are having their jobs transferred to a whole range of different providers of services, not just one provider but a whole range of them, as part of this process. Is that really intended?

(Mr Dorrell) No. The purpose of the process is to deliver the support functions to the NHS as efficiently as possible in order to deliver better health care. Now, if as a result of these changes that Mr Betts refers to there is a more efficient delivery of the support services to the patients of the Hallamshire Hospital that seems to me to be an outcome that I would find easy to defend.

673. I do not think that is the reason that has been given, I think it was something to do with they were in a position where that was an inevitable conclusion of the way that the PFI drove them.

(Mr Dorrell) If indeed it drives them to that conclusion I say, and I say it again, it seems to me that it is an outcome that is easy to defend.

674. Can I just go on and look at one further issue and this is the clinical and non-clinical split. In the past the Government has said: "Of course, while we are quite happy that efficiencies should be obtained by transferring the non-clinical support services to the private sector, our policy is not to transfer clinical services, we do not wish that". Mr Whitney, I think very expeditiously, told the Committee that it is not that simple when managing hospitals because some services are combined, that the housekeepers are an important part of the teams that operate within the wards, clinical and non-clinical people, in your definitions, working together. Once you start splitting up responsibilities for managing those people it becomes that much more difficult to integrate their working together. Again, does that not show that perhaps PFI which tries to extract some of those people, some of those services, out and say: "You are non-clinical, the rest are clinical", really is artificial in the way that it seeks to delineate services in that way?

(Mr Dorrell) I certainly do not accept that it is unworkable. Any line in any organisation is to a degree artificial but it seems to me that it is artificial in support of a very, very important principle which is that the health service has two defining characteristics as of this moment, the first is that it is delivered on the basis of clinical need, largely free at the point of delivery, and the second is that the clinicians who deliver it are themselves the employees of the National Health Service. I think that voters, and certainly the Government, regard it as important that both of those principles should continue. If you accept that it is important to have it largely free at the point of delivery, that is not in dispute, and also important that the people, the clinicians, who deliver health care should be the employees of the health service and not of the private contractor that necessarily means "unless you are going to keep the private sector out of the NHS in its entirety, and so far as I know none of the parties in British politics now think that is the right policy", you have to draw a line that distinguishes the clinicians from the services in which you are prepared to bring the private sector in.

675. What Mr Whitney was saying to us was that people like the housekeepers not merely work as a team but people who are providing support services of that kind are also involved with clinicians on a daily basis and are also doing certain jobs now like taking blood to vary people's jobs and make jobs more rewarding. That is written in and it is done with the support of the clinicians. Presumably you are not in favour of transferring that sort of service into the private sector so those people are going to have their jobs changed, they will go back to doing just domestic work, we are not going to be able to enhance people's lives and enrich them, are we, in your world, Mr Dorrell?

(Mr Dorrell) I am not going to get involved in individual job descriptions in individual hospitals.

676. Why not, you are telling the Hallamshire what to do.

4 March 1996]

THE RT HON STEPHEN DORRELL MP and MR ANDREW NEILL

[Continued]

[Mr Betts Contd]

(*Mr Dorrell*) What I have done in my previous answers to Mr Betts is to seek to explain why a line that has to some degree an artificiality about it—I do not deny that all lines in all organisations have an artificiality about them—is the inevitable consequence of accepting firstly that clinicians should continue to be the direct employees of the health service, and secondly that there is a role for the private sector in achieving the kinds of objectives that I have been articulating. I think that role is an important one. I think that the result can be a significant enhancement in the quality of service we give to patients and in those circumstances we have to seek to draw a line. The distinction is set out in the definition of clinical and clinical support services, those are the services that we seek to put in almost all circumstances on the direct employment side of the line and the others are available as part of the public/private partnerships that we are discussing.

Ms Abbott

677. But it is artificial. When you go into hospital, Mr Dorrell, your perception of the quality of care that you are offered is as much coloured by your experiences with what used to be called the ward maid, the person who brings your meals, as it is with perhaps the fleeting minutes you spend with the consultant. In practice the patient—your constituent and my constituent—their perception of health is about the treatment they get from the team and what you are doing is bringing a totally artificial distinction to bear between some members of the team and other members of the team. To the actual patient what matters is how the whole team works together. What we are saying is that the PFI brings this wholly artificial distinction which actually militates against people working together as a team in the care of our constituents.

(*Mr Dorrell*) I do not believe for one moment that it militates against their working together. I accept that there is a different policy steer that applies to the two different groups of employees. I do not accept for one moment that a public/private partnership prevents public and private sector employees working together within a hospital, nor do I accept for one moment the proposition that the private sector employees have in some sense a quality ceiling applied to their work. The opportunity is there both for private and public sector employees in the context of these partnerships to see the quality of service that they deliver enhanced.

Mr Betts

678. Finally, Mr Dorrell, the Sheffield bid that is going in actually includes some clinical services for part of the PFI bid. When the Chief Executive was asked why clinical services were being included, the clearest response was because there was a need to renew some very old equipment that was first put in when the hospital was built in 1979, diagnostic imaging, sterile service and pathology laboratories, and the only way now because of the 16.9 per cent cutback in capital

funding of the health service to get any money for those facilities was through a PFI bid. It was not a question of whether it was the best route, it was the only route, it was Hobson's choice. So the clinical services have been transferred into the capital funding starvation.

(*Mr Dorrell*) With respect, clinical services have not been transferred.

679. Well they may be.

(*Mr Dorrell*) What has happened is that the hospital has invited bids and expressed an interest in those services. In that field we return to one of the first answers I gave this afternoon which confirms something which I think I said when I was here last time, that in the context of services of that nature we expect the hospital managers only to proceed in the context of agreement with local clinicians.

Mr Timms

680. Can I come back to what you were saying earlier about the major projects that are going forward under PFI. You have sent us a note about the South Buckinghamshire NHS Trust. Has that been contractually committed?

(*Mr Dorrell*) No.

681. You indicated that there were two others that had been given the go ahead, one of them was St James' in Leeds and there was another one.

(*Mr Dorrell*) Battle in Sussex. Sorry, the Royal Berks & Battle.

682. Have those been contractually committed?

(*Mr Dorrell*) No. If you would like to put them in a commercial sense I think the best way to put it is we are in a letter of intent stage. I am not sure whether we have actually signed a letter of intent but we have expressed a clear intention.

683. None of them have so far been contractually committed?

(*Mr Dorrell*) No.

684. Over the past year there has been a much longer list of hospitals that has appeared in the press. There was an article in *The Independent* on 30 May last year which lists all the ones that Mr Sedgemore was referring to earlier. There was an article, again in *The Independent*, in November listing the Norwich Hospital, the Norfolk & Norwich, and several others. The implication of those articles seemed certainly to be that these are on the point of going forward and of being committed. It would be true to say, would it not, that things have taken much longer than you envisaged or your predecessors envisaged?

(*Mr Dorrell*) No. The only conclusion that can be drawn from that article I think is that it may have taken longer than the author of the article envisaged. It has not actually taken any longer than I envisaged. As I said when I spoke about this subject more than once around the time of the Budget, I anticipated that we would bring forward

4 March 1996]

THE RT HON STEPHEN DORRELL MP and MR ANDREW NEILL

[Continued

[Mr Timms Contd]

new projects at roughly the rate of one a month and that, as it happens, is so far precisely what we have done.

685. But none of them has got to a contractual commitment stage?

(Mr Dorrell) No, but once again that does not surprise me because, as I have said, in each of the three where we have made firm announcements we have expressed our clear intention to proceed. We are now at a stage of intention subject to contract, if you like.

686. Can I ask you something about the overall NHS capital budget. You have indicated there is a decrease for next year from 1.8 billion to 1.54 billion, that is in the Government's own spending, made up for partly by the PFI sum, the figure of £165 million anticipated under PFI in 1996/97. Are you able to tell us how much of that sum, the £165 million, is contractually committed so far?

(Mr Dorrell) There will be some that will be committed under the small scale projects that are going on anyway but the main bulk of that I would anticipate would be under the projects which we have been discussing where clearly the contracts have not yet been signed.

687. Given that you are proposing to spend £165 million in the next financial year, are you concerned that so little is committed so far?

(Mr Dorrell) As of this moment, no.

688. Right. Can I ask you about the impediments that there may be to contracting this very large sum of money. Is it the reality that this Bill that we have talked about has to be in law before any of these projects are committed?

(Mr Dorrell) No. It is certainly something that potential partners will be interested in and will follow but there is no bar on a contract being signed until this Bill is launched.

Ms Abbott

689. But will they sign until the Bill is launched?

(Mr Dorrell) That I cannot tell you.

Mr Timms

690. You indicated that there was some anxiety on the part of the people financing these projects about this matter and one can well understand why. If you can abolish an NHS trust under your powers one can understand why they are reluctant to put in £165 million or any other sum without some protection.

(Mr Dorrell) You say that but what is also true of course is that the health service business continues and large sums of money are provided to the health service on a normal trade creditor basis every day and all of those in theory are at risk from the same source.

691. So you are telling us that the absence of this Bill has not held up, has not postponed, these commitments being entered into?

(Mr Dorrell) I do not wish to mislead the Committee. It is perfectly true that the recognition of this lacuna arose, in the context of the discussions about the PFI. I do not believe that it is yet true that any contract has been held up by the absence of this Bill.

Mr Timms: You are telling us that this is a lacuna that has existed since 1948.

Ms Abbott: A hole!

Mr Timms

692. Something that Nye Bevan overlooked!

(Mr Dorrell) That is right.

693. Is it not the case that the problem does not arise until you have these autonomous bodies which are the NHS trusts, which we have established are able to borrow money, and it is only when we are in the position that we are in that there is this problem?

(Mr Dorrell) No, that is not right. The liabilities side of a health authority balance sheet, whether or not it contains borrowings, will also contain trade creditors, all of those people are at risk in theory from this hole.

Mr Betts

694. It has never stopped them selling potatoes before, has it!

(Mr Dorrell) That is perfectly true to my knowledge.

Mr Timms

695. We have established that in the past there has not been much borrowing by trusts because they have got nothing to secure their borrowing on. Is not what you are doing in this deal giving them effectively a blank cheque, they have got all the security in the world, they will have the whole public sector standing behind them if they take on borrowing?

(Mr Dorrell) No. The Private Finance Initiative does not change the trusts' power to borrow, nor does it give the trusts power to pledge trust assets.

696. But there is power to borrow, they have already got power to borrow in certain circumstances. What your new Bill will do is indicate that you would stand behind those liabilities in a way that you do not at the moment.

(Mr Dorrell) The trusts' power to borrow will be constrained by their external finance limit in the same way that it is now and it will be constrained for the same reason that it is now, namely in order to control the capacity of the pace at which trusts take on liabilities which the taxpayer stands behind.

697. But how do you control trust borrowing?

(Mr Dorrell) The external finance limit is a control on the trusts' activity.

698. Are you able to tell me where that is set out in the NHS and Community Care Act?

4 March 1996]

THE RT HON STEPHEN DORRELL MP and MR ANDREW NEILL

[Continued]

[Mr Timms Contd]

(Mr Dorrell) It is not set out in the NHS and Community Care Act, it is part of the management controls of the health service. Can I suggest, Mr Chairman, that since the Committee is clearly interested in the trusts' power to borrow, and I am bound to say on the basis of the question and answer session this afternoon so am I, that we might both benefit from a paper that sets out with great clarity what is the trusts' power to borrow and what controls exist to constrain that power.²

Chairman: That would be very helpful.

Mr Betts

699. The PFI schemes do not count against the external finance limit, do they?

(Mr Dorrell) No.

700. That is the difference.

(Mr Dorrell) There is indeed a difference and Mr Betts has put precisely his finger on it. The external finance limit is a limit on the taking on of liabilities which the taxpayer does guarantee and the borrowings of the PFI partner are completely for the PFI partner and are quite clearly not guaranteed by the taxpayer.

Mr Timms

701. It is possible to envisage circumstances in which there is borrowing carried out by the trust.

(Mr Dorrell) I think, if I may, I will write to the Committee setting it out in great detail.

702. That will be very useful. I think it is just worth making the point that the Bill appears to some of us at least to open up the public sector to very serious risks that we need to be reassured about.

(Mr Dorrell) I accept that. The proposition is very simple, it is that the taxpayer should stand behind the liabilities of the health service. If I had been asked on my first appearance before this Committee on the subject of the Private Finance Initiative whether the taxpayer stood behind the health service I would have answered "Of course".

² See Appendix 23.

703. But the health service has changed, I think that is the issue, the nature of the health service. The decision making bodies in the health service have changed. That is why these questions are being raised. Can I just ask one final question. You have indicated to us that none of the major hospital building projects have yet been committed. Are you able to speculate about when those first three will in fact be committed?

(Mr Dorrell) No, nor would I want to because I do not want the negotiators on my behalf to have a sense that there is a political timetable which might prejudice their negotiating position.

Chairman

704. I have only one final question. It may be rather technical, in which case perhaps you could let us have a note again as to how you see the answer from the perspective from the Department of Health. It may be we shall need to go back to the Treasury as well. How is this policy going to affect what I would call the balance sheet of the public sector so far as your Department is concerned?

(Mr Dorrell) I think it is an important question and it goes to the heart of what the PFI is about. When I was the Financial Secretary I used to say that in a sense to describe it as the Private Finance Initiative was a misnomer because it implied that the principal purpose was recruiting off balance sheet finance, if you like. I do not see it at all in that light. I see the Private Finance Initiative being much more about the purchase of a service from a new sector which will specialise in the development of health buildings and health support facilities. I do not see it as impacting directly or even indirectly on a putative NHS balance sheet. I see it as the NHS using its power as a purchaser to encourage the development of a new sector that will specialise in the delivery of these services. I see the NHS as a purchaser of services from that sector.

Chairman: Mr Dorrell, thank you very much for coming back to the Committee this afternoon. Thank you.

APPENDICES TO THE MINUTES OF EVIDENCE

APPENDIX 1

Letter from the Audit Commission

PRIVATE FINANCE INITIATIVE

I note from the Press Notice of 14 December 1995 that the Treasury Committee has decided to conduct a short inquiry into the Private Finance Initiative (PFI). I wanted to bring the Audit Commission's interest in this matter to the Committee's attention.

The Audit Commission (the Commission) was established by the Local Government Finance Act 1982 and came into existence on 1 April 1983. I enclose a copy of the Commission's latest Annual Report.¹ Since then Roger Brooke has taken over from Sir David Cooksey as our chairman.

The Commission's stated mission is:

"... to promote proper stewardship of public finances and help those responsible for public services to achieve economy, efficiency and effectiveness". The main duties of the Commission are to:

- appoint external auditors to local authorities and NHS bodies in England and Wales, who may be from its own arm's length auditing agency, District Audit, or from private sector firms of accountants. The Commission determines fee scales payable by audited bodies for audits and regulates the audits;
- carry out studies of economy, efficiency and effectiveness (the "3 Es") of services provided by audited bodies, and of the effect of government legislation, regulations and directions on local authorities; and
- specify the indicators of performance which every local authority must collect and publish locally to facilitate comparisons of authorities' performance.

Once appointed auditors:

- must ensure that audited bodies are spending money and reporting their financial situation in accordance with the law, and that there are proper safeguards against fraud and corruption; and
- help audited bodies to improve their performance by showing how all services can be provided as cost-effectively as possible.

Therefore the Commission is very interested in the impact of the PFI, both in relation to NHS Trusts and health authorities where the issue is currently very significant and also in relation to local and police authorities where it may become more significant over time. It is examining both the accounting and other regularity issues associated with the investment appraisal and bidding procedures and also the implications of PFI projects which proceed for the balance sheets and revenues both short-term and long-term of the audited bodies with a view to giving advice to auditors on their duties. It will also be considering how best to address the issue of measuring value for money in PFI projects.

While the Commission has no specific evidence to submit to the Committee at this stage, I am sure it will wish to be invited to submit evidence to any future considerations of the PFI by the Committee.

9 January 1996

APPENDIX 2

Memorandum submitted by Sir Alastair Morton

I would like to thank the Committee for this opportunity to record briefly some key points about the early period of establishment and growth of the Private Finance Initiative under the impetus of the current Chancellor of the Exchequer.

The PFI perhaps was conceived and announced under his predecessor, but it had made little progress and had achieved little conviction within the Treasury, let alone outside, when the Chancellor

¹ Annual Report and Accounts of the Audit Commission 1995 (Year ended 31 March 1995).

approached me to chair a "PFI Working Group" (soon the Private Finance Panel or PFP) in autumn 1993.

I asked the Chancellor to release me from chairing the Panel in September 1995 in order to ensure that no conflict of interest arise between the PFI and my task to protect the best interests of Eurotunnel's shareholders in coming negotiations with banks, Governments, railways and contractors. In practice, I served about 1½ useful years from the launch of the PFP.

My appointment was announced at the CBI conference early in November 1993 and was followed by a little over three months of preparation, culminating in a "launch" at the Mansion House on 22 February 1994. In those three months, I recruited the "Panel" of business leaders and civil servants and an Executive of bright young secondees. I also had to begin to establish the relationship between the Panel and Executive on one side and Whitehall and Ministers on the other, with the Panel physically and procedurally very close to the Treasury.

The first task was to establish what was meant by whom when anyone referred to the "PFI". There was no clear, single definition, book of rules or defined list of governing precedents. We had to develop the main elements defining "a PFI project" from disjointed components, no one prior to that having the complete picture—or list of projects!

The second task, occupying with the first most of our limited resources until mid-1994, was to establish who was doing what in which department or agency to further or block the PFI—in which projects. We had to build the database and identify protagonists—and antagonists. The Chancellor's diktat in summer 1994 that all projects had to be "tested for PFI" was a key building block.

The third introductory task was (a) to publicise the essentials of the PFI to a somewhat baffled world (your own Committee displayed startling incomprehension of it in the report of their hearings on the 1994 Budget); and (b) to tutor—an appropriate term—civil servants, financiers, industrialists and all the advisers panting to profit from the PFI in the practical realities of the Initiative. A lot of speeches, a lot of lobbying, on into 1995.

These things we did, largely through the strenuous efforts of a small Executive consisting of six secondees from the private sector led by Mr Douglas Hogg; but with ever more purposeful assistance not only from HM Treasury, led by Mr Steve Robson, but also from more and more Whitehall departments and agencies as time passed.

Members of the Committee will recognise these as symptoms of a major culture change in the business of Government—which the PFI is, and needs to be. Perhaps the most useful thing I can offer the Committee in this memorandum at this time is a description of the change in culture involved and why I believe it was and is necessary. I am sure my successor, Sir Christopher Bland, will provide the Committee with a clear insight into the current workings of a now vigorous Initiative, and into any issues currently needing attention.

THE PFI AS A NECESSARY CULTURE CHANGE

For decades, the United Kingdom has underinvested in its public sector. Not even the immense wind-falls of oil and gas revenues and then privatisation proceeds reversed this deeply unhealthy state of affairs. It has not been unhealthy because public spending is good per se; it has been unhealthy because for 40–45 years after World War II virtually all services to the public and their infrastructure were in the public sector (plus industries such as steel and ordnance).

Because pretty well every government since 1946, under consistent Treasury direction, has seen capital investment in the public sector as the marginal means of regulating public spending; and because pretty well every government has been trying to limit or avoid budget deficits, this country has underinvested in the services needed by our society and in their infrastructure.

Given the bloated scale of our public sector—from prisons to schools to hospitals, from roads to rails to airports to sewers, from electricity to gas to water, from computer services to telecommunications—that public sector underinvestment gave a powerful shove to our post-war decline over those 40 years.

"Privatisation" removed large areas of the public sector from the shadow of this blight, making investment possible to enable many services to become more efficient and internationally cost-competitive. Look at BT.

"Contracting out" permitted the public sector to acquire certain goods and services more efficiently and at lower cost—but they were still being purchased for services hamstrung by lack of spending and also by bureaucratic or ministerial controls on management and on efficiency.

I see the Private Finance Initiative as the next move after privatisation and contracting-out. The further frontiers of privatisation have been reached—witness the agonies of British Rail and the Post Office, also nuclear power—yet there are still large areas of public service, including rail transport, royal mail and nuclear electricity generation, whose weakness will cause our economy and our society to limp into the next century if they continue to be deprived of essential investment. And behind rail, mail and power are vital areas such as healthcare, education, the administration of social services, etc., etc., etc.—in fact, *all* the services our society needs.

The PFI makes it possible to invest in those services without privatisation, yet without derailing our currency or government economic policy through a soaring budget deficit. However, intellectual reflexes conditioned by 50 years of Treasury single-mindedness generate some antediluvian responses to a simple slogan: "PFI makes it possible to invest without ballooning public spending".

Let me deal with a few of the most conventional wisdoms, first noting that both the Comptroller and Auditor General and the Chairman of the House's Public Accounts Committee have assured me they favour a PFI approach.

First conventional wisdom: "The Treasury can borrow for less, therefore the PFI wastes scarce resources and costs the nation more."

Response: 8½–9 per cent p.a. paid on debt outstanding during the limited number of years of investing and paying back 100 of capital is far less money than 7½ per cent p.a. paid for longer on 133. In short make your comparison on outturn cost, not on public sector budget estimates which are subsequently far surpassed.

In PFI cases (a) overruns are to be absorbed by the parties stipulated in the contract; and (b) innovations by private sector designers, builders and managers produce both capital and operational savings.

Second conventional wisdom: "PFI is merely off-balance sheet financing; there will be recourse to the taxpayer in the event of failure."

Response: Why? Only if failure is caused by Whitehall meddling in specifications, in financing or in revenue-earning environment after the agreements are signed. A PFI operator has to put up the capital and then (a) recoup it and (b) earn its return on it from the revenue stream permitted under an incentivised/penalised agreement, contract or concession. If the operator cannot, it goes bust; the ministry/agency/local authority then lets the concession out again to the best qualified high bidder. Capital is lost, but not service; and the procedure for retrieval and transfer is set out in the initial contracts. Given that, just how does the taxpayer move from being purchaser of the service, or preferably part-purchaser, to reimbursing of investors? In short, PFI projects should not be anywhere near HMG's balance sheet!

Third conventional wisdom: "Corners will be cut by investors in pursuit of profit. Safety and quality of service will suffer. Only by public ownership can the public get the necessary assurance of service."

Response: Rot! And happily this one is beginning to be perceived as nonsense. The service to be provided must be adequately specified, and its provision must be regulated or supervised—either by contract or by regulatory office or by ...

In my 28 years of experience of the interfaces between ministers, unions, the public sector and its contractors and suppliers I have found little or nothing to encourage me to believe that public ownership is the key to quality of service except in extreme cases such as the fighting minority of the armed forces. But the service to be supplied *must* be adequately specified in agreements—then private sector management and capital can be held responsible for what is required by those agreements. Quality is better assured by contractual specification than by ownership.

The role of ministers, their departments and agencies is not to own and manage, but to specify and then supervise and regulate delivery. *There* lies the first part of the culture change; the second is for the Treasury to comprehend that it cannot continue to direct the United Kingdom into decline at a Treasury-regulated pace by controlling every detail of the capital invested in or denied to large areas of our society. There are now many officials who have seen the Chancellor's light: there are still a number who have not, some of them in high places.

And also ...

Two final questions. First, how does the above square with Eurotunnel's current pursuit of this Government for restitution? Second, what can Parliament do, specifically the Treasury Committee?

The Channel Tunnel was a very primitive form of pre-PFI project. Above all, it lacks in this country what it could have in France—the primary characteristic of a public authority (ministry/agency/local government) purchasing a service via a “concession de service publique” from a private sector concessionaire whose funding is a negotiated blend of public and private funds adapted to the mission. Eurotunnel has a concession but in this country it is neither a public service concession à la Française nor a PFI à l’Anglaise.

Eurotunnel does not seek to complain to the Governments that the ferries offer 50 pence fares in competition with Le Shuttle; that the contractors failed to finish construction on time; that there were commissioning problems with rolling stock, etc., etc. Those are not Government failures.

Eurotunnel can and vigorously does complain that the states granting the Concession have failed to fulfil their explicit and consequent commitments to all the banks and equity investors who funded the Channel Tunnel and transport system on the basis of those promises. Herein is a fundamental requirement for PFI projects—the state entity specifying and regulating the public service to be procured must, on an ongoing basis and not once only, live up to the commitments offered to private sector capital to persuade it to invest. The state also must adjust to the consequences of any explicit primary commitments. Our Government in particular has failed to do so in the case of Eurotunnel. 720,000 individual shareholders (five-sixths in France) and 225 banks worldwide will hold Her Majesty’s Government to account for that.

To list a small minority of the charges laid—the fragmentation of BR, which has brought disruption to the development of traffic plus unilateral breaches by BR of relevant contractual protections for Eurotunnel; and the recent cavalier abandonment of the rail traffic forecasts which were initially put forward by HMG (and the French) as consideration for their demand (a condition of the Concession) to fix the terms on which 50 per cent of the Tunnel’s capacity was to be reserved to BR/SNCF for the life of the Concession. If I may continue, I must cite also the unprincipled extension of intra-Community duty free into the Single Market era, offering a huge subsidy to the Tunnel’s competitors without compensation to Eurotunnel or Eurostar; and then the constant, subsequent tightening of Tunnel safety requirements without comparable standards being applied to the competition; and so on.

Her Majesty’s Government and the French Government, being sovereign, may be jointly entitled to do each or all of those things. But there will be no PFI projects if HMG thinks such things can be done without compensation or amendment of the terms of the contract/franchise/concession. The agreements establishing a PFI project do not become “yesterday’s business” like a privatisation prospectus seems to these days. Any amendment during the concession period must be negotiated and terms adjusted or compensation arranged.

Finally, what can Parliament do about the PFI? It can welcome it in principle as a long overdue opening for a sound way forward to a better future made possible by more and better investment—as the C&AG and the PAC Chairman do. It can call for reports on the nature and progress of the important culture changes necessary in Treasury and Whitehall, and for ministers, and it can monitor those changes with encouragement not reluctance. It can instruct HMG to maintain its undertakings, in equity as well as contract, to ensure they achieve and continue to achieve what was intended. Otherwise the PFI will fail for lack of capital willing to risk the Government’s future behaviour.

9 January 1996

APPENDIX 3

Memorandum submitted by Mr Mark Johnson, Solicitor, Infrastructure Group, SJ Berwin & Co.

1 INTRODUCTION

SJ Berwin & CO’s Infrastructure Group acts as legal advisor to both private sector consortia bidding for PFI projects, and on behalf of public sector clients who wish to develop such projects. Our experience covers all sectors of the PFI including healthcare, DBFO roads, rail projects and education. We wish to make a number of comments and suggestions for consideration by the Committee.

2 BIDDING PROCEDURES

2.1 DBFO Roads

SJ Berwin acted for Graham Network Operators (“GNO”) on its bid for the A69 DBFO Road Project. GNO achieved the position of short-listed bidder but the contract was eventually won by the Roadlink Consortium. A number of criticisms can be made about the conduct of the tender process:

- the Highways Agency did not provide clear instructions as to the procedure and timing of bids. GNO found themselves in a position where they submitted what they thought would be a final bid price for the project on 5 June 1995, there then followed five months of negotiations on the contract documents during which time some bidders were allowed to adjust their bid price and re-enter the race: it was not clear how many bidders were in the race. During this time all the bidding consortia incurred very considerable costs in terms of management time and professional advisory fees. It should have been made clear that on a certain date the competition would be narrowed down to two bidders only and thereafter on a fixed date the preferred bidder selected who would be asked to submit a best and final price based on the tender submitted on the Tender Date.
- the Highways Agency twice extended the deadline for receipt of tenders: once at the request of the other bidder. GNO complied with the published timetable precisely at all times, whilst other bidders were given extensions of time.
- the final pre-condition to award of the contract was a requirement to have committed finance in place within a fortnight of the selection of a preferred bidder: it is understood that Roadlink has still not obtained committed finance whilst GNO had finance in place at the required time.

2.2 Docklands Light Railway

SJ Berwin acted for the Meridianrail Consortium which submitted a pre-qualification submission for the project to extend the railway to Lewisham. The submission contained innovative financing proposals which involved capturing the development value of the land along the corridor for the proposed extension. These proposals did not find favour with Docklands Light Railway at the time of submission in Autumn 1994; consequently, Meridianrail did not pre-qualify. Since then DLR has had a completely re-structure the financial structure for the project to include a £50 million government subsidy. Meridianrail believes this subsidy could have been significantly avoided if its development strategy had been pursued.

It is arguable that the bidding competition should have been re-started as a result of this fundamental change in the nature of the project.

2.3 Exemptions from Competition

Considerable uncertainty surrounds the applicability of the exemptions from the obligation to conduct a competition contained in the Treasury Guidance Note of March 1994 on Competition. The Guidance Note identifies a number of situations where (subject to procurement rules) a public body may proceed to negotiate directly with a private sector partner. A number of our clients hoped to benefit from these exemptions in order to enter into joint ventures with NHS Trusts—the Private Finance Unit of the NHS Management Executive apparently does not recognise these exemptions. The status of these exemptions, which could be used to kick-start a number of smaller projects by removing the need for a competitive process, needs to be clarified.

3 EFFICACY OF PFI

- we constantly receive complaints from clients and prospective clients that they are forced to explore private finance options for projects that are plainly not financeable by the private sector. A larger minimum value threshold should be established for PFI.
- some public bodies pursuing PFI are wasting their own time and resources and those of the private sector with ill-thought out schemes. Two examples can be cited: Highlands and Islands Airports project: the information issued to prospective bidders was woefully inadequate (see Appendix 1)[*not printed*]. Doncaster MBC has employed expensive consultants to produce a glossy brochure about the Interchange Project: most financiers agree that it is not viable (see Appendix 2)[*not printed*]. Public bodies need to be clear what it is they wish to achieve before launching a bidding competition and need to provide as much information as possible to tenderers.

11 January 1996

APPENDIX 4

Memorandum submitted by the British Medical Association

INTRODUCTION

This evidence is in three parts. The first consists of our views on some basic principles of the PFI itself. Appended to this are two documents. Annex I deals with the initiative as it applies to the National Health Service (NHS), and has been agreed as a statement of our concerns by the Council of the Association. Annex II[*not printed*] is a copy of a letter sent in September to the Director of Finance of

the Prison Service setting out the views of the Association's Private Practice and Professional Fees Committee on the role of the PFI in health care in HM Prisons. While the first part deals with general principles, we have found it helpful to use hypothetical examples drawn from the health sector to illustrate our concerns.

BASIC PRINCIPLES

The two main principles underlying the initiative are that it will lead to a transfer of risk to the private sector and that it will provide continuing incentives to efficiency and value for money in public spending. We consider both premises to be arguable. Recent guidance on the PFI from the Treasury¹ identifies three types of PFI project:

- Financially free standing projects.
- Services sold to the public sector.
- Joint ventures.

It is primarily with the second category that our comments are concerned.

TRANSFER OF RISK

The Treasury guidance identifies seven types of risk as needing consideration in most PFI projects:

- Design and construction risk
- Commissioning and operating risk
- Demand risk
- Residual value risk
- Technology/obsolescence risk
- Regulation and similar risks
- Project financing risk

It is easy to see how risk can be transferred to the private sector where projects are free standing. In such cases the involvement of the private sector is not dependent on a public sector alternative. If the risk associated with the return is too great then the project will simply not take place. The flow of rents to the private supplier will always be proportional to risk unless the government regulates it. Such projects (e.g. river crossings) commonly involve charges to third party private customers and if the government wishes to avoid passing too great a cost to them, it can subsidise the return or arrange to cover the rents itself (by a system of shadow tolls for example).

In cases where there will be a public sector customer, for example where a private hospital is being built to discharge an NHS need, the private supplier will require a contract to minimise risk or will levy charges which reflect that risk. If the calculations of risk and return are well founded there should be no difference between these two approaches. In such cases the public sector merely replaces capital with revenue spending. The short term public spending gains of doing this are clear but the longer term objectives are not.

In all cases the private sector will expect an appropriate level of return which the public sector will find difficult to meet without an opportunity cost. Expected returns of between six and eight per cent are not unusual in this context.

In its guidance to public sector bodies, the Treasury emphasises that no payments should be made to suppliers under the initiative until the facility is working acceptably. It is determined that no public sector indemnity should normally be involved. However in cases where the facility is required and the private sector has secured the contract to build, operate and own it, it is difficult to see how the public sector could avoid some form of implicit indemnity if the entire project were to founder for reasons which could not be otherwise insured against.

EFFICIENCY AND VALUE FOR MONEY

Various claims are made for the efficiency of projects covered by the initiative. Some of these concern the suitability of the design of the facility for its purpose and operation and flexibility and economies of scale in usage. These advantages cannot in all honesty be claimed for PFI projects alone. If they have been weaknesses in publicly funded projects in the past this is as much to do with lack of control as with any inherent public sector inefficiency.

¹ Private Opportunity, Public Benefit—Progressing the Private Finance Initiative. HM Treasury 1995.

Value for money gains, where they occur, will tend to accrue from the operation of the facility and it is in this area that our concern is greatest. Staffing ratios, skill mix, and pay and conditions of service changes leading to reduced levels of quality are feared on the operating side of such projects.

ANNEX I

PRIVATE FINANCE INITIATIVE IN THE NHS: AN UPDATE

In 1994, the Health Policy and Economic Research Unit prepared a paper on the use of private capital in the NHS. Since then, some privately funded schemes have been completed and many more are planned. Meanwhile, the scope of the government's private finance initiative has been extended further into NHS services. Comment from policy experts, the media and the public has ranged from an acceptance of the need for alternative finance to concern over its implications.

The following paper will provide an update on the use of private capital, its background and framework, and the numbers and scale of projects within the NHS. Main topics covered will be the private finance initiative and the involvement of private sector providers in the contracting process. Criticisms and concerns over the effects of private finance are also considered.

THE PRIVATE FINANCE INITIATIVE

The Government introduced the 'private finance initiative' (PFI) in autumn 1992 as part of a move to encourage private companies to fund and/or manage projects which would previously have been financed and run directly by the public sector. It was envisaged that these would be projects in many sectors of state provision, including health. The Government's main stated aims in recommending PFI were to improve cost effectiveness and reduce the risk born by the public sector in capital projects.

The Treasury's Ryrie rules were altered to allow much greater use of private finance. Public bodies were allowed to use a higher level of private capital (up to £10 million) without necessarily obtaining central approval. Since November 1993, trusts and health authorities have been expected to consider private sector alternatives in capital projects. In June 1994, a database was set up to match private companies and NHS projects by the firm Newchurch and Company. NHSE issued the *Capital Investment Manual*, which made it clear that private finance options must be considered first.

Four further guidance notes from the NHSE have followed in 1995, including two on market-testing^{1, 2} and one on PFI and capital investment projects³. These emphasize that PFI options must be rigorously explored before any request for public funding can be made. The process of completing a PFI contract is complex and lengthy, but ministers claim capital projects will still be completed more quickly. The most recent guidance note is on post-project evaluation, which must be carried out for projects costing over £1 million, and planned for before the tendering process⁴.

The initiative received a further boost in November 1995 with the launch of the Treasury Private Finance Panel's report "Private Opportunity, Public Benefit"⁵ and in the budget, which made clear the Treasury's expectations that a significant proportion of public sector capital projects must be financed in future through the PFI.

DEVELOPMENT OF PFI SCHEMES

In spite of concerns over whether the NHS could commit to purchasing services to a sufficient extent to attract investment, and whether acceptable agreements could be reached on risk sharing, private capital has been involved in several schemes and interest has been expressed in many more.

By July 1995 324 private organisations and 400 NHS trusts or commissioning agencies were registered on the Newchurch database. 133 projects were completed or close to completion, and a further 800 projects had been identified as suitable PFI schemes, representing £2 billion in costs⁶. In November 1995, 44 NHS schemes with a value of £1 million each had been approved with a total capital value of £166 million. A number of other schemes of under £1 million had received approval locally⁷.

¹ Market Testing for Healthcare Services—A Guide for Purchasers. EL(95)28, NHSE, 1995.

² Marketing Testing in the NHS. EL(95)29, NHSE, 1995.

³ Private Finance and Capital Investment Projects. HSG(95)15, NHSE, 1995.

⁴ Capital Investment—Post Project Evaluation. EL(95)102, NHSE, 1995.

⁵ Private Opportunity, Public Benefit—Progressing the Private Finance Initiative. HM Treasury, 1995.

⁶ Testing Private Finance in the NHS. Paul Nash and Kingsley Manning of Newchurch and Co. British Journal of Healthcare Management, 1995. Vol 1, No 9, 21 July 1995.

⁷ First Major Private Finance Initiative Scheme Approved. DoH Press Release, 95/557.

Some schemes involve mixed funding, some the leasing of NHS land, whilst others involve design, building, financing and operation by the private sector (DBFO). Forward sale of NHS land is also possible with Treasury approval. Examples of large schemes include:

- Mid-Sussex NHS Trust with private sector—MRI scanning (mostly private capital, company rents site and offers Trust preferential fees and profit-sharing)
- William Harvey Hospital, Kent—waste incineration plant serving 9 NHS Trusts (D)BFO⁸

The importance of the PFI to the future funding of NHS was stressed in the November 1995 budget, in which the Chancellor announced that although the NHS budget would increase by £1.3 billion, government spending on the health service capital programme would fall by 16.9 per cent, with the expectation some of the shortfall would be met through obtaining funding from private sources. In practice this will mean that the NHS will be expected to obtain £165 million worth of funding from the private sector in 1996–7, and a total of £700 million over three years.

The current Secretary of State for Health is also committed to the development of the PFI in the NHS and in November 1995 announced the first private sector funded hospital building scheme with the approval of a contract for £35 million for the redevelopment of the South Buckinghamshire NHS Trust. The trust will lease the buildings from the contract consortium, who will be responsible for maintaining them.

The private sector has, in the past, been sceptical about involvement in providing more mainstream facilities such as hospital building projects, for reasons already outlined and some of this scepticism remains. However it appears likely that further large hospital building projects will be approved in the next six months, including a £90 million rebuilding of the Swindon and Marlborough NHS trust facilities, a £140 million hospital building project at the Norwich and Norfolk trust and a £70 million scheme at North Durham trust⁹. The buildings will be owned by private companies but sited on NHS land, and leased back to the NHS with support services provided privately.

In a recent speech¹⁰, the Secretary of State for Health stressed that in such projects there would remain a distinction between privately owned support services and clinical services. Trusts would continue to be the direct employer of clinical staff in the overwhelming majority of cases. The speech acknowledged that some trusts had explored local arrangements for private sector provision of some clinical services, however, such arrangements were nothing to do with the PFI.

This is not the case in Scotland. The successful bidder for the Stonehaven project will be expected either to provide the specialist input into the new hospital in the fields of urology, ophthalmology; dermatology, audiology, diabetes, leg ulcers, back pain, ante natal care and gynaecology or to make arrangements with NHS trusts to continue and extend existing provision. Nurses, other professional posts and support staff will be employed by the successful bidder¹¹. Eight expressions of interest from NHS Trusts and seven from private providers have been received. The outcome of the tendering process will be announced in May 1996.

CONTRACTING WITH THE PRIVATE SECTOR

The NHS continues to purchase healthcare services from the private sector, but the relationship is complicated as services may be purchased through the contracting process by health authorities and fundholders or by trusts and health authorities through market testing.

The perception of private companies remains that the NHS is not able to enter into long-term commitments to purchase, and therefore the private sector is unlikely to make large investments involving any substantial transfer of risk. Lengthy contracts, however, reduce competition, particularly if the need for commitment is pointed out by a private provider in their outline proposal or tender. These problems have not dissuaded some companies from forming consortia in order to bid for NHS contracts, including McAlpine Healthcare and Tarmac Health Estates. Furthermore, some long term contracts have been agreed for clinical services, such as a 7 year contract for pathology services in North Hertfordshire.

The private sector's ambivalent relationship with the NHS is increased by the competition posed by NHS paybed units. There are also limitations to the development of independent hospitals because increased day surgery reduces the need for beds. Laing's 1995 Review of Private Healthcare estimates NHS purchases from independent hospitals in 1994 as £45 million, only a small percentage of the total market.

⁸ Laing's Review of Private Healthcare, 1995.

⁹ Health Service Journal, 30 November 1995.

¹⁰ Speech to Royal College of Physicians, 21 November 1995.

¹¹ Grampian Health Board, Hospital Provision in Kincardine, Background notes, 1995.

CONCERNS AND CRITICISMS

The cost of using private finance in capital investment schemes must ultimately be greater in terms of interest charges (i.e. public capital is cheaper), but it is difficult to compare this cost with that of waiting for desperately needed facilities when public money is not forthcoming. The financial pitfalls of private/public partnerships have been demonstrated by the £300,000 losses of the incinerator built and run by the Royal National Orthopaedic Hospital and Motherwell Bridge Environtech in Stanmore, Middlesex. Closing it down will involve further losses of £3.5 million¹².

The ultimate savings (if any) to the public purse cannot yet be evaluated and the principle of private investment in the NHS is not new—for example—the provision of loans for GP practice premises. Of more pressing concern are the principles which may be at stake in the NHS. A report from the Association of Community Health Councils of England and Wales in August 1995 outlined many of these and gave examples of problems encountered around the country¹³. At the same time, they noted that many of these schemes could not have taken place in the foreseeable future without private capital, since there is no indication of how long it would be before public money becomes available.

One of the major practical problems is the delays due to the contracting process and the expense of tendering. In the Prison Service, secure units for mentally ill offenders have been delayed in Oxfordshire and West Berkshire (*ibid*). In Swindon, a new women's and children's hospital had been planned for over a decade, but when Treasury approval was finally received, implementation was delayed again due to PFI. The process is further lengthened and complicated by the application of EC procurement rules to PFI projects.

The government's argument is that tendering costs and delays are outweighed by efficiency savings. It is all but impossible to make a fair and accurate comparison of the cost of NHS and private provision. The independent sector argues that the NHS does not include the cost of overheads in assessing the profits from paybeds, for example. At the same time, the private sector has not yet had to make any contribution to the NHS for the cost of training clinical staff.

The impact of the PFI must be seen in the wider context of other aspects of the involvement of private sector provision in the NHS, including contracting directly for health care and the market testing of services. Although it has been stressed that the PFI in itself will not result in the employment of clinicians by private companies, it forms part of an environment which encourages a diversity of non-NHS suppliers, some of whom will be supplying clinical services, whose main motive has to be profitability. Of particular concern is that a profit-making company may be tempted to cut costs by reducing the quality of the service. There may also be financial pressure on clinical decisions, leading to ethical problems for clinicians and to a reduction in the choices patients can make about treatments. There is also a likely human cost where privately employed staff have lower wages and poorer terms and conditions, affecting morale and reducing commitment. Such staff may also be more likely to have 'gagging' clauses in their contracts, preventing them from speaking out about low standards of care.

This last point leads on to the principle which is the greatest instinctive objection to private finance. Private sector involvement in the NHS is bound to affect its ethos. Indeed, it is arguable that it will no longer be the National Health Service, but a fragmented and competitive market. Private companies making a considerable capital investment will expect some element of control, perhaps to the extent of the appointment of Trust managers¹⁴.

Equity of access and quality of care may also suffer. Criticism from many sections of the media have reflected public fears about the implications of privately run NHS services. The PFI has been described as 'an instrument of systematic inequality', as those parts of the service owned by private companies will attempt to increase revenue and lower costs by seeking out private patients and catering for fundholding GPs with the largest budgets, threatening the care of others¹⁵. Cost cutting may also be attempted by shifting costs out of hospitals and avoiding expensive patients/treatment. Any charges, even for 'additional' services, may deter patients from using services¹⁶.

It may be difficult for health authorities to obtain quality control information from private providers. Public fears already suggest that goodwill towards the NHS may be undermined even if quality and equity are maintained, since staff will not be seen as having the altruism or dedication of NHS employees.

¹² NHS Trust Deal Lost £3.5 million. David Brindle. *The Guardian*, 6 October 1995.

¹³ Private Finance and Public Health. Association of Community Health Councils in England and Wales (ACHCEW), 1995.

¹⁴ Profiting from the NHS. Chris Ham. *British Medical Journal*, 18 February 1995.

¹⁵ Will Hutton. *The Guardian*, 5 June 1995.

¹⁶ ACHCEW (*op cit*).

The Labour Party has not ruled out the continuation of PFI should they come into office, but have been strongly critical of many aspects. Meanwhile, the more private investment and involvement, the more dependent the NHS becomes on private provision. Where the private sector owns a building or equipment there will be no publicly owned facilities when a PFI contract comes to an end.

FUTURE DEVELOPMENTS

The private sector expects that purchasers will have to become more involved and has welcomed the change in the Treasury's language from 'transferring' risk, to 'sharing' risk¹⁷. The recent Health Service Guidelines also stress purchaser involvement. For example, Trusts may make a PFI proposal, and the purchaser may decide to market test the private sector directly (*ibid*).

As already noted, under current government policy, the PFI seems set to continue and to accelerate the growth and completion of schemes. The amount of capital to be made available to the NHS has been reduced to encourage this acceleration, but doubts have already been expressed¹⁸ about whether the private sector will be willing or able to make up the shortfall in NHS expenditure.

Where PFI funded hospitals are planned, private finance will be involved in every aspect of NHS healthcare including in some cases the supply of medical practitioners. Much will depend on the success or otherwise of these schemes, their public reception, and their value for money over the long term.

Finally, the willingness of the private sector to become involved in a new building project will increasingly influence whether that project goes ahead or not. This raises the prospect of the siting of hospitals in the future and type of provision being determined by commercial considerations rather than planned on the basis of local health need. The likely future impact of the PFI on the future shape of hospital provision in the UK cannot be ignored.

Health Policy and Economic Research Unit

January 1996

APPENDIX 5

Memorandum submitted by Barclays Trust

1 INTRODUCTION

1.1 In responding to the Treasury Select Committee's invitation to submit evidence on the Private Finance Initiative, BarclayTrust wishes to concentrate on the need to establish and a suitable proposition for retail private investor involvement.

2 BARCLAYTRUST

2.1 BarclayTrust is the division of the Barclays Group which provides personal financial services. It was formally established on 1 January 1995 as a result of the amalgamation of Barclays Stockbrokers, Barclays General Insurance Services and Barclays Bank Trust Company. Services include retail stock-broking, management and administration of Personal Equity Plans, provisions of household, motor, travel and creditor insurance, fund management, taxation services, executor, trustee and will writing services.

2.2 The Chairman is Anthony Vine-Lott, who was previously Managing Director of Barclays Stockbrokers, and a Board Director of Barclays Financial Services. Until May 1995 he was also London Stock Exchange Regional Chairman for Scotland.

2.3 BarclayTrust's evidence is based on its experience in providing financial services to both corporate bodies and the retail market. BarclayTrust provides a range of branch facilities for corporate bodies and financial intermediaries, and has pioneered the development of company PEPs and other investment services for shareholders. With regard to the retail market, it has extensive experience in handling new issues, including the large privatisation programmes.

3 BARCLAYTRUST AND THE PFI—BACKGROUND

3.1 While the PFI was established as a means of highlighting the strength and effectiveness of private capital in the public domain, private involvement has to date been restricted to the corporate sector. Although this has enabled the initiative to get under way, it has failed to harness the potential opportunities provided through retail participation.

¹⁷ Laing's Review of Private Healthcare, 1995.

¹⁸ For Better or Worse. John Appleby. Budget Special—Health Service Journal, 1995.

3.2 Since the beginning of the Government's privatisation campaign in 1979, the large issues have more than demonstrated the power of the retail investor. Indeed, the later privatisations have highlighted the loyalty of such investors—principally because of the more targeted pricing of the investment packages. Many of the structures and products already established could be used to facilitate the provision of such services. These include Personal Equity Plans, specifically in view of the introduction last year of the ability to include corporate bonds. It is through using similar structures that PFI projects could also be marketed to the retail sector and, in so doing, further utilise a proven and profitable area of capital fund raising.

3.3 BarclayTrust believes there is a strong requirement to establish a working model to assess the feasibility of operating such a facility. If implemented on a regional or local basis, there is considerable scope for harnessing potential investor interest and enthusiasm for local projects, as well as encouraging local investment in the infrastructure which is of direct community benefit. Previously issues—such as improved sewage/water control mechanisms, local environmental improvements and local transport initiatives—have failed to attract sufficient attention as they were not considered to be of significant or national importance.

4 SUITABLE PROJECT—KEY ELEMENTS

4.1 There are significant key areas against which the effectiveness of a particular project should be measured. Underlining all of these is the need to ensure that the credibility is reflected in the quality of the proposal itself, and should apply as much to the participants and the structure as to the end project goal.

4.2 The key elements involve:

- a Local and specific appeal
- b Investor outlay potential
- c Risk level and security

5 LOCAL AND SPECIFIC APPEAL

5.1 Clear definition of a tangible project with specific benefits should be selected in order to properly evaluate the opportunity and to best attract the investor. Examples could include local infrastructure improvements, such as bridges, bypasses and water/sewerage schemes.

5.2 Local interest and need is a prerequisite to ensuring that the finance structure is viewed as an enabling facility to achieve a goal—rather than as a form of backdoor privatisation of public works.

5.3 A local community element is also important in terms of its ability to broaden the potential investor net. By helping the community at a time when it is known that public funding is restricted, it is also more likely to both overcome local opposition and to appeal across the political parties.

6 INVESTOR OUTLAY AND POTENTIAL

6.1 Investors must see a reasonable return, and this is likely to be in the form of income rather than capital—although capital bonus structures may also be an attractive element. While pre-set or guaranteed income hold the greatest attraction, some variation can be built in at the early stages. The position would also be significantly enhanced if the investment was capable of being housed within a PEP, either as an equity or as a bond.

6.2 The minimum acceptable size of investment will depend on the scale of the project finance. However, a level of £500 for an initial investment will attract small investors, while £1,000 is a more cost-efficient level for PEPs.

7 RISK LEVEL AND SECURITY

7.1 As the security of capital is of overriding importance for investors, individuals are best attracted if a good level of security is given. This should ensure satisfactory completion, as well as some ongoing support for its financial viability. As the market develops, the level of such support should be able to fall away. An example of this was seen with the withdrawing of underwriting from privatisations, once the flotation process involving retail had been improved.

7.2 Investors are generally prepared to accept a period of "lock-in" to investments, but will expect to have opportunities to sell at some point. In addition, they will also look for a valuation, and thus a listing for price quotations will be necessary.

8 SOCIAL AND POLITICAL CONTEXT

8.1 In view of the Government's warning to expect further expenditure cuts, it is likely that existing infrastructure facilities will be affected, and future projects delayed or even cancelled. Added to this, the ageing population and the decreasing numbers in work will pose problems for all political parties as a result of the pressure placed on tax income.

8.2 Retail private investor involvement in the PFI holds the potential to ensure local infrastructure projects are carried forward with 100 per cent central Government control. Shareholder culture has become effectively established since the early 1980s, and individuals are accustomed to the process of completing coupons and applying for shares. The effort required to focus investor attention on local rather than national projects is not a large one. With Corporate bonds now allowed into PEPs, investors have the added benefit of avoiding Capital Gains Tax or Income Tax.

8.3 Private capital investment can be made to coincide with community involvement and ownership, with the additional benefits of perks and discounts on specific projects. Planners also have greater flexibility—by seeing assistance provided to projects lower down the scale of priority.

9 BARCLAYTRUST ACTIVITY TO DATE

9.1 Approach has been made to the Scottish Office to consider such funding mechanisms for the proposed second Forth road bridge. The proposal was well received and acknowledged by the Department as an opportunity to involve the community not only in such communications projects, but also in water and sewage developments which are unlikely to be privatised in Scotland. The proposal has not yet been taken further.

9.2 Other occasional projects have been raised as potential opportunities and these have included local coast sewage outlets where other funding had not been available.

10 CONCLUDING REMARKS

10.1 Over the past 15 years, the privatisation campaign has provided an excellent opportunity for educating the retail market on the benefits of direct equity and capital investment. By utilising this knowledge, and the skills learnt over years, the retail investment community is in a good position to provide a creative mechanism for providing capital for infrastructure projects. While not providing the total capital requirements, these could nonetheless supply a significant funding element. With the enhancement of corporate bonds being allowed into PEPs, the opportunities are even more attractive for individuals as a means of medium to long term tax efficient investment.

10.2 The detail of the structure outlined in this submission needs to be analysed further, but at BarclayTrust we believe that it contains the basis of a creative and realistic opportunity to release investment funds for essential regional and local projects. We argue that it holds significant benefits in terms of UK regional economic development, Government and political accountability and private individual empowerment. We ask the Committee to study the proposals and the implications closely.

11 January 1996

APPENDIX 6

Memorandum submitted by Wimpey Construction Investments Ltd.

This memorandum reflects the Wimpey Group's view on a number of key aspects of the PFI. It is written in response to the Treasury Committee request for submissions on this subject.

BACKGROUND

1. The Wimpey Group has taken an active part in PFI projects over the last 18 months. It sees such projects as providing opportunities both for the winning of construction work at margins which are less cut-throat than those obtainable on contracts won in open tender and for investments at returns which are reasonable in relation to the risks involved. Not surprisingly Wimpey is only interested in PFI projects which contain a substantial construction content.

2. Wimpey is currently building the first PFI project in the Education sector (the University of Greenwich Avery Hill project). We are also currently taking leading roles in the bidding for DBFO road projects, hospitals and in the Docklands Light Railway extension to Lewisham.

3. Wimpey sees the investment of funds in PFI projects as requiring separate skills from those of constructing the projects. A separate business unit, Wimpey Construction Investments Limited (WCIL), has been formed to undertake the investment activity. This unit manages the process of bidding for the

PFI concessions, provides the investment funds which constitute Wimpey's share of the risk capital provided by the private sector and participates in the management of the special purpose companies ("the SPCs") established to undertake the projects.

During the bid process WCIL liaises with Wimpey's construction businesses which provide the construction cost estimates on which the bids are based. When a PFI project is won, these cost estimates will form the basis for the construction contract which will be signed between Wimpey and the SPCs

4. Large scale PFI projects are normally bid in consortia, so that WCIL will have 50 per cent or less shareholding in the SPCs formed when the project is won. This is because:

- i. Wimpey does not have all the skills required to build and operate all PFI projects in-house. Ideally those parties providing the other skills required, e.g. operators, will also contribute risk capital and
- ii. Wimpey's balance sheet is not sufficiently large to be able to stand the consolidation of all the project debt if the SPC is treated as a 'subsidiary undertaking' for accounting purposes.

5 Large scale PFI projects are normally financed by a substantial amount of debt, normally between 80 per cent and 90 per cent of the total funding requirement. This debt is raised in the main as 'project finance', i.e. the lenders are relying on the cash flows arising from the project in order to obtain repayment.

This arrangement limits the exposure of the sponsors to the project to their investment contribution. The principal reason for the high level of debt, however, is that equity is more expensive than debt. It would be difficult to structure a PFI bid to pass the Government's value for money test unless at least 80 per cent of funding was debt.

EFFICACY OF PFI

Wimpey's view of the efficacy of PFI is that:

1. it is perfectly possible to create individual projects which meet both the public sector and private sector minimum requirements i.e.:

- For the public sector to achieve an efficient contribution to public infrastructure which meets both 'value for money' and 'risk transfer' tests.
- For the private sector to achieve an investment and operating opportunity which offers reasonable investment returns without uncontrollable risks.

2. the public sector clients letting PFI schemes seem to be driven by the wish to score maximum points for risk transfer on each individual scheme, frequently forcing the private sector to take risks which are not within their control. They are not taking a long term view of what is reasonable in order to ensure the long term success of the programme. Unfortunately their advisers generally seem to be encouraging them in this approach.

3. there seems to be remarkably little perception in the public sector as to the complications involved in the process of project financing and in the burden in terms of time and resources it places on the parties involved. Because the project finance lenders are essentially risk averse, they seek to identify each risk being taken by the SPC and parcel them out to the parties most able to control and manage them. Agreement on this risk allocation is often hard won. The negotiation and the subsequent drafting and redrafting of interlocking agreements is very time consuming.

As an example it took a year to progress the University of Greenwich project from the stage of WCIL being made 'preferred bidder' to the full documentation being signed.

The strain on the human resources involved in the implementation of PFI projects sets a limit on the level of public investment which can currently be undertaken under the PFI. This limit is well below the current expectations of Government.

Wimpey's WCIL business unit employs 17 professionals. It anticipates being able to bid a maximum of 12 large projects per year and to implement only 3 or 4. It is having to be increasingly selective as to the projects to follow. It is noticeable that in several sectors the public sector clients are finding it increasingly difficult to fill their bid lists with acceptable private sector groups.

4. there remains a significant shortage of risk capital available for PFI projects. Until now the vast majority of PFI equity has been put up by the parties who are interested in providing services to the project. These have mainly been the contractors, though in some areas where there are substantial

operators they have contributed as well. There has been a disappointing lack of interest from the investment community.

It is absolutely essential for the future of PFI that every encouragement is given to the development of non-interested party equity. The contracting industry simply cannot provide the level of equity required to meet the Government's programme. A construction programme of £7.3 billion of projects over the next 3 financial years implies total equity of around £1.5 billion. It is unlikely that the contracting industry will supply more than £300 million, and we will want to start recycling that by the turn of the century if we are to continue to support PFI.

BIDDING PROCEDURE

1. Bidding Costs

The private sector's concern about the cost of bidding PFI projects is well documented. We would, therefore, simply want to put forward a few simple suggestions for minimising the costs. These are:

- a The public sector should be very confident that a project will proceed before it is put out to bid.
- b Allocation of risks should be set by the public sector on a basis of what is objectively fair and reasonable for the private sector. Underlying principles which the Government wishes to lay down for all schemes should be published.
- c The lawyers drafting PFI concession documents for their public sector clients should be instructed to start by preparing a reasonably balanced document. If they follow their natural instincts and provide a document weighted totally to their client's interest, the result is enormous legal fees for all parties, as the private sector attempts to negotiate back to a reasonable position.
- d Wherever possible standard documentation should be used to minimise the legal costs in negotiation. In particular, NHS trusts should be discouraged from reinventing the wheel for each project.
- e The public sector should, when setting PFI bid procedures, attempt to identify the expensive elements of the bid cost e.g. full design, obtaining of firm financing commitments, and attempt to delay them until the number of bidders has been reduced or, if possible, even until there is a single preferred bidder.

2. Encouragement of 3rd Party Equity

Wimpey believes that it is essential if PFI is to provide major levels of infrastructure spending that 3rd party investors are actively encouraged to put equity into projects. There are a number of ways in which at present bid terms may actively discourage such investors.

Examples are:

- a universally public sector entities with PFI projects are requiring that events of default by the private sector concessionaires can lead to the confiscation of the concession without any compensation to investors.

During construction the big risk that this puts on the private sector is that the construction project is not finished by a long stop date. Even if the project is all but finished it can be confiscated so that the investors lose all their money. As contractors and investors Wimpey can live with this risk. It is not surprising that most outside investors can not.

Post construction the rule still applies. To us it seems absurd that, if there is a management failure during the operational phase, the entire concession can be cancelled and the asset which the private sector has built can be taken back into public ownership at no cost, with the result that the equity investors lose their whole investment. Surely the solution here is an enforced change of management so that the 3rd party investor, who has no voting control and so cannot influence management, suffers only by loss of profit share while the project is non-performing.

We have put this proposal forward on a number of projects without any positive reaction.

- b there is often inadequate provision for compensation to investors if the concession is terminated because of the public sector's failure to perform. Such compensation should be based on the market value of the investment at the time of termination, i.e. it should be based on the then view of future concession income and the then risk of not-achieving it.
- c there are too often unreasonable restrictions on the sale of shares by PFI sponsors even after the project construction is complete and the operation is underway.

OVERALL IMPACT ON INVESTMENT LEVELS

We fear that PFI will not achieve anything like the levels of investment which are currently predicted by the Government. We see the major restraints on the growth of PFI as being limited resources

- limited staff in sponsor entities and in the key advisors (lawyers, financial advisers) with the skills to undertake the enormous volume of work in implementing a project finance package.
- limited availability of equity.

We do not see that adequate attention is being paid to these problems. Lip service is being paid to the need for the creation of true operating industries but the emphasis on value for money makes it very difficult to achieve such growth through the normal process of retention of earnings. Solutions to this problem need to be explored actively as do the identification of alternative finance structures for PFI projects which will meet the Government's value for money criteria without the need for time consuming project finance. The alternative could be that the PFI process simply seizes up within the next 2-3 years because of lack of resources.

9 January 1996

APPENDIX 7

Memorandum submitted by Ryder Defence

Ryder Defence is a newly established subsidiary of Ryder Plc which currently provides 60 per cent of UK MoD full service leasing requirements in the area of commercial vehicles. We are committed to pursuing the opportunities provided by the Private Finance Initiative in offering innovative solutions to Government requirements. In addition to vehicles we intend to offer the MoD a range of other services such as vehicle storage facilities, logistic support services and base depot services.

The PFI has yet to make a significant impact in the MoD. The Department is seeking to rectify this through its series of pathfinder projects, the setting up of the Private Finance Unit within the MoD and the announcement in the 1995 Budget that MoD will be substantially increasing the total value of PFI projects within the Department over the next three years. We have experience of the initial MoD PFI projects through our bid for the contract for non-operational 'white' vehicles for the British forces in Germany. Ryder very much welcomes this growing emphasis on PFI-type solutions in the defence field and believes that it will offer the Government vastly increased flexibility and efficiency savings.

We perceive, however, that there remain a number of doubts about the suitability of the PFI approach within the MoD which may be summarised as follows:

- Industry has difficulty relating to the requirements of the MoD—in fact, it is the vehicle industry that builds the equipment used by the MoD and this equipment is largely derived from that developed for the commercial market.
- Industry currently has a knowledge gap on the PFI at middle management levels—to the extent that this is true we would like to see it rectified by the provision of more frequent, detailed industry briefings, a more open relationship between the MoD and its private sector suppliers and the more extensive use of attachments and secondments.
- Industry is not capable of supporting the MoD's Transition to War (TTW) requirements—actually industry, in effect, operates on a 'war' footing (365 days per year, 24 hours per day) all the time. The Reserve Forces Bill further facilitates the seamless transit of assets accessed by the MoD under the PFI to a war footing. A recent survey of Ryder Defence personnel showed 100 per cent willing to undertake a reserve forces role.

Ryder Defence seeks to meet the MoD requirements by offering full service leasing of vehicles within the PFI. This has the following advantages for the Government:

- Full service leasing of this type releases capital for core tasks.
- Management of vehicle assets and vehicle maintenance responsibilities are transferred to the private sector.
- The MoD gets the optimal fleet mix for its purposes at all times without carrying assets which are surplus for a large proportion of the time.
- Public sector human resources costs are reduced.
- PFI offers greater budget control with guaranteed costs for the life of the contract.

- Equipment can be brought into service more expeditiously.
- The contractor has responsibility for ensuring vehicles and auxiliary equipment meet statutory and environmental requirements at all times.

We believe that these advantages make a compelling case for increased use of PFI in MoD procurement and contracts. The progress made in the UK will be watched closely by other European countries where British companies like Ryder Defence might also benefit from PFI type systems adopted in those countries by bringing experience of working with the UK Government. We fully support efforts to increase the range and number of PFI projects in the MoD and across Government as a whole.

11 January 1996

APPENDIX 8

Letter to the Chairman from Mr Barry Francis, Beachcroft Stanleys, Solicitors

I understand that your select committee is enquiring into the Private Finance Initiative.

I head my firm's PFI group which is currently involved in over 20 PFI projects, primarily in the health sector, including:

- 1 the hospital re-building projects at Amersham & Wickham (South Buckinghamshire)
- 2 the St Thomas' Hospital redevelopment for Guy's & St Thomas' NHS Trust
- 3 the single site redevelopment of a hospital at Hereford for Hereford Hospitals NHS Trust
- 4 the single site redevelopment of a hospital at Walsgrave for Walsgrave Hospitals NHS Trust
- 5 the single site redevelopment of a hospital at Middlesbrough for South Tees Acute Hospitals NHS Trust
- 6 the redevelopment at Stoke Mandeville for Stoke Mandeville Hospital NHS Trust.

In general, but not exclusively, our experience has been in advising the public sector. Our experience is not limited to large-scale projects; we are advising in relation to a number of smaller projects for residential units and health centres and also on a number of information management and technology projects. We are addressing further projects in the education and defence sectors.

Having been involved in these projects for rather more than a year we have developed an understanding of the benefits and pitfalls of the PFI particularly in the health sector and would wish to make the following general points:

Central control of the process

In the health sector, the degree of central control of the negotiations between NHS Trusts and private sector "partners" has perhaps been rather less than in other sectors. I believe that, in the case of health, this is the correct approach because:

- each individual NHS trust is itself responsible for the ownership and management of its hospital facilities and, as a matter of law, the decision to contract must vest with the NHS Trust board
- it is important that any PFI solution for a Trust's requirements meets the individual requirements of that Trust which are determined in the course of consultation with management, clinicians and other interested parties; central control of the negotiating process is unlikely to produce contracts which are responsive to local needs

A Trust's ability to control its own negotiating process.

The management of a PFI procurement process requires new skills which are not necessarily vested in existing Trust management. It is important that Trusts are properly advised by experienced consultants and whilst the costs of those consultants during the development phase of the PFI is high (but not particularly so in relation to the value and complexity of the transactions), these are likely to reduce as all parties to these transactions further develop expertise.

The use of a tender style process¹ can be used by a Trust effectively to maintain competition; there is no reason why a Trust should be "at the mercy" of private sector tenderers.

The cost of the bidding process

There has been much complaint from the private sector that the cost of a competitive bid for a PFI hospital building project is prohibitively high and there is a stated reluctance on the part of the private sector to devote substantial resources to the bidding process before they are selected as a preferred or exclusive bidder.

There are clear advantages to the public sector in ensuring a robust competitive process but this is dependent upon a willingness of the private sector to provide high quality bids; it is important for the public sector to seek to help minimise bidding costs by identifying precisely what areas they wish to be addressed at different stages of the bidding process and, at each stage, ensuring that the parameters of each bid are clearly defined in relation to key areas

The difficulties with long term contracts

The primary term of the arrangements for hospital development PFI contracts is typically in the region of 25 years and involves the provision of serviced buildings during that term and often the provision of other services (domestic services, catering, IM&T etc). Inevitably the requirements of a Trust board will change during the primary term and it is important that continuing contractual arrangements recognise this adequately. In our experience, appropriate models are being developed to address this very important issue.

I hope that these initial thoughts may be of some interest to you and your committee and, consistent with our confidentiality obligations, I would be delighted to provide you with further written or oral information should you so wish.

11 January 1996

APPENDIX 9

Memorandum submitted by the Comptroller and Auditor General, National Audit Office

I submit this paper in response to the request dated 19 December from the Second Clerk. The NAO have been keeping in close touch with developments in the PFI and we have recently announced plans for further work in this area. The text of the Press Notice is reproduced as Annex A to this evidence [*Not printed*].

This announcement was concerned exclusively with potential Value for Money (VFM) investigations into PFI projects. In addition, as the external auditor of central government expenditure, I am concerned with the financial accounting aspects of the PFI.

This paper accordingly describes the role of the NAO both in VFM and in accounting aspects of the PFI.

VALUE FOR MONEY INVESTIGATIONS

The National Audit Act 1983 gives me the right to report to Parliament on investigations I have carried out into the economy, efficiency and effectiveness with which government departments and certain other bodies have used their resources in discharging their functions.

In accordance with these powers, I am planning to carry out a series of value for money examinations in the PFI area. I expect these examinations to lead to reports to Parliament in due course.

These examinations must take full account in particular of the provisions of the National Audit Act concerning my value for money work: that it must not question the merits of policy objectives.

It appears to me that the objective of increasing the involvement of the private sector in the provision of services traditionally provided directly by government is a policy objective. I have therefore concluded that any investigations I carry out should relate to the execution of that objective in particular individual projects or groups of projects.

¹ Most PFI projects are conducted under an EU procurement process known as the "negotiated procedure" which is, as its name suggests, not a traditional tender procedure but rather a structured negotiation process. There is some dispute amongst lawyers as to the circumstances when a negotiated process can properly be used. Our experience is that that process makes it a great deal easier for a tailored and innovative solution to be developed for an individual Trust.

Although it is not for me to express a view on the merits of the PFI as a whole, I do wish to emphasise that the NAO will be taking a constructive approach to it. The PFI offers the prospect through its innovative approaches that public services might in future be delivered more efficiently, effectively and economically than through the traditional route. That in principle must surely be something to welcome. The NAO will certainly not wish to criticise departments simply because they have departed from tradition and innovated. We recognise that innovation must involve taking risks, but welcome well-thought out innovation and risk taking.

In looking at individual projects one can distinguish two stages on which my investigations could focus. First, there is the determination of the contractual arrangements for the project. The questions for examination would relate to the way the relevant department had conducted the negotiations leading up to the signing of a deal and to whether the approach to those negotiations could be expected to secure good value for money. Secondly, and of course in the longer term, there is the way the project works out in practice. The questions for examination would relate to whether services had been delivered as required and at what cost to the public purse.

I have it in mind to conduct both types of investigation. Although I am conscious that a final view on the success or otherwise of the negotiations must depend on seeing how the arrangements work out in practice, I am convinced that an investigation conducted shortly after the signing of contracts is capable of throwing useful light on the process of negotiation of PFI deals. For many years now the NAO have been conducting investigations of individual privatisations on the basis of looking at the negotiation of the deal. These investigations have brought to light many lessons to be borne in mind by those responsible for carrying out subsequent privatisations.

Although the NAO's investigative work on PFI projects has just begun, it is quite clear that a key issue will be the way PFI projects handle risk: who bears what risks, how much risk traditionally borne by the public sector is transferred to the private sector, and at what price. Consistently with my attitude of welcoming well thought out innovation, the NAO will be looking for thorough analysis of risks in PFI projects.

As regards pricing, the Committee of Public Accounts have for very many years pointed to the importance of open competition in demonstrating value for money in procurement. It is clear that competition will play a similarly essential role in PFI projects, but because the PFI necessarily involves innovation in the way the various parties to a transaction relate to one another it is likely to involve some new ways in which competitive pressure is brought to bear on the negotiations. We must therefore expect to see innovations here too.

ACCOUNTING FOR PFI PROJECTS

It is the responsibility of the Treasury to determine the way in which central government bodies account for their activities. Where these bodies account on an accruals basis (for example, executive agencies and, in the future, departments) the standards and policies they apply should as far as possible be in accordance with generally accepted accounting practice. On major questions of principle the Treasury consult the NAO.

In the case of PFI projects questions arise about the appropriate accounting treatment, partly because there are no direct private sector parallels. The Treasury are therefore developing their own guidance and consulting the NAO on this.

Pending the production of accounting guidance, each case is being considered by the Treasury and the NAO on its merits.

11 January 1996

APPENDIX 10

Memorandum submitted by Hambros Bank

Annexed to this note are two papers with some reflections—based on our practical experience of the analysis of PFI projects—which may be of interest to the Committee. They concern:

Annex 1: Measuring Value for Money in PFI projects

Annex 2: Techniques of Investment Appraisal.

11 January 1996

ANNEX 1

MEASURING VALUE FOR MONEY IN PFI PROJECTS

Value for money (VFM) is not an absolute measure but in most instances represents a subjective assessment based on needs and the alternatives available for meeting those needs.

VALUE FOR MONEY IN A WIDER PERSPECTIVE

To measure VFM for an individual outcome in isolation is both difficult and meaningless. All that can be done is to analyse it against an alternative so that one may conclude that it represents either better or worse VFM than the alternative.

From the public sector's perspective, the measurement of VFM will require analysis of:

- The needs of the purchasing department, and
- The options and alternatives for meeting those needs.

Establishing the needs of the purchasing department or other public sector body is obviously not a requirement solely of the Private Finance Initiative and is not discussed in this paper. When measuring VFM in respect of a PFI project it is also necessary to consider wider needs and their relative priorities. The analysis should not only cover the relative VFM of a PFI approach and a conventional public sector procurement, but should also consider whether the resources, either private or public, are better allocated to an alternative project. For instance, providing a new road may appear to be better VFM when analysed as a PFI project, but are the wider benefits such that the resources would be better allocated to, say, a rail link?

To assess VFM in respect of the options and alternatives available to meet the needs, it is obviously necessary to establish the cost associated with each solution. It is possible to make a theoretical assessment of the relative attractiveness of a number of alternatives, but until these are tested in the market place and a full assessment of the prospective costs to the public sector is undertaken, the VFM measurement will not be reliable.

THE VALUE OF COMPETITION

The easiest and arguably the best way of assessing, and obtaining, VFM is through open competition.

Before such a competition is held, the following three issues need to be considered:

- Will the competition be fair and full?
- Is it the right time to be procuring services from the private sector?
- Is the private sector capable of providing part or all of the services to be procured, and hence managing the risks more cheaply than the public sector?

The general rules governing public sector tendering procedures—and especially the European Community procurement rules—should ensure that the competition will be fair and full.

The second point highlights the need to understand the market. For instance, has a glut of work made it a seller's market? If so, would a delay result in better pricing for the public sector?

To answer the third point, the public sector effectively has to be included as a bidder. It will then be possible to measure whether a conventional procurement would provide better VFM for part or all of the services (eg the construction and maintenance of a road) that are included in the specification of the PFI project.

Each project will involve a number of risks that can affect the provision of services to the level specified and they should be considered either individually or in identifiable groups. This analysis can then be used to demonstrate whether retaining each risk within the public sector or transferring it to the private sector would provide better VFM. An optimal transfer of risk can then be identified.

CONSISTENCY BETWEEN PUBLIC AND PRIVATE SECTOR APPROACHES

As mentioned previously, VFM is a relative concept. The public sector comparator must therefore be calculated on a basis consistent with that used to evaluate the private sector bids. To ensure that an accurate comparison is made, the following should be considered:

- Are all the risks being priced?
- Are the risks being estimated and priced on a commercial basis?

The private sector will price, implicitly or explicitly, all the risks and costs over the term of the project including items such as insurance premiums, higher than forecast inflation and unknown future maintenance costs (including possible cost overruns). The fact that the public sector would normally carry some risks without explicit charges is no reason for excluding them in the comparison. For example, the state may act as insurer of last resort; but this has a cost, no matter how remote the risk may be, and it should be included.

When estimating and valuing risks and their associated costs, it is right that any inherent advantage that the public sector has should be brought into the assessment. In the case of insurance, the cost of actual cover would be similar to what it would be if insured privately, but the other costs included in insurance premiums, such as commissions and profit margins, would not be costs if the risk were insured by the state.

In other cases the public sector may be less able to manage the consequences of something going wrong—eg the discovery of incorrectly specified equipment. Commercial incentives are usually sharper than those applying in the public sector and a commercial firm may be able to manage and respond to the risk more quickly and more effectively. If so, the cost of this risk in the public sector would be greater than if it were the responsibility of the private sector.

THE BASIS OF MEASURING VFM

VFM in PFI projects has to date been assessed by comparing the NPV of the monetary costs to the public sector of each alternative course of action.

The choice of the discount rate is always a contentious issue. The extent to which the choice of an inappropriate rate will distort an estimate of VFM is reduced if the same rate is used for each option. Similarly the actual NPV figures are not as important as their value relative to those of the other options.

The factors that affect the choice of discount rate, which are discussed in Annex 2, suggest that the rate should vary to reflect changes in real interest rates and the risks inherent in each public service investment. Whether it is possible to devise a practical methodology that would allow for the equitable use of different rates for different investments at different times is doubtful. In our view the advantages of using a single fixed rate in the public sector in general outweigh the disadvantages; but the ability to increase the rate for particularly "risky" investments or in times of high real interest rates should be retained.

The generally accepted discount rate appropriate to the analysis of public service investments is 6 per cent in real terms. Many commercial firms use discount rates much higher than 6 per cent and the Committee may receive arguments that—to ensure consistency—such higher rates should be used for the analysis of PFI projects.

However, to accept such an argument could result in the wrong decision. High discount rates reduce the significance of maintenance and operating costs over the whole life of the asset by comparison with the initial costs of building it. In our view valuing whole life costs at 6 per cent real will produce a fairer assessment of the value of the project to the taxpayer and consumer of public services than the use of very high rates favoured by many commercial companies.

An assumption will also have to be made about the rate of inflation because not all items of cash flow will be linked to inflation (eg cost of funds). It is essential that the inflation assumption used is the same for calculating costs in both the private and public sectors unless it can be demonstrated that one has an advantage over the other in managing inflation risks.

THE MECHANICS OF THE PROCESS

Valid conclusions can only be drawn from any analysis of VFM if it is conducted rigorously. The following paragraphs describe the successive steps that need to be taken in a rigorous analysis.

The objective is to compare the NPV of costs to the public sector of the private sector bids and the public sector comparator. Following that comparison, the option that provides the best VFM should be assessed in a wider perspective against the purchasing department's needs.

The degree of detail required and the timing of the process will vary for each project. The following is an indication of the tasks to be undertaken and the order of each one in the process.

- (i) Identify all costs and risks that may have an impact on them.
- (ii) Where possible, group inter-related costs and risks.
- (iii) Project unknown future costs and estimate the impact of the risks on them.
- (iv) Calculate NPVs for private sector bids and public sector comparator.

(v) Consider NPVs to measure best VFM.

(vi) Assess in a wider perspective.

The first point highlights the need for a full risk analysis to be undertaken to ensure that all the potential costs associated with the project have been identified. (This point is discussed in more detail in Annex 2.)

The purpose of grouping inter-related costs and risks is to simplify the process without necessarily making it any less accurate. Indeed it may make it more accurate since the correlations and contingent nature of some risks make it difficult to price them separately. An example is IT, where all the costs and risks associated with the hardware, the software, maintenance and updates can be grouped together.

Projecting future costs over the whole life of the project—step (iii)—will require input from surveyors, engineers and planners, amongst others, to build up an expert view of the costs and the potential impact of certain risks on those costs. Since the emphasis is on relative values between available options when measuring VFM, the precise costs are less important than those required for assessing the potential financial returns for a single course of action. The key is for consistency of approach and ensuring that any relative advantage within the private sector or between the private and public sectors is included.

The next step is to calculate the NPV of the public sector comparator and those of the private sector bids. This requires a discount rate to be chosen—not an easy task as is explained earlier and in Annex 2. Since the objective is to measure the total cost to the public sector, the calculation in respect of the private sector bids should cover the payments for providing the service as well as any subsidies, costs and risks remaining with the public sector.

Once the above steps have been completed, the option whose cost has the lowest NPV can be identified.

The final step is to consider the benefits to the public, including social and environmental benefits, measured in monetary terms and discounted at the same rate as that used to calculate the NPV of costs. The relationship between the benefits and the costs should be compared to other projects which meet other needs of the purchasing department. This comparison will ensure that proceeding with the project will be an acceptable allocation of resources.

LIMITATIONS OF THE NPV APPROACH

Net Present Value is the most generally useful tool for the analysis of VFM achieved by PFI projects. But it has certain limitations which are discussed in Annex 2.

ANNEX 2

TECHNIQUES OF INVESTMENT APPRAISAL

Appraising any investment, be it a project under the Private Finance Initiative (PFI) or quoted securities in a multinational company, requires the definition of the scope and requirements of the investigation before the appraisal begins. The initial considerations are often overlooked or taken for granted. It is essential at the outset to establish:

- From whose perspective the appraisal is being conducted,
- The purpose of the appraisal, and
- The level of data that can be accessed.

Different parties such as bankers, shareholders, operators, users and the public sector will all bear some risk in a PFI project. They will not only want to appraise the project for different reasons (eg investment, pricing or value for money) but will each have different views about how prudent or optimistic the projections of future cash flows should be.

Consideration should also be given to the quality and amount of detailed information that is available in respect of the project, which, together with the number of similar projects that provide a comparison, will determine the level of sophistication of the appraisal.

THE FIRST STEP—RISK ANALYSIS

Before any financial appraisal can be undertaken, the project must be fully understood. For this reason, the first step in the appraisal of a proposed investment should be a thorough analysis of the risks.

The risk analysis will not only increase understanding of the project but will also highlight all the risks that have a potential impact on the timing and level of future costs and/or revenue and benefits. This

knowledge is essential if the cash flow model is to include all the relevant items and to incorporate allowances for the variability of the future cash flows which are unknown at the outset.

A thorough risk analysis would typically include:

- Identification and Definition
- Assessment and Quantification
- Allocation
- Risk Management

Identifying all the risks associated with the project should be undertaken with a view to defining each risk separately and precisely. If the analysis is to be effective, the use of loosely defined "catchall" risks should be avoided. The assessment of risks will include understanding how the important risks may occur, quantifying their possible effect on the project and identifying any unusual risk characteristics, such as catastrophic risks and correlations between risks. Consideration should be also given to fitting statistical distributions to some risks and cost estimates (eg traffic forecasts or the frequency of software upgrades).

Risks should ideally be allocated to the party best able to manage or control each risk. The analysis should identify, not only to whom each risk should be allocated, but also when, how and how much of it should be allocated.

The final step in the analysis of risks should identify how to manage risks before they occur and how to respond or how to mitigate risks if they do occur.

Investment decisions are seldom made solely on the basis of the numerical results of an investment appraisal. Decision makers also like to get a "feel" for the project and in particular a feel for what could go wrong. The risk analysis is therefore not only a tool to make the investment appraisal process more thorough—it also helps the decision maker to understand the project. It should therefore be included in any report on the results of the appraisal.

THE CASH FLOW MODEL

All investment appraisal techniques are concerned with comparing the costs of acquiring and servicing an asset with the benefits derived from it. The majority of the costs and benefits are monetary and even those that are intangible (eg reduced congestion or environmental impact) have to be given some monetary value if they are to be included in the appraisal. Hence the need to consider the real and notional cash inflows and outgoings of the investment.

The second reason for building a cash flow model is that for a typical PFI project the cash inflows and outgoings will have very different profiles. Raising capital or debt has a price and the present value of that cost will alter with the timing. The timing of cash flows is as important as the amounts.

For these reasons it is impossible to conduct anything other than a simplistic investment appraisal without building a cash flow model.

A DETERMINISTIC OR A STOCHASTIC APPROACH?

The traditional approach to projecting future cash flows, the deterministic approach, is to consider each item separately and estimate its most likely value. The next step is to conduct sensitivity tests which typically involve making a pessimistic and an optimistic estimate in addition to the most likely. All the results of the investment appraisal are then presented based on three scenarios—pessimistic, most likely and optimistic.

The conclusion that can be drawn from such an analysis is necessarily limited. The answer will lie somewhere between the pessimistic and optimistic scenarios and is most likely to be the middle scenario. But how likely is most likely, and is optimistic equally as likely as pessimistic? To answer those questions—and others such as what is the probability of a rate of return less than x per cent or between y per cent and z per cent—a stochastic approach is needed.

A stochastic approach involves fitting statistical distributions to cash flow items instead of making a fixed number of individual estimates. For example, instead of estimating three values for the growth in demand, a normal distribution can be used to simulate the variation in future demand growth. The choice of the statistical distribution and the parameters is made by studying historical records and discussing future trends with the relevant experts.

As a consequence of inputting data into the cash flow model in the form of statistical distributions, the results of the investment appraisal can also be presented as a statistical distribution. This resultant

distribution is derived using typically random or "Monte Carlo" simulation software whereby thousands of simulations of the cash flow model are run, each time sampling from the distributions for the cash flow items.

The stochastic approach has to be used with discretion. Correlations should be allowed for—thus it would be inappropriate to ignore the fact that there is a linkage between short-term interest rates and inflation. The number of cash flow items expressed as statistical distributions should be limited in order to make the process more manageable.

The decision to use a stochastic or deterministic approach depends on the scope of the investment appraisal. For appraising PFI projects, the level of sophistication required and the information that is likely to be available (eg access to experts), make the use of a stochastic approach highly desirable.

NET PRESENT VALUE (NPV) USING THE CAPITAL ASSET PRICING MODEL (CAPM)

The most widely used technique for appraisals is the Net Present Value (NPV), even though the choice of the discount rate gives it the most subjectivity. Selecting a discount rate requires an understanding of the relationship between risk and return because PFI projects have to compete with other investments for capital. The Capital Asset Pricing Model (CAPM) was developed to address amongst other things this relationship. By defining the return as comprising a risk free return (eg the short term gilt rate) and a risk related component, "the risk premium", a discount rate for each project can be derived.

The CAPM assumes that economic equilibrium would be reached if certain conditions are fulfilled. In this state of equilibrium the discount rate for a particular project can be derived by considering the means, variances and covariances of returns on other PFI projects.

The conditions to be fulfilled if the CAPM is to be strictly applicable include the following:

- All assets are perfectly divisible and marketable.
- There are no taxes or transaction costs.
- All investors can borrow or lend an unlimited amount.
- All investors have identical subjective estimates of risk.
- There are no costs of bankruptcy.

The application of the CAPM to PFI projects is limited because their financial structure differs from those of corporate entities quoted on the stock market where the method is mostly used. For example, PFI projects tend to be exceptionally highly geared. Furthermore, because PFI projects are typically financed without recourse to the general business of the sponsors, lenders will wish to examine the most important project risks with especial care. They may for that reason wish to examine diversifiable and nondiversifiable risks (see next section) separately—a process which is not permitted by the CAPM.

Other aspects of PFI projects that do not comply with the CAPM conditions for economic equilibrium include:

- The private sector appetite and pricing of risk may vary from those of the public sector.
- There exists at present only a limited number of PFI projects from which to observe returns and variances (ie. volatility of returns) or which can be bought or sold as assets.

The assumptions of the CAPM make its application of questionable value when appraising PFI projects.

NET PRESENT VALUE (NPV) USING ACTUARIAL TECHNIQUES

The actuarial approach endeavours to shift the allowance for risk to the calculation of the cash flows which are specifically affected and to use the discount rate to value the remaining risks.

This involves breaking down the risks into two groups, diversifiable and non-diversifiable, considering the statistical distribution of diversifiable risks and calculating a risk adjusted discount rate to value the non-diversifiable risks.

Diversifiable risks are, as the name suggests, risks that can be averaged out by investing in a number of similar projects. In the context of PFI projects, they can be allowed for by adjusting the cash flow items rather than simply increasing the discount rate. For instance, initial cost overruns are better dealt with by considering the probability of say a 10 per cent, 20 per cent, 30 per cent etc. overrun and then adjusting the expected cash flow item by adding to it the statistical mean (average) of the cost overrun (eg £10m plus say 18 per cent average overrun).

Non-diversifiable risks, such as the increase in the general level of prices, cannot be averaged out by investing in many different PFI projects in the UK, because they are all affected by the risk. This type of risk is allowed for by increasing the discount rate used for calculating the NPV. The approach for deriving this risk adjusted discount rate is to consider the weighted average cost of capital employed in projects with similar levels of non-diversifiable risk. There are no mathematical rules for establishing this. The size of the risk premium (above the risk free rate) should therefore be set after considering the level of diversifiable risk, any single large risks that are fundamental to the success of the project and the rates of return available in the market for projects with similar non-diversifiable risk.

The actuarial approach is therefore to address the subjectiveness of the risk/return relationship by breaking down the total project risk into individual or groups of related risks. It is then possible to allow for some risks more specifically than the broad brush approach of simply increasing the discount rate which encourages a short term outlook.

THE OPTION PRICING APPROACH

The option pricing approach places a value on the availability of options such as that of delaying the start of project. The NPV approach is more limited. For example it compares investing today with never investing at all. The option pricing approach examines a range of possibilities including investing today and delaying the investment by one or more years.

Consider for instance a project where the present values of construction costs and net revenues are £80m and £100m respectively, and construction costs are less volatile than the present value of net revenues because the latter are dependent on a second PFI project which may or may not be started in the next year. In one year's time construction costs may therefore either be £75m or £85m and the present value of net revenues either £95m or £110m. Currently the NPV of the project is £20m, whereas in one year's time it will be either £10m, £20m, £25m or £35m. The average NPV in one year's time—namely £22.5m—is more attractive than the current NPV of £20m and it may therefore be desirable to delay the project for one year.

The same approach can be used to value other options such as combining the public service investment with related commercial investments and the assessment of the opportunities presented by future changes in technology.

The option pricing approach is potentially a useful tool for appraising PFI projects but its practical application is at present limited by the lack of mature PFI projects from which to estimate the volatility of returns. In future, as the experience of PFI projects expands, it will be possible to use this approach to complement traditional NPV techniques.

11 January 1996

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APPENDIX 11

Memorandum submitted by WS Atkins Ltd.

1 INTRODUCTION

WS Atkins Ltd. is the largest engineering based consultancy in the United Kingdom, with a turnover now in excess of £200m and a total staff of some 5,500 people, mainly professionally qualified. A copy of the company's latest Annual Report and Accounts is attached for information. [Not printed]

The Company has been extensively involved in privately financed infrastructure projects for a number of years, including a key role as Maitre d' Oeuvre to the Channel Tunnel Project.

WS Atkins is now fully committed to the Government's Private Finance Initiative, as indicated on the attached project schedule. We feel therefore that our experience to date makes us well qualified to submit written evidence to the Treasury Select Committee. We confirm that we would be pleased to supplement this with oral evidence at a later date if required. Our evidence is presented under the following headings:

- client organisations
- promoting groups
- the bidding process
- bidders' costs and bid bonds
- financial issues
- legal issues
- risk transfer
- project suitability and de minimis issues

2 CLIENT ORGANISATIONS

We have observed a high degree of variability in the degree of expertise exhibited by Government Client Organisations in promoting PFI projects. Those departments which frequently promote major capital projects (for instance, the Department of Transport through the Highways Agency) have demonstrated a high degree of competence in the project documentation; other departments which are less familiar with project promotion have appeared less comfortable with the concepts.

In the particular case of Healthcare projects, we are concerned that so many of these have already been launched by the NHS Trusts whose covenant cannot be relied on in view of their constitution and funding arrangements. We believe it is essential that the Department of Health should immediately confirm its commitment to provide the support necessary for these projects to be fundable in order to end the uncertainty surrounding them. An additional problem is the structure of the purchase arrangements of medical services from the Trusts which are very short term in nature against the long term nature of the debt.

All the Government clients employ teams of Professional Advisers, who generally have considerable experience of the issues involved. It is important that the Government Clients take due cognisance of the advice they receive, as it is likely to be based on prior experience of the practical problems which have to be solved in making these complex projects works.

3 PROMOTING GROUPS

Most major PFI projects initiated to date involve a substantial element of capital works and are therefore of keen interest to the construction industry. While the bidding process varies (and this is discussed further below) it is almost impossible to achieve a winning position in certain types of PFI projects without the inclusion of a major contractor in the team, unless there is a major operator involved, who will frequently act as the Project Leader. Indeed indications have sometimes been given to prospective bidders that they would be unlikely to prequalify without the inclusion of a major contractor in their consortium. We believe that this has two major impacts:

- restricts the ability of the promoting consortium to procure the capital works at the most competitive market price;
- it turns on its head the traditional role of the contracting industry which has generally operated at very low margins but has been cash generating: the very high costs to contractors of promoting PFI projects will reverse this situation and result in the need for higher margins—and hence higher construction costs—in order to provide an adequate return on the capital employed.

As yet, with the exception of a small number of the cash-rich utilities, a new breed of project promoters has not yet emerged to work with major consultants such as WS Atkins to bid for PFI projects. We see this as crucial to the future success of the initiative as the contracting industry has limited cash resources available to commit to an intensive programme of bidding.

4 THE BIDDING PROCESS

The process of bidding for PFI projects to date has followed the EC procurement guidelines for negotiated projects. This almost invariably involves:

- advertisement in OJEC
- expressions of interest
- prequalification submissions
- reduction to "long list" of potential bidders
- interviews and presentations
- final "short list" of 3–4 prequalified bidders

- issue of bid documentation
- submission of initial offers
- period of negotiation
- submission of "best and final offers" (BAFO)
- appointment of preferred supplier
- further negotiations with preferred supplier
- execution of contract
- finalisation of conditions precedent
- achievement of effective contract/financial close.

What is evident in dealing with different Government Departments is the varying degree of commitment—and hence bidding cost—required at each stage, in particular the work required to achieve Preferred Supplier status. Our experience has been that the Department of Transport (through the Highways Agency) has required very fully detailed designs, fully documented construction proposals, marked up model forms of contract and finance packages subject only to final due diligence prior to the submission of BAFO. This has involved bidders in considerable expense, particularly in terms of legal drafting and due diligence by lenders, leading to bid costs running well into seven figures.

Conversely, for NHS projects, Preferred Supplier status is reached with a much lesser degree of certainty attaching to the proposals and consequently lower bidding costs.

Projects such as the prisons seem to fall in between these two categories.

We believe it is essential that a common approach is adopted to the degree of detailed project development required to enable Preferred Supplier status to be achieved such as would keep bidders' costs to a manageable level yet provide the Client Organisation with an adequate degree of certainty that Financial Close can be achieved.

In certain instances Trusts have been over-zealous with respect to potential savings contained in OBCs which means sorely needed PFI schemes will not stack up against Treasury funded options. In our view it is therefore sensible for Treasury to consider Gap funding. How is this viewed?

Confusion reigns within the industry as to what needs to be done to satisfy the Audit Commission following the implementation of FRS5 that PFI Concession Agreements are to be treated as operating leases as distinct from finance leases. A great deal of emphasis is therefore placed on residual values which are very difficult to assess 25 years hence.

5 BIDDERS' COSTS AND BID BONDS

We have referred above to the problem that high bidding costs could exhaust industry's ability to bid for a continuing flow of projects. It is inevitable that costs escalate significantly after achievement of Preferred Supplier status such that costs from appointment of Preferred Supplier to Financial Close could be between 2 and 5 times the Bidder's costs up to appointment of Preferred Supplier. While in general industry is prepared to take risks on bid costs up to appointment as Preferred Supplier, we remain very concerned that a subsequent decision by the Client not to proceed with the project could leave Bidders with unrecoverable costs running into millions of pounds. We believe that the future success of the PFI is dependent on the Government being prepared to compensate Bidders for their costs incurred after appointment as Preferred Supplier in the event that a decision is taken not to proceed with the Project.

Equally, we are firmly of the opinion that Bonds, particularly Bid Bonds, have no place in the PFI where the negotiated tender route is being followed. The high costs incurred by Bidders are in themselves the strongest possible incentives to conclude a contract agreement.

6 FINANCING ISSUES

Financial markets are gradually becoming accustomed to the risks and returns associated with PFI projects and it is to be hoped that the average costs of funds will show a downward trend. Negotiations over recent months have gradually recognised the need for Direct Agreements between the Government Client and the providers of Senior Debt to permit step-in rights in the event of failure of the project company; we see the acceptance of this need as a substantial step forward.

It is hoped that funds will emerge as the market develops which will be tailored to the needs of PFI projects and will provide, the longer maturities with a greater willingness to assume a share of the project risks which will lead to lower overall projects costs and a more equitable share of the risks.

It should also be recognised by government that there is a finite amount of funds available to invest in equity in PFI projects, particularly equity participants willing to support the up front development costs. As a result, once projects have worked into the operational phase, the original equity participants/sponsors should be allowed to sell their equity participation to long term institutional investors, to enable them to reinvest in new PFI projects.

7 LEGAL ISSUES

The PFI to date has been it must be said a lawyers' charter, with legal fees being probably the greatest single item of cost for both the Government Client and Bidders. It is to be hoped that standard clauses will be developed as a matter of urgency to deal with particular issues which are common to all projects—for example, the Corrupt Gifts Clause (which all agree to be necessary but for which a workable wording needs to be agreed based on that agreed for the prisons projects), Direct Agreements provisions, requirements for Design Certification and Checking, etc.

8 RISK TRANSFER

The oft-stated principle is that under the PFI, risk will be allocated to the party best able to manage that risk. It has to be said that we have felt from time to time that the proposed allocation of risk has shown only limited adherence to that principle.

We believe that the allocation of risk under the PFI should recognise two different types of PFI project:

- those projects where revenue arises directly from a cash transaction between the project promoter and the end user and where the project revenue is subject to market forces;
- those projects where revenue arises from a transaction between the project promoter and the Government and is not subject to market forces.

In the former, tariffs can be adjusted to take into account changes in the costs of the project promoter and market forces will determine total revenue accruing. We believe that these projects can cater for a high degree of risk transfer. The proposed Birmingham Northern Relief Road falls into this category.

In the latter, tariffs are generally fixed at the beginning of the project, other than for an element of indexation. On these projects (for instance, the DBFO roads) the project may fail through changes in costs which the promoter had no way of predicting or recovering.

We believe that care must be taken not to transfer too much risk on such projects in order to avoid the possibility of multiple failures in the future.

Negotiations to date have in our view tended to place too much risk on the project promoters, a situation driven largely by the catastrophic shortage of work in the construction industry. We remain concerned as to the long-term implications.

9 PROJECT SUITABILITY AND DE MINIMIS

Hard and fast rules as to which projects are suited to PFI are difficult to make but we would suggest the following points:

- it is essential that the Government Client is able to define a clear project brief with an "output driven" specification;
- projects should not be defined by detailed technical specifications any more than is strictly necessary (e.g. where the design must comply with published orders);
- a "de minimis" level should be established for capital projects where significant bank debt is likely to be required; we believe that this should be set at around £20m, otherwise the legal documentation and other costs become disproportionate.

ANNEX

WS ATKINS LTD

INVOLVEMENT IN UK PRIVATE FINANCE INITIATIVE

Railway Projects

Channel Tunnel Rail Link
 Docklands Light Railway Extension
 Croydon Tramlink

Highways Projects

A1(M) Alconbury-Peterborough Improvement
 A417/A419 Swindon-Gloucester
 A50/A564 Stoke-Derby Link
 A30/A35 Exeter-Honiton-Bere Regis
 M6 Paddy's Rickle Bridge—Border (Scotland)

Prisons

Bridgend Prison
 Lowdham Grange Prison

Hospitals

Bedfordshire and Shires NHS Trust—new facility
 Hereford—rationalisation of existing facilities
 Kings Healthcare NHS Trust—rationalisation/new building
 Oxfordshire Community Healthcare NHS Trust—advice
 Rochdale Infirmary—refurbishment and new build
 Royal United Hospital Bath NHS Trust—rationalisation and new build
 Sheffield and Hallamshire NHS Trust—refurbishment and new build
 South Manchester University NHS Trust—Wythenshawe Hospital new build

Other

DSS Newcastle Estate Redevelopment Project
 DFTS (MoD) New Telecom system
 Highways Agency Pavement Management System
 PRESTIGE—Ticketing System for London Transport

12 January 1996

APPENDIX 12

Memorandum submitted by BMI Healthcare

1 INTRODUCTION

1.1 This memorandum is submitted with the objective of providing additional information and insight which may assist the Treasury Select Committee in its inquiry into Private Finance Initiative (PFI) issues in healthcare. BMI Healthcare is one of the few major providers of independent healthcare facilities in the UK which is involved in PFI projects with the Department of Health.

1.2 Although positioned as a provider of private acute healthcare services, BMI Healthcare also delivers its facilities management services. We currently supply, manage and resource all of our own support facilities. This experience provides us with an invaluable background in tendering for and hopefully delivering the non-clinical support services that are being offered by NHS Trusts as part of PFI projects.

1.3 General Healthcare Group plc through BMI Healthcare has been pursuing a strategy of working closer with NHS Services. We have been actively pursuing the development of Fundholding Practices and a number of our hospitals now provide physiotherapy, pathology and some clinical services to GP Practices. In addition, we also undertake work for NHS Trusts assisting them with the management of waiting lists initiatives.

1.4 BMI Healthcare therefore sees the development of offering facilities management services to NHS Trusts as an expansion of their core business and consistent with our corporate strategic objectives.

2 COMPANY BACKGROUND

General Healthcare Group plc is a subsidiary of Générale de Santé International plc, which is wholly owned by Compagnie Générale des Eaux SA. General Healthcare Group plc is a leading provider of independent healthcare across a broad range of services. It owns and operates 25 acute care hospitals, is in a joint venture with Columbia/HCA of the United States of America for four central London hospitals, owns 7 psychiatric hospitals and a range of other clinical and preventative services.

BMI Healthcare, the trading entity of General Healthcare Group plc for its acute care hospitals, has been established in the UK as a provider of independent health care for over 20 years. All of the 25 facilities are managed by BMI Healthcare. We therefore have extensive experience in the delivery of private elective surgical and medical care.

In addition to the traditional "District" hospital, we also operate regional centres which also meet the needs of the local community and accept tertiary consultant referrals. These are classified as "Regional" hospitals. Over recent years, we have also been involved in the development and establishment of "Partnership" hospitals, which are stand-alone private facilities located on NHS Trust sites. These hospitals, whilst having their own theatre and general support services, contract with the host NHS Trust for the provision of pathology, pharmacy and a range of other services.

General Healthcare Group plc had a turnover in 1994 of £250 million and employed nearly 5,800 staff.

3 TOPICS BEING INVESTIGATED BY THE SELECT COMMITTEE

3.1 *Techniques of investment appraisal*

3.1.1 Historically, the techniques used by Her Majesty's Treasury could have been seen as failing to reflect the true costs of public sector finance in comparison with private sector finance. Some progress has been made with the Treasury and the techniques applied to investment appraisal. More work needs to be done by the leading merchant banks. As advisers to PFI bidders and contractors, this issue is best addressed to and by them.

3.2 *Situations for which PFI is suitable*

We would view these as being:

- (i) after a realistic Outline Business Case has been formulated following genuine consultation and support from the purchasers, it is our understanding that the overall dimensions of a PFI Outline Business Case, i.e. size of the hospital, revenue stream, market demand assumptions etc, have to form the basis of the Full Business Case otherwise a new Outline Business Case has to be presented and the PFI cycle repeated. This is a major constraint on the development of innovative ideas in this process.
- (ii) we would encourage the Treasury to promote and support Health Boards in the initiation of PFI projects. This we believe is a strategy particularly suitable to the development of community services.
- (iii) where there is a realistic potential for the private sector (partner) to obtain a reasonable market return on their investments. In respect to the National Health Service, this could be related to:
 - (a) Her Majesty's Government's White Paper "Putting Patients First" proposals, involving landswaps/financial offset arrangements where a capital gain may be accrued and used in the evaluation of the process.
 - (b) Management contracts that take consideration of a longer term timescale, i.e. contract lengths of 25 years plus.
 - (c) Development of complementary health services and products including private patient facilities, medical research establishments and community services.
- (iv) where commercial risk can be evaluated and assumed by the special purpose company. Projects which have high local or national political risk would adversely affect the bankability of projects. In such cases the financing requirements are likely to make the projects poor value for money; it may therefore be appropriate for the Treasury to ring fence funds. This would involve unnecessary private sector comparisons being made and avoid the Trust and the bidding companies incurring not insignificant abortive costs.

3.3 Efficacy of PFI

We believe the efficacy of PFI for the health sector is for us predicated on a number of key elements:

- (i) the acceptance of a realistic and agreed return on investments for the private sector partner.
- (ii) consistent application of mutually understood and agreed tender/bid/contract monitoring and appraisal processes.
- (iii) the use of benchmarking rather than market testing for hospital services reviews in PFI contracts where market testing has established a cost-effective basis at the start. Incremental savings are unlikely to be obtained for the same quality of service. Benchmarking (which includes a quality element) is a more satisfactory basis for assessment.
- (iv) from our experience the process for the PFI procedures are themselves inefficient. It also stifles the opportunity to introduce innovation. In order that competing consortia proposals can be evaluated, historically the Trust, through its financial advisers' have required a prescribed format for the delivery of services and the structure of the proposal. The justification for this being to allow the evaluators to compare "apples with apples". Whilst the options provided to offer a variant bid, in reality, the time constraints and the costs of putting the proposals together discourage the organisations from exploring variants. The result is the Trust will receive proposals in the mould of their current organisation expectation.

3.4 Bidding procedures

3.4.1 Current bidding procedures inevitably involve significant costs to the tenderer. We believe that once the initial award of a PFI contract has been made to a tenderer which at a later stage fails to proceed, the cost to that early stage should be reimbursable to the successful tenderer.

It is currently accepted within the construction industry that commercial success in Health Sector PFI contracts depends on gaining two out of every three tenders. In comparison, there is a ratio of one to three and a half for other PFI contracts. In our view there is therefore justification for some form of reimbursement for the tenderer when an awarded contract falls through.

3.4.2 In recent history construction firms would have established partnerships with caterers/facilities management firms for PFI contracts in this sector. Tender and bidding procedures were tailored accordingly. Recently there has been the participation of specialist healthcare service providers such as ourselves in partnership with construction firms for PFI contracts. Service/facilities provider partnerships will continue to exist. We believe that historically the bidding process has been complicated at an unnecessarily early stage when superfluous operational details are added, for example, the consideration of meal menus and the frequency of lawn mowing and window cleaning.

At this relatively early stage of the process where a Trust is endeavouring to select a preferred consortium, we believe that the value for money evaluation should be undertaken on the basis of a basket of services with a generally stated and expected level of output specifications for service delivery. In all aspects of services being offered, there will be development and change in expectation and the way services should be delivered, therefore, establishing contractual arrangements for the method of delivery five years before a hospital is open we believe is unnecessary and premature.

Bidding procedures should be updated to reflect the experience and expertise of total hospital/healthcare facilities management in a bidding partnership. These revised procedures should provide a tiered bidding process where considerations of detailed costings on minor operational matters are not considered at the outset. This would provide a simpler, cost-effective bidding procedure.

3.4.3 We welcome the announcement of the establishment of a team of specialists to ensure that contract negotiations in PFI issues are conducted on a consistent basis throughout the NHS. However, we remain concerned that there is no progressive transfer of lessons learned in the development of contracts through the bidding procedure among those in the Department and among Health Service management who are responsible now or in the future for PFI developments.

Similarly we would like to see a significant effort made to have this learning experience made available as part of management development processes within HM Treasury, the Department of Health and the NHS itself at an appropriate level. The Civil Service/Treasury training college, and private sector business schools could provide a useful role in meeting these particular management development training requirements.

ANNEX 1

Description of healthcare facilities provided by BMI Healthcare:

A1 Acute Care Hospitals.

The 29 Hospitals have over 2,000 beds, accounting for some 17 per cent of independent hospital beds available. BMI Hospitals undertake a wide range of procedures, from routine day cases to the most complex organ transplants and neuro-surgery. The Hospitals also offer many outpatient services for patients referred by consultants or GP's and on a self-referral basis.

A2 Preventative and Occupational Healthcare.

BMI Health Services provides occupational and preventative health services to businesses and individuals.

A3 Audiology Services.

BMI Audiology Services offers audiology testing through fixed and mobile centres in the United Kingdom.

A4 Pathology Services.

BMI Pathology Services operates pathology facilities in conjunction with NHS Hospital Trusts.

A5 Partnerships in Care Limited.

Partnerships in Care Limited is the General Healthcare Group's psychiatric company run in parallel with BMI Healthcare. The company comprises seven units with a total of 400 beds for specialised assessment, treatment and rehabilitation for mentally handicapped, mentally ill and brain-injured people.

APPENDIX 13

Memorandum submitted by the Finance and Leasing Association (FLA)

ABOUT THE FLA

1. The Finance & Leasing Association welcomes the opportunity to submit written evidence to the Treasury Select Committee on the Private Finance Initiative (PFI).

2. The FLA is the major UK representative organisation for the finance & leasing industry and the largest association of its type in Europe. Members of the FLA achieved £60 billion of outstandings in 1995. This represents more than 30 per cent of all UK fixed investment and virtually all consumer credit apart from conventional lending by the clearing banks and building societies.

3. FLA represents the interests of companies offering business finance and leasing, consumer credit and motor finance. For business customers in both public and private sectors members provide leasing and hire purchase for plant, machinery, ships, aircraft, major infrastructure projects, office equipment, business loans, etc. In the consumer sector members provide hire purchase, personal loans, mortgages, various types of credit and credit/store card facilities. FLA members supply 70 per cent of all finance for vehicles in this country. There are more than 100 full members which are drawn from high street banks and their subsidiaries, merchant banks, building societies, leading finance houses, leasing companies and the finance sections of manufacturing and retail companies. In addition there are more than 50 associate members which are companies, institutions, solicitors and accountants providing services to the industry.

4. Many of these members have become involved with the PFI and this document has been prepared after wide scale consultation with the industry on the Initiative.

FLA INVOLVEMENT

5. The latest available figures for the FLA members' involvement in PFI projects are for 1994, when £227 million was financed. This is around 17.5 per cent of all finance provided to the PFI that year.

6. The FLA's members have a strong commitment to PFI, and have been involved in its evolution through contact with Government departments, the PFI Panel and the Executive. We welcome the new Treasury publication "Private Opportunity, Public Benefit", and would like to see further work done (to which we should be happy to contribute) in establishing thorough and detailed guidelines on how leasing can be best employed in PFI. FLA is represented on the CBI's PFI Task Force. We have also offered to contribute to the Price Waterhouse training arrangements for Government officials and to seek a seconded from the industry for the PFI Executive.

7. Involvement includes well-publicised PFI projects with a significant leasing content, notably the Northern Line, the Ashford International Passenger Station and the networker trains for British Rail. It is, however, important to note that much leasing in the PFI relates to small and medium ticket items, such as school computers and furniture, and hospital equipment.

8. The benefits of leasing are substantial. Contrasted with conventional bank finance it is long term and leasing companies can accommodate lease periods of in excess of 20 years on major projects. It is flexible and enables finance to be structured where rental payments are matched to income flow derived from the use of the asset after construction has been completed. It is thus well suited to infrastructure projects from which income builds up over time.

9. Given these advantages, lease finance is an essential element in the success of the PFI in achieving the targets set by the Chancellor.

10. FLA agrees with the concept of PFI and appreciates the necessity of risk transfer and value for money. But, without some changes in the ground-rules, there remain significant concerns about the commercial reality of PFI being on the road to meet the Chancellor's targets. Leasing companies as well as Government departments are on a learning curve and welcome the opportunity to assist Government in defining and managing the new risks which arise from the PFI concept.

11. A short note annexed to this Memorandum explains unavoidable technical terms associated with leasing.

PFI CHALLENGE

12. A principal objective of the PFI is to harness the skills and expertise of the private sector and apply them to public sector projects. It is essential to understand that FLA members are seeking to apply their financing skills to the PFI in the same way as they do in their normal operations. There appears to be an unjustified suspicion that the Government is being treated more stringently in areas of contract length, continuance of operation and exit options.

Members of the FLA have encountered two principal areas of difficulty which are:

A. Risk

B. Taxation

A. RISK

A principal requirement of the PFI is the transfer of significant risk to the private sector and FLA understands and appreciates this.

Many PFI projects are in their nature long term. Lease and asset finance providers have a good understanding of the commercial risks associated with the financing of particular assets over time. Government criteria exclude finance leasing as such, although finance leases play a part in funding other parties (such as construction companies) in PFI deals.

The specific rules require assets valued at less than £1 million to be leased on an operating lease basis as defined in SSAP21 (see the Annex). Between £1 million and £10 million the minimum value of lease payments must not exceed 70 per cent of the value of the asset. Above £10 million a more detailed risk analysis is required which must take into account residual value, potential obsolescence of the asset, performance risk and third party liability and maintenance risks.

Generally, these rules need to be reviewed and made more flexible. In particular, the £1 million to £10 million category is a difficult area because the assumption of 30 per cent residual risk will often not be acceptable to a lessor although much will depend on the nature of the asset and the availability of a second-hand market.

We feel that tangible criteria for risk analysis need to be further worked out. There are many ways to transfer risk other than by requiring a percentage of asset value to be retained by the lessor and this area deserves consideration by the Private Finance Panel. A possible way forward is an increase to, say, £8 million of the SSAP21 operating lease limit, with deals in excess of £8 million being assessed in the same ways similar to, but more flexible than, those currently applicable to assets over £10 million.

Of particular concern is political risk. While the leasing industry is experienced in assessing commercial risk, it is simply not in a position to undertake political risk. It needs to be recognised that financial institutions require a guarantee or indemnity against changes in policy which interfere with the income stream generated by a project.

Such risks include not only direct renegotiation of contracts, but also, for example, changes to environmental law which cast a higher burden than originally anticipated on a project operator. An instance is "statutory novation" which occurs when assets leased to a local authority on the basis of an assessment of its credit risk are transferred to a contracted out services company which will have a quite different credit risk assessment. A particular example is the transfer of refuse collection arrangements together with the leased vehicle fleet.

A leasing company recovers capital expenditure incurred at the beginning of the lease contract over the period of the lease. It is therefore greatly at risk from early termination of the lease period. In the context of the PFI, this could occur where, for example, a railway or prison was closed at an earlier time than had originally been anticipated.

We identify three main categories of project and believe that risk should be shared between Government and the private sector in accordance with the category into which the project falls. We see the categories as being as follows:

- *Category 1:* Vital national interests are at stake and the Government should take the majority of the risk regarding continuation of the business subject to the PFI and policy changes affecting the operation of the project. In this category we would place major investment projects in the Health Service, Public Transport, Civil Aviation and support for the European Transport Plan.
- *Category 2:* Projects which are desirable but not vital, where there would be a sharing of risk between public and private sectors. We would consider that roads and other DBFO type projects should fall into this category.
- *Category 3:* Projects which are desirable in principle, where the risk should rest principally with the private sector. Such projects would be initiated by the private sector effecting operations hitherto performed by Government. It is possible that these projects could be initiated by Local Government, but the principal sponsor will be the private sector.

B. TAXATION

The competitiveness of leasing depends to some extent on the leasing companies' ability to claim capital allowances in respect of assets financed, passing, in current circumstances, virtually all of the tax advantage thus obtained to the lessee in the form of lower finance charges. It is most important that this transfer of the benefit of allowances is fully appreciated. Where assets are leased to the private sector, the benefit of those allowances is retained in the private sector, except, perhaps, to the extent that they enable a private sector lessee to be more competitive in tendering for PFI projects. If, however, assets are leased to the public sector the benefits of the allowances are immediately recycled within that sector, thus minimising the economic cost of capital allowances to the Treasury.

It should be emphasised that there is no overall difference to the tax take if the allowances accrue to the benefit of the private sector rather than to the public sector. It is merely a question of where the benefit of the allowances rests. A further point is that capital allowances represent only a deferral of tax and do not give rise to any exemption. We doubt whether these points are generally fully understood.

Where the assets involved fall within the statutory definition of machinery and plant or industrial buildings or structures, it is usually reasonably clear that the leasing company will be able to claim the allowances. However, there are some particular areas where changes in tax legislation are necessary to enable the leasing industry to play its full part in the PFI.

One area meriting special attention in the PFI context is design, build, finance and operate (DBFO) roads. Capital allowances were made available for DBFO roads by Finance Act 1995 which made industrial buildings allowances available to the holder of a 'highway concession'. The way in which the existing legislation works is unique in that while most industrial buildings allowances are available in respect of an interest in the building or structure known as the 'relevant interest', this is not the case with DBFO roads.

Under the usual provisions it is a simple matter for the leasing company to acquire the relevant interest in the building or structure which it will then lease to the user. However, in the case of DBFO roads the relevant interest is declared to be the highway concession, which is not an interest in property but a right to receive, effectively, shadow tolls from the Government. A leasing company cannot itself obtain the highway concession and lease it to the operator and so leasing finance is precluded in this one area where, by reason of the long term nature of the project, the leasing industry is uniquely experienced in providing finance. A simple solution would be to permit an election (such as is already available in the case of leased fixtures) whereby the holder of the highway concession and the leasing company could elect that the leasing company should be entitled to capital allowances.

Another area which needs to be addressed is the availability of capital allowances for leasing machinery and plant to a non-trading lessee (such as a school or hospital). The current state of the law remains

unsatisfactory following the decision in *Barclays Mercantile v Melluish* but it is understood that the Inland Revenue are reviewing the law in the light of that decision and the effect of any change on the ability of the leasing industry to contribute to the PFI should be borne in mind. In this context the point made above about the incidence of the benefit of capital allowances is most important.

ADMINISTRATION

13. We welcome the recent initiatives to improve procedures concerning the PFI. We have referred above to the training programme for civil servants, and our willingness to contribute to it. Should Government find it helpful we would consider providing secondees from the industry to help their appreciation of the intricacies of long-term financing techniques. We feel that it is important that each department establishes and strengthens its PFI unit, and that officials concerned with the PFI should be encouraged to approach projects with more confidence. The steepness of the learning curve needs to be appreciated and we feel that it is important that in the area of assessing value for money, certifying officials should not feel under pressure to be over-cautious through fear of criticism by NAO and ultimately the Public Accounts Committee. PFI opens up a new area of unfamiliar risks on both sides. Empowerment of officials to decide to use the PFI route will inevitably lead to some mistakes. Whilst the balance is difficult to achieve, we believe this issue merits attention. We also feel that there is a need to monitor performance in this area, that typical pure public sector cost analysis provides an inappropriate benchmark and that the wider economic and social benefits of the earlier completion of projects through PFI involvement should be appreciated.

FURTHER EVIDENCE

14. FLA hope to have more up to date information on the industry's involvement in PFI in 1995 which we can bring to the Committee's attention.

15 January 1996

ANNEX

TECHNICAL MATTERS

LEASING TECHNICALITIES

1. It may be helpful to explain in simple terms the distinction between finance leasing and operating leasing.

2. The distinction is drawn for UK accounting purposes by Standard Statement of Accounting Practice (SSAP) 21. This requires that an operating lease is one where the minimum value of lease payments must not exceed 90 per cent of the discounted value of the leased asset. Where they do exceed 90 per cent the lease is a finance lease.

3. A finance lease effectively transfers to the lessee most of the risks and rewards of ownership of the asset, but without transferring ownership itself. Under a finance lease the leasing company will recover the full capital cost of the asset from the rentals during the primary lease period, covering most of the expected useful life of the asset. At the end of the primary lease period, there may be a secondary lease period at a nominal rental or the asset may be sold to an unrelated third party. It is normal for the lessee to receive the bulk of the sale proceeds.

4. An operating lease is one under which the leasing company retains a significant interest in the residual value of the asset at the conclusion of the lease. It does not therefore recover the whole of the capital investment from the primary lease rental. At the end of the lease period the leasing company will usually either enter into further leasing arrangements for the asset or sell it in the second hand market, and therefore operating leasing is particularly appropriate for assets for which a second hand market is available, such as vehicles and aircraft.

5. Under current accounting standards, both in the UK and internationally, the lessee must account on its balance sheet for assets subject to finance leases, but not those subject to operating leases. The terms "big ticket", "medium ticket" and "small ticket" refer to the value of the item(s) leased. Thus ships, aircraft and infrastructure projects are typically "big" (over £5 million), plant, machinery and new commercial vehicles—"medium" (over £1 million) and office equipment, vending machines—"small".

APPENDIX 14

Memorandum submitted by the Automobile Association (AA)

INTRODUCTION

1. The AA is concerned with how the PFI affects the level and quality of UK transport investment, and the price users have to pay. Transport finance, including the role of the PFI, is fundamental to addressing the UK's transport policy and planning problems. The PFI also impacts on how well our transport infrastructure is operated.

2. Currently the UK faces two serious problems of transport finance:

- (i) the level of finance
- (ii) the stability of finance

There is also considerable scope for greater efficiency in public procurement which the PFI can help fillip. If the necessary steps are taken to win public confidence, there are also economic and environmental efficiencies to be gained from evolving the way transport is priced.

3. There is global recognition and cross party support for the role of private finance in transport infrastructure investment. The AA welcomes many of the proposals put forward by the Government and opposition. However, the AA has concerns that elements of short term expediency in roads investment have been introduced in the last budget under the pfi banner. This paper therefore concentrates mainly but not exclusively on major roads. It sets out what we think is going well, what is not, and recommends a series of practical steps which the AA believes would lead to a significant improvement in the provision of roads and transport in the UK.

THE PROBLEM OF INVESTMENT LEVELS

4. The UK's first major transport problem is the level of transport finance. Even before the last budget, quantitative reports have continually identified the weakness of the UK's competitive position on transport investment (eg refs 1, 2). In shorthand, the UK is at the bottom of the European investment league. Qualitative research also suggests that the British public now contrast the quality of transport in Europe with their own (ref 3).

5. The Government have recognised the importance of investing to protect assets in the one special and unhappy case of the London Underground but the National Audit Office has repeatedly criticised the backlog of maintenance on motorways which results in avoidable costs and disruption to users. The National Road Maintenance Condition Survey shows deterioration in all categories of roads in the last 15 to 20 years. Today, one third of English motorway miles have four years life or less before major roadworks should be carried out.

6. The pfi can help scheduling but deferring public capital expenditure will not address the problem that there is simply not enough capital expenditure available. Various Government policies and statements on road taxation, road costs and expenditure, resource accounting, tolling, and the PFI suggest muddled and contradictory objectives.

7. Professor Newbery of Cambridge University has called transport policy "incoherent and out of control" (ref 4). He has identified investment as "below rational levels". There is a vast queue of road and transport projects that pass any rational economic and environmental test which are not being financed because of capital starvation. Normal rational decision making employs economic concepts such as test discount rates. These underpin decisions on allocations for preventative maintenance or new capital projects in developed economies. Efficient allocation of resources cannot be undertaken if the capital is not then made available.

THE CURSE OF ANNUALITY

8. A major reason that Britain has uncompetitive investment below rational levels is that investment levels are not determined by the worth of projects but by a crude process of political bargaining in the annual public expenditure round. In this process, short term current account gain can be cheaply bought at the price of long term harm in capital programmes. Roads and transport is now the last utility left in the public expenditure round. As a result, its capital investment programme has been ruthlessly hit in the search to bolster current spending.

9. Even if the level of finance were unchanged, annuality brings so many secondary inefficiencies that it must be addressed. Major capital projects in transport typically need 5 to 10 years to unfold yet we have no link between our plans for transport and the amount of finance available. In the UK, particu-

larly in England, there is no clear transport programme or strategy for delivery but just a list of piecemeal projects which may, or probably will not be financed at sometime. We therefore:

- do not have the right priority projects designed and ready to go at the right time;
- have massive waste in preparing schemes that are never built;
- have developed a national culture where it is normal for projects not to be delivered at all, let alone to time and cost;
- have no articulated strategy which, when combined with the randomness of finance, acts to feed feelings of unfairness about what is financed.

A fresh approach is essential—one which looks at how we pay for roads and local transport overall, and how long term programmes of transport infrastructure can be properly financed. In this the PFI has a role.

PROGRESS WITH THE PFI TO DATE

10. In the development boom period up to the late 1980s, there were many cases of commercial developers contributing useful amounts towards road and transport schemes. While this form of finance can ensure development takes at least some account of costs imposed on the transport network, it is difficult to see how it can be developed as other than a localised and opportunistic form of finance.

11. Long term stable forms of transport finance must come from a blend of taxes, fares and charges. New income streams to repay privately financed roads with toll income have only been introduced at the Dartford, Severn and Skye crossings. Even at these crossings a substantial proportion, or even the majority of the project, has been financed through the normal public programme in the form of approach roads and other ancillary expenditure.

12. The Channel Tunnel has similarly required publicly financed road and rail connections in order that the whole network can make sense. As with the new bridges, public and private bodies (police, transport authorities, motoring organisations etc) have acted to plug the infrastructure into the wider transport network and travel support system.

THE PROBLEM OF TOLLS AND DIVERSION

13. Unlike Dartford, the public at the Severn and Skye crossings have felt that the level of tolls has gone beyond a reasonable surcharge for a high cost facility. Otherwise these new privately funded bridges have overall been successful projects so far but, despite their near monopoly positioning, there have been issues of traffic diverting to avoid tolls at all of them particularly at the Severn.

14. The Severn Bridge illustrates the general problem with introducing real tolling on British motorways. Even a small percentage of traffic diverting from the motorway can mean substantial increases of traffic for local communities on unsuitable roads. An extra 3,000 vehicles a day on a motorway is difficult to perceive at all but that much additional traffic can be an environmental catastrophe for a village.

15. The British motorway network has been developed as an untolled network performing two tasks simultaneously—trade route and local bypass. Since the mid-1960s, planners have sought deliberately to route motorways to attract as much local traffic as possible. Most of the UK has a very developed secondary network providing many alternative routes for most traffic. So even modest toll levels on parts of the British network are likely to send traffic back onto the local network.

16. The French toll road model cannot therefore be carried too far in British circumstances. Unlike France, Britain does not have many motorway sectors carrying mainly long distance traffic between major settlements (the M6 Preston to Glasgow sector is a rare exception). In France, tolling of French motorways starts away from the urban network, which reduces diversion. Some local councils also repay the tolls of truck operators to keep them away.

BUNDLING

17. The PFI has proceeded in roads and transport on a project by project basis in which the design, build, finance and operation of projects has been bundled together.

18. As a short run way in which to experiment and develop new methods of working, this has been useful. Other than for massive one-off projects—such as the Channel Tunnel—this is not likely to be the most effective way to introduce private finance into roads and transport unless the projects might expand and develop into businesses (eg as seems likely for the City of Edinburgh Rapid Transit project).

19. Many in both the City and construction companies have questioned the general wisdom of bundling the construction, the financing, and operation of routine major road construction projects.

20. *Construction.* Within construction, there is a strong case to procure major projects from a consortium of designers and builders who work together to produce a competitive, well designed, buildable, enduring product.

21. It also makes good sense to make this group commission the project, ie be responsible for it during an initial running-in period (probably three years). It also makes good sense to make the consortium give long term warranties for the major components of their product (ie the life of the road and structures). The vast majority of efficiency savings possible in DBFO come from the design build, commission and warranty stages.

22. It does not necessarily make sense for this consortium to take on routine maintenance of what they have built.

23. *Finance.* There is little obvious dynamic from making particular construction companies link with particular project financiers in a bundled tender. The two industries are not keen bedfellows and there is insufficient scope for the construction cost to affect the cost of finance and *vice versa*. The relationships primarily concern risk management.

24. As a result, the client will therefore frequently be faced with the keenest finance not linked to the keenest construction cost. This is only untrue when a construction group decides to self-finance. However this is, in effect, a different way of expressing the tender price for construction.

25. *Operation.* Historically, bridges and tunnels have always required special ad hoc arrangements for operation which are specific to the particular structure to be managed in the particular location.

26. As the PFI on roads has unfolded away from concentrated activity around water crossings to longer lengths of road, it has been realised that the whole network is different from the sum of the parts. There is an emerging distinction between the maintenance activities keeping the fabric of the road in good order, and the traffic control and travel information activities which help and assist the traveller before and after his journey.

27. This is particularly true for activities reliant on information technology and its operation which are quickly increasing in scale and sophistication in policing, in strategic and tactical traffic control, and in travel information, breakdown recovery and call handling.

28. The introduction of variable speed limits on the M25 is just one outward and visible sign of these changes. More sophisticated strategic traffic management systems are being developed in a number of parts of Britain as part of the push to make the best possible use of the existing network as a whole by warning, guiding and advising drivers. "Intelligent transport systems" are emerging as a distinctly different industry.

29. The AA welcomes the new emphasis by transport Ministers on the quality of service that the motorist should enjoy. Increasingly, however, it seems that maintenance and services looking after the motorist should not be bundled. There are plenty of signs that the long term operation of the road in DBFO schemes is being treated as the poor cousin. The financial importance of the upfront construction stage is overwhelming with ongoing costs, and service to the motorist, something to be minimised.

DBFO ROAD SCHEMES

30. In the last budget, the Government announced yet further tranches of schemes to be procured by the bundled shadow tolling method—DBFO (design, build, finance, operate). The total is around 40 schemes announced to date. This decision appears to the AA to be more driven by short term expediency than by a wish to develop an efficient structure for those who use or pay for roads.

31. Prior to the announcement, some five per cent of the trunk road network was already to be tendered by DBFO but only one small contract yet to start has been let by this method. There are obviously no post-project appraisals. There is no published evidence as to their value for money.

32. If these waves of DBFO schemes are let, it appears that around 50 per cent of the national roads vote would in future be expended not on construction but on interest charges. There has been no statement that a vote transfer will take place so that interest charges on borrowing will continue to be made by Treasury. Schemes which are procured by DBFO may defer capital payments for two to three years—useful for short term purposes—but they then have to be repaid from the public purse over 25 years or so. In a handful of years it seems likely that virtually the whole existing roads vote would be committed for a generation to making repayments unless some other action is taken.

33. The Government justify DBFO on the grounds that the efficiency gains from DBFO outweigh the cost of private capital (believed to be around 6 per cent—9 per cent pa higher than gilts). This argument

is sound as far as it goes—there are significant gains to be had from tighter control of initial design and construction costs, and of whole life costs. It is wholly justifiable to experiment with DBFO.

34. There are however other forms of contract which can also achieve major savings which seem, at the least, likely to cost less for those who in the end have to pay. These would avoid expensive project by project finance. One must nonetheless have sympathy for the pressure on transport Ministers when their potential returns on stalled investment are so high following the most recent rounds of cuts that they outweigh almost any conceivable cost of finance.

THE COST OF BIDDING AND IPR

35. One disadvantage in the DBFO approach is that the cost of bidding is a significant deterrent and on-cost for even the largest firms. One rule of thumb is that while “design and build” bidding is three times the cost of conventional road contract bidding, the cost of DBFO bidding is five times the cost. These costs eventually have to be recovered from successful projects.

36. Another well understood problem of the PFI is intellectual property rights (IPR). There is a major deterrent in coming forward with proprietary ideas if these are subsequently put out to open tender. There are few “template” projects to be seen which show that the Government’s suggested solutions to these problems have been deployed in practice eg “single tender competition”.

DEFINING ROAD NETWORKS WHICH CAN BE EFFICIENTLY MAINTAINED

37. Following the budget, it appears that DBFO schemes are to be tendered in short ad hoc lengths dotted round the country. Where a new improvement scheme has completed its planning procedures, an ad hoc decision is to be taken as to what surrounding miles it might be sensible to add on to the new build to create a length of road to maintain.

38. This expedient policy seems now to be overtaking a competing policy where a careful look had been taken at tendering sections of network which were large enough to bring resources to bear on the job efficiently (around 25 sub-regional networks had been defined in England and the Scottish network has already been tendered in sub-regional units.)

39. Letting five or seven year term contracts in this way had a number of advantages:

- inter-business comparisons can help raise standards for the road user;
- modestly or poorly performing firms or local authorities can be replaced without invoking the doomsday conditions contained in DBFO contracts;
- performance specifications can be regularly updated in line with technical progress without one-sided renegotiation;
- the lengths of network tendered can be readily modified in the light of cost analysis or the developing network;
- firms or local authorities who were highly capable in this sector but not in major construction could lead.

REAL TOLLING AND SHADOW TOLLING

40. The Government originally announced that DBFO would be an interim step ahead of real tolls collected using electronic technology. The AA commissioned work from the LSE (ref 5) to examine the case for shadow tolling as now being introduced by the Government.

41. In short, as a way of introducing private sector management skills, shadow tolling has a number of major advantages over real tolling. The most obvious are:

- it avoids the high cost of toll collection equipment, enforcement etc,
- it avoids the public resistance real tolling would introduce;
- it avoids the major problem of diversion.

The main disadvantages are that, on its own, shadow tolling:

- does not raise toll or charge income to pay for infrastructure;
- does not enable price to be used as a management tool;
- results in expensive project by project finance.

42. To make the best use of the transport system, any direct tolls or charges on the network should be set within a framework which fosters economic and environmental efficiency. The AA agrees with the Transport Select Committee's conclusion that the problem of diversion is likely to be significant.

43. Should any direct charging be introduced as part of long term reforms in how we pay for roads and transport overall (ref 4), the levels and structure of direct charging should be set to increase the economic and environmental efficiency of the performance of the network. Charges at the pump will remain an efficient non-distorting way of balancing total revenue and total expenditure.

THE COST OF CAPITAL

44. The efficiency of financing of roads and transport should be a major consideration of policy within the private finance initiative. One way or another, the risks inherent in each individual project need to be averaged out either by raising capital linked to the programme as a whole or in part, or by some other portfolio approach. Inherently, the roads and transport sector has utility characteristics and ought to enjoy the appropriately low costs of finance.

REFORM OF ROAD TAXATION

45. In the Foreword to the report "Reforming Road Taxation", the AA sets out proposals to develop a new system of finance for roads and local transport based on the analysis by Professor David Newbery (ref 4). The AA welcomes recent press reports that proposals along the AA's recommended lines are to be examined by a cabinet committee chaired by the Deputy Prime Minister.

46. The first step is a change in approach. It does not affect the Chancellor's revenue nor the amount any user pays at the pump or to the DVLA today. The change is to separate out the revenue from taxes on motoring which go to support general expenditure, from the charges which support the development of roads and our local transport.

47. In 1994/5, a typical litre of petrol cost 53p of which revenue from the road fund licence, together with just 8p a litre from fuel, covered the UK's entire public expenditure on roads together with general local transport expenditure. There is no reason in logic or international convention why this charge revenue could not flow directly to a corporation established to finance roads and local transport infrastructure. The Chancellor's remaining tax income of over 31p from each 53p litre for general expenditure would be unchanged.

48. The first major gain from doing this is that a long term programme of infrastructure could be developed which is actually linked to a revenue stream of charge income to support it. This revenue stream could also be used to raise private capital more economically than today's project by project finance.

49. There are various subsequent possible steps outlined in the "Reforming Road Taxation" report, dependent on whether public support and trust is established, on how the charging system might be evolved. For example, AA surveys already reveal support in principle to reduce the road fund licence charge and increase the charge at the pump correspondingly. The Freight Transport Association has pointed out that the £5000 licence for heavy trucks is a UK anomaly and has indicated support for a switch towards collecting the revenue from direct charging of trucks on trunk roads and motorways where 55 per cent of their mileage is done.

50. There is widespread agreement that transport should be planned regionally linking transport with land use and economic development decisions. There therefore may be public support for spending regionally what is raised regionally—and so regional corporations.

51. Most analysts argue that it would be better if what we paid were more closely linked to each journey on the transport system. This would lead to better investment decisions and better use of the network in environmental terms. If public confidence in the system were truly established, the public might or might not support lower charges at the pump offset by more direct charging if they were convinced by the arguments. Professor Newbery argues, for example, that rural motoring is too expensive and urban motoring too cheap. He argues charges off-peak ought to be lower than those during peak periods.

THE PUBLIC ACCOUNTS COMMITTEE

52. One problem faced generally in implementing the PFI is the role of the Departmental Accounting Officer and the PAC. Over generations, Departments have sought to protect the accounting officer from criticism by the PAC. This tradition ensures great transparency and accountability for the expenditure of public money. But it also discourages managed risk taking and sits uncomfortably with the PFI's "deal led" approach.

53. The AA believes that PAC and Treasury should develop a framework of guidance in this area which is more encouraging of reasonable decisions.

CONCLUSIONS

54. The key conclusions in this submission are that:

- the AA believes that the UK faces serious problems in transport policy, planning, investment and stability of finance. Those can only be addressed by a fresh approach to transport finance via reform of our road taxation system. The AA welcomes the signs that the Government is giving serious study to reform of road taxation based on AA proposals;
- there is significant scope for greater efficiency in public procurement which the PFI can fillip;
- the AA is not convinced that project by project finance is cost effective for routine schemes in the roads programme and has concerns that the acceleration of the "DBFO" programme is driven by short term expediency. There are competing forms of contract—such as "design, build, commission, warrant" that can give procurement efficiencies but do not involve expensive long term project finance;
- the PFI can help schedule the availability of capital better. Private finance is best raised at the programme level, in whole or part, or by some other portfolio approach. This will reduce complexity and tendering costs. Roads and transport should enjoy low "utility" costs of finance;
- a better and more cost effective maintenance approach for the user and those who pay, is likely to be obtained from tendering sub-regional networks selected for that purpose rather than by selecting sections of road which opportunistically are ready to be reconstructed or upgraded;
- there is a growing distinction between maintaining the fabric of the network locally and the increasingly sophisticated technology being deployed to manage control traffic and inform travellers over a wide area.

January 1996

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APPENDIX 15

Memorandum submitted by the Construction Industry Employers Council

INTRODUCTION

1. The construction Industry Employers Council comprises the four leading contractors' organisations in the Construction industry—the Building Employers Confederation, the Federation of Civil Engineering Contractors, the Federation of Master Builders and the Major Contractors Group. These organisations represent over 20,000 member firms of all types, sizes and trade categories throughout Britain who are responsible for over 75 per cent of total construction output.

2. Construction has, in recent years, accounted for approximately half of all public sector capital expenditure, and therefore the advent of the PFI was extremely significant for the construction industry. The industry has generally been supportive of the Initiative, and has demonstrated that support by the significant investment it has made in tendering for the range of PFI projects which are currently being developed. Indeed, it is usually a contractor who has acted as the catalyst in bringing together a team of financiers, designers, constructors and operators which is capable of entering into a long-term contract with the public sector for the provision of services.

3. Although contractors have responded positively to the challenge of the PFI, the sheer scale of the Initiative, the demands that are being made of the private sector in respect of the transfer of risk and the high cost of tendering for PFI projects are beginning to weigh heavily on an industry which has already been hit extremely hard by difficult trading conditions and which, despite recovery in the general economy, remains in recession.

4. CIEC would therefore like to make the following points on the specific issues identified in the Committee's request for evidence.

SITUATIONS FOR WHICH PFI IS SUITABLE

5. It is important to appreciate that there are certain types of project which are not suitable for the Initiative.

6. This is usually for one of two reasons:

- there is an overriding operational need for the service to be provided by the public sector. In defence work this may, for example, be for security reasons. Alternatively, Government may decide for political reasons that it would be inappropriate for the private sector to provide a particular service; or
- the project is one where private sector funding and management is not viable because the financiers do not consider it to be a sufficiently attractive investment proposition, either because of the relatively low rate of return or because of the level of risk which the private sector is being asked to assume.

7. Having established that not every construction project can be procured by means of the PFI, it is essential that Government focusses both its own and the private sector's resources on those which are suitable for the Initiative. Although Ministers appear to have accepted this in principle, in practice public sector bodies are continuing to explore PFI options for manifestly unsuitable projects.

8. Projects which generate their own income streams, such as car parks, have been shown to be ideal for the PFI, as have projects where there is a high residual asset value at the end of the contract with the public sector. In contrast, refurbishment of existing facilities, particularly if it involves refurbishment of only part of a building, are often difficult to fund in this way.

9. Although the nature of the work will usually be the main factor which determines the feasibility of the use of the PFI, the size of the project is also important. The present complexity of putting together a PFI bid deters smaller and medium-sized contractors from taking an interest in projects which would usually be well within their range if the construction work was being procured in the normal way. As a result, smaller companies have been hit particularly hard by the Government's current requirements for PFI testing.

10. CIEC has therefore proposed that a *de minimis* threshold should be introduced below which there is no requirement to test proposed capital expenditure against a PFI option. This would not, of course, prevent the private funding and management of projects below that threshold where appropriate, but removing the requirement to test PFI options would break the "logjam" which PFI has created on many small projects for which it is most unlikely that private funding will be available.

BIDDING PROCEDURES

11. Putting together a PFI bid is an extremely expensive exercise, and this is viewed by the industry as a real barrier to entry into this vital new market.

12. In addition to the cost of bidding for a specific project, considerable sums of money are often required to set up joint ventures or consortia of builders or civil engineering contractors with designers, service providers and financiers.

13. It has been suggested by some that the costs involved are no more than contractors would incur in bidding for any major construction project. It has been difficult for representative bodies to obtain evidence of the level of costs actually being incurred, as many contractors regard this information as being commercially sensitive and therefore confidential. However, CIEC has been able to assemble some evidence of the level of bidding costs for PFI projects and to compare them with the costs of bidding for ordinary construction projects, and this is set out in Annex 1.

14. The current level of bidding costs will be sufficient to bring the Initiative to a halt unless action to lower them is taken as a matter of urgency. A system must be evolved which ensures fair competition and value for money for the public sector without placing such an inordinately heavy burden on the private sector.

15. CIEC therefore proposes that the Government should:

- (i) *ensure that only those projects which are genuinely viable for PFI are put out to competition;*
- (ii) *ensure that the recently issued Treasury guidance that no more than three or four bidders should be invited to produce a full tender is strictly adhered to by public sector bodies;*
- (iii) *identify a single preferred tenderer as early as possible.* The gestation period for most private finance deals is extremely long, and therefore involves considerable expense. Bidders are generally willing to make a significant investment if they have a good chance of securing the project,

but as the costs escalate they would be reluctant to continue spending if they are still in a competitive situation. A reasonable target would be for 25 per cent of the costs of putting the deal together to be incurred during the competitive process, with the remaining 75 per cent being incurred only by the preferred tenderer. As the majority of the bidding costs relate to financial and legal advice during the detailed negotiations on the contract documents, this would not prevent genuine competition. It would, however, reduce the overall cost burden on the private sector, and would also reduce the Government resources which are currently required to deal with more than one tenderer. This would also ensure that Government could not be accused of artificially lowering prices through a process of "Dutch auctioning" which might occur if it negotiates with more than one party until every aspect of the deal has been settled.

- (iv) *take a more realistic attitude at the outset to those risks which can be transferred to the private sector.* If concession contracts are offered containing unacceptably onerous conditions, the private sector—particularly the bankers—will employ lawyers to negotiate them out, which increases bidding costs. However, if the contract terms are drafted to take account of what is generally acceptable, the negotiations will be shorter and more straightforward and thus legal costs will be lower for both public and private sector.
- (v) *produce and use standard contract documents for PFI projects.* This is likely to reduce bidding costs more effectively than any other single measure. It is appreciated that the Treasury's "deals not rules" approach during the early stages of the Initiative was necessary in order to ensure that genuine innovation could occur, but now that so many PFI projects have reached an advanced stage of negotiation it should be possible to draw up "core" conditions which can be used for most PFI projects.

OVERALL IMPACT ON INVESTMENT LEVEL

16. The PFI has undoubtedly had a significant impact on public sector investment in construction in recent months. A chart indicating the recent fall in the volume of new orders in the public sector housing, infrastructure and public works sectors is attached to this paper as Annex 2.

17. A reasonable level of capital expenditure on construction is essential not only to the construction industry but also to the creation of an acceptable environment for the public at large and the proper provision of vital public sector services such as health and education.

18. The construction industry believes that PFI is capable of delivering a substantial part of the public sector's infrastructure needs, but only if the reforms proposed in this paper are implemented.

January 1996

ANNEX 1

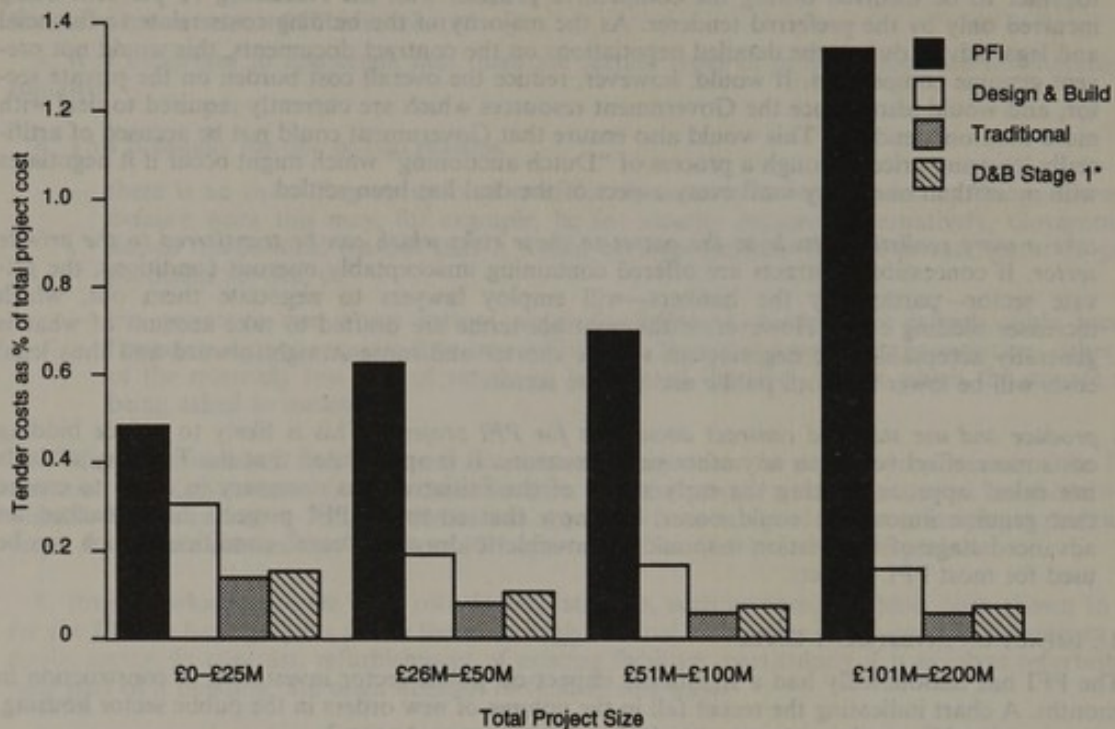
TENDERING COSTS OF PFI PROJECTS

The comparatively high tendering cost for PFI projects is illustrated in Figure 1, where average tender costs (expressed as a percentage of the projects's expected total costs) are compared across different project sizes and the following procurement routes:

1. PFI (Based on average costs from a confidential survey of major contractors' tender costs for a number of major transport, health and prison projects)
2. Single stage Design and Build
3. Traditional Procurement
4. First stage of two stage Design and Build

There are two key points to note from the comparison of tender costs. Firstly, PFI tendering costs are well in excess of the average tender costs of other procurement methods—whatever the project size. Furthermore, the PFI tender costs are likely to be underestimated because many of the survey estimates represent the tender costs involved in achieving preferred tenderer status only. In tendering for large health and prison projects for example, contractors have estimated the full tendering cost to be above 2 per cent of the total project cost. Table 1 below shows that even using simple averages of the partial costs, PFI tender costs are some 955 per cent greater than alternative forms of procurement; and for projects over £100m in value, some 1828 per cent greater.

Secondly, in contrast to other procurement methods (which benefit from economies of scale), PFI tender costs (as a proportion of total costs) are an INCREASING function of project size.

Figure 1 Tender Costs

Sources: BEC Survey and Constructing The Team (Sir Michael Latham)

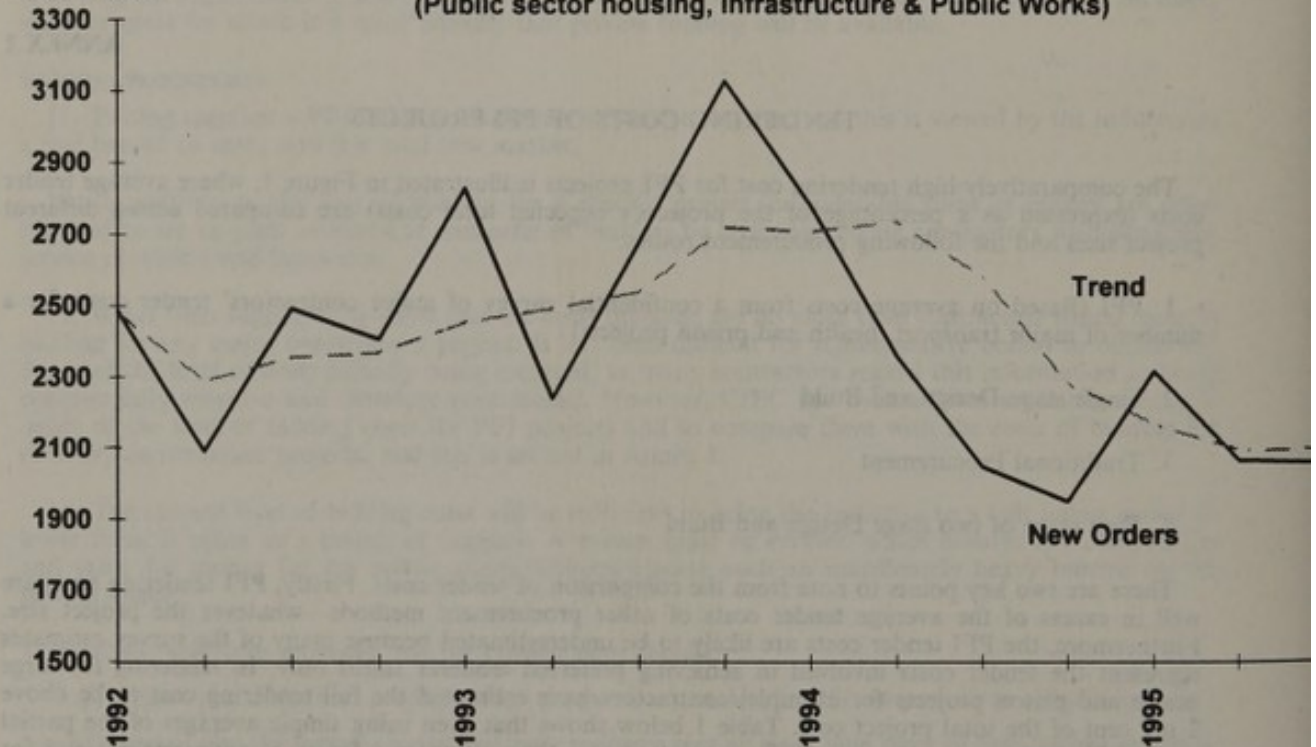
Appendix 2

ANNEX 2

£M Constant
1990 Prices

Volume of New orders

(Public sector housing, infrastructure & Public Works)



Source: DoE

Table 1

(Unweighted) Average Tender Costs (As % of Total Costs)—Across all Project Sizes

PFI	0.79%
Design & Build	0.22%
Traditional	0.09%
D&B (Stage 1)	0.10%

APPENDIX 16

Memorandum submitted by the Freight Transport Association

FTA welcomes the Private Finance Initiative as a means of providing greater investment in transport infrastructure and in particular roads through the "Design, Build, Finance and Operate" (DBFO) arrangements. It has, however, a number of concerns over the sustainability of the PFI concept when applied to infrastructure projects.

FTA regrets that any private finance which is forthcoming will be a substitute for public investment in transport infrastructure and not additional to it, as originally promised by Government. Private financing of transport infrastructure to date has been confined to tolled estuarial crossings where the risk of traffic diverting to avoid payment is low and the rate of return virtually assured.

Such certainties do not arise with conventional roads where diversion to untolled routes would be difficult to prevent and their market capture could not be guaranteed. Comparison with PFI projects to date is not therefore valid.

Furthermore a proven means of reliably and accurately collecting or debiting tolls from road users has not yet been demonstrated. The commercial attractiveness of road schemes to a private investor is substantially weakened by the absence of an identifiable and ringfenced revenue stream.

In the absence of direct revenue from users the Government proposes instead the payment of "shadow tolls" to investors in road schemes. These payments would be made out of the public finances over the duration of the project regardless of the actual level of usage of the road. No direct transfer of money from user to investor is envisaged.

The vulnerability of these payments to changing Government spending priorities is a source of risk the investor and tangible assurances about the security of such payments will need to be provided in order to remove this risk and encourage take up by the private sector.

Given limited Government spending the scope to fund private road schemes through shadow tolls is ultimately limited to the sum currently directly invested in roads as capital programmes. This limit will prevent the take-up of projects which cannot be funded. It is questionable whether such schemes meet the basic criterion for PFI projects, namely that there is a transfer of risk from the public to the private sector.

Rather the DBFO concept merely provides a means for Government converting a capital investment into a long term revenue expenditure. As representatives of the users (customers) of the road network FTA questions whether this will give better value for money or any greater assurance that much needed transport infrastructure projects will get built.

THE FREIGHT TRANSPORT ASSOCIATION

The Freight Transport Association represents the freight transport and distribution interests of UK industry. FTA's 12,000 members range from multi-national manufacturing companies to small businesses operating only one or two vehicles. Most of the freight moved by rail, and substantial deep-sea and air cargo tonnages, are consigned by FTA members.

In relation to the provision of transport infrastructure FTA members are the industrial users of roads and railways. They are customers of the agencies, whether publicly or privately owned, who design, build, finance and operate roads and railways.

APPENDIX 17

Memorandum submitted by Professor David Heald, Specialist Adviser to the Committee

THE PRIVATE FINANCE INITIATIVE: VALUE FOR MONEY AND PUBLIC EXPENDITURE CONTROL

I INTRODUCTION

UK Government policy is that '... a steadily rising proportion of capital investment in the public services should be financed by private capital, based on a proper sharing or transfer of risk' (Treasury, 1994c, para 3.28). The speed with which this may happen is indicated by Table 1.1 of the 1996-97 Red Book (Treasury, 1995b, p. 5) which projects public sector net capital spending falling from 1.75 per cent of GDP in 1995-96 to 0.75 per cent in 2000-01. 'Total publicly sponsored capital expenditure' has made its appearance as a new technical term, consisting of total public sector capital expenditure and estimated capital expenditure under the Private Finance Initiative (PFI) (Table 6.4 on p. 120).

The development of policy on the use of private finance for what have conventionally been publicly provided services now commands a high political priority. This is clearly related to the 'hollowing out of the core state' (Rhodes, 1994) which has resulted in rapid and extensive changes in modes of public service delivery. Much of traditional government activity is being taken outside general government, with the associated financing flows for purchasing and/or formula funding being scored within General Government Expenditure. This transfer of service provision is both to the private sector and to a growing quasi-public sector in which the delivery organisations are often constituted as private sector bodies, though remaining tightly government controlled. Developments since 1989 appear to mark a decisive shift in policy towards what had until then been widely regarded as the continuing core of the public sector. The Government has sought to identify in the PFI an extension of the privatisation policies which it judges to have been so successful in the formerly nationalised sector. Increasingly, private finance is being presented as being about a fundamental change in the approach to public services, going beyond assessments of capital and operating costs for particular projects to wider and longer-term perspectives on the nature of the project, the nature of the service and the potential for future change (Clarke, 1993). The role of private finance in public services has been elevated to one of 'fundamental belief' (Department of Transport, 1993, para 7).

Economic evaluation of government policy initiatives such as the PFI often confronts two difficulties. First, there may be ambiguity about objectives, partly because these are conflicting and partly because spoken and unspoken motives may differ. Second, the predicted consequences of a policy initiative may depend not only upon the model of the economy to which policy-makers subscribe but also upon the model of the political process which is considered to be relevant. For instance, evaluation of the use of private finance for public projects depends crucially upon empirically verifiable economic magnitudes (e.g. efficiency gains and higher financing costs) and upon judgements about the political process (e.g. whether the desire for higher infrastructure spending, thought to be frustrated by macroeconomic constraints, will lead policy-makers to shield private investors from risk).

II IDENTIFYING THE KEY ISSUES

A helpful starting point is to note that the Treasury approaches the issue of private finance from three different perspectives: macroeconomic policy because of the scoring of publicly financed projects in macroeconomic aggregates which figure prominently in policy formulation; microeconomic efficiency because of the Treasury's responsibility for public sector efficiency; and Government political strategy due to the way in which changes in the public-private mix of the UK economy have been a consistent theme since 1979. Conclusions derived from these three approaches may not necessarily be consistent with each other (Heald, 1997). This memorandum considers only the first two approaches, though the importance of the third is undeniable.

From a Macroeconomic Perspective

When approaching public expenditure from a macroeconomic perspective, it is natural to think in terms of decisions being taken politically about public expenditure aggregates and perhaps, but not necessarily, about the proportion which will be public capital expenditure. Top-down decisions having been taken, it will be left to decision-makers to optimise within their own policy sectors. Global optimisation, between the public and private sectors or across the whole of the public sector, is not feasible as a decision-making rule. However, over the medium term, there ought to be an iterative process which leads to modified judgements about the desirable private/public balance in the light of information about, *inter alia*, relative returns.

One key aspect of macroeconomic balance is the need to avoid an excessive expansion of public investment so as not to crowd out private investment. An important insight is that private investment is just as likely to be crowded out by privately financed public projects as by publicly financed public projects. The Treasury does not consider that the use of private finance to replace public borrowing will have macroeconomic effects measurably different from those of public finance:

The well developed system of capital markets in the UK, with the access to global markets, means that a wide range of funds is available to both Government and to private promoters to finance UK-based projects. It is possible that private promoters may be able to tap some funds which would not normally be used for gilts. But no *measurable* differences in macroeconomic effects are likely to follow (Treasury, 1993a, p. 13, italics added).

This statement prevents reliance by the Treasury upon a macroeconomic justification for using private rather than public finance. However, this characterisation of the policy problem is disputed both by some opposition politicians (Brown, Cook and Prescott, 1994) and by some providers of private finance (Hancock, 1993). Moreover, spending ministers in the present Government often rely explicitly upon 'the shortage of public funds' or 'the shortage of public funds on a relevant timescale' when they justify recourse to private finance for capital projects.

Extensive use of private finance for public projects would necessitate a reconsideration of existing data on the fiscal deficits of governments. This is particularly important in the context of European economic integration owing to the commitments undertaken through the Maastricht Treaty whereby member states have pledged themselves to 'avoid excessive government deficits', interpreted as ceilings of 3 per cent for the ratio of the government deficit to GDP at market prices and of 60 per cent for the ratio of government debt to GDP at market prices. To be meaningful, cross-sectional comparisons must take account of the different economic and institutional structures of member states within the European Union. In the United Kingdom, public capital expenditure is scored against the Control Total, GGE and the Public Sector Borrowing Requirement (PSBR) according to the control status of the organisation; for example, External Financing Limits (EFL) contribute towards the PSBR. Extensive use of private finance for public projects would necessitate a reassessment of how the PSBR and the Public Sector Financial Deficit should be measured and interpreted. More general issues are raised, relating to wider debates on how fiscal deficits ought to be measured (Blejer and Cheasty, 1991) and on how government contingent liabilities, whether derived from loan guarantees or from the structuring of government funding, ought to be valued (Towe, 1991). The fiscal rectitude obligations entered into under the Maastricht Treaty render comparability of fiscal data more important, and also create powerful incentives to structure transactions in ways which evade those constraints. Moreover, there are obvious dangers in concentrating attention exclusively upon reported indebtedness, to the neglect of measures of the public sector's underlying net worth.

From a Microeconomic Perspective

It has long been recognised that government can borrow cheaply because it has access to tax revenues; lenders to government do not have to be directly concerned with the quality of its projects. There are two distinct sets of circumstances which can lead to the adoption of low public sector discount rates: the ability of the Treasury to borrow more cheaply than the private sector; and acceptance of the theoretical rationale, extensively developed in the social discount rate literature, for a discount rate based upon social time preference rather than opportunity cost.

Nevertheless, the Treasury's view, articulated within its guidance on public sector investment appraisal (Treasury, 1991; Spackman, 1991), has traditionally regarded the marginal opportunity cost of capital as the relevant discount rate in public sector decision-making. In order to prevent the public sector from becoming overexpanded because of access to cheap capital, the Treasury has shadow priced capital, by means of mechanisms such as the Test Discount Rate and the Required Rate of Return, set at levels well above government financing costs. There ought to be a parallel concern that certain organisations, whether classified as belonging to the public or private sector, can borrow 'cheaply' from private sources because of their 'closeness' to government, whether through contracting or grant arrangements. It may be advantageous for an organisation to opt for private finance provided that its actual cost is less than the shadow cost of public capital. The Treasury recognised this point by requiring project appraisals following standard procedures, including the shadow cost of capital (Treasury, 1989, as amended 1992, para 29.1.17); effective enforcement within a fragmented public and quasi-public sector has always seemed doubtful.

Whereas EFLs are often discussed in terms of being manifestations of macroeconomic constraints, it is also important to note their microeconomic role as a mechanism designed to secure cost reductions. One justification for tough EFL controls, much stressed by the Treasury (Byatt, 1984), is that they provide general pressure to enhance cost efficiency, thus releasing internal resources for, *inter alia*, capital projects. The corollary is that any relaxation of such pressure, say due to the ready availability of private finance, might weaken the incentives for cost reduction.

Recourse to private finance for public projects is often claimed to lead to better executed projects (Ryrie, 1989) and thus to enhance microeconomic efficiency. Those advocating the use of private finance contend that these efficiency gains outweigh the higher financing costs associated with private borrowing. This argument is rarely empirically documented, and is normally asserted to be a consequence of the better incentive structures which prevail in the private sector. A key obstacle to the use of private finance in public projects is that private finance is always more expensive. Therefore, private sector financing must bring with it operational efficiency gains so that the present value of operational efficiency gains exceeds

the present value of additional financing costs. Crucially, the drive for efficiency gains is argued by the Treasury to be the transfer of risk to the private sector.

III SOME HISTORY ABOUT THE RYRIE RULES

The retirement of the Ryrie rules has tellingly been likened to 'the retirement of an opera soprano' (Beith, 1993, Q. 43). Over the period from their inception in 1981 until the first retirement in 1989, they acquired the status of Treasury bogey. The substance of the Ryrie rules was summarised by the Treasury in the following way:

- (i) decisions to provide funds for investment should be taken under conditions of fair competition with private sector borrowers; any links with the rest of the public sector, Government guarantees or commitments, or monopoly power should not result in the schemes offering investors a degree of security significantly greater than that available on private sector projects; and
- (ii) such projects should yield benefits in terms of improved efficiency and profit from the additional investment commensurate with the cost of raising risk capital from financial markets (Treasury, 1988, annex).

These rules are best understood in terms of their origins.

Prior to 1977, all the capital expenditure of nationalised industries and public corporations was scored within public expenditure and thus contributed towards the PSBR, even when wholly financed from internal resources derived from user charges. The 1977 redefinition of public expenditure and the 1978 White Paper on nationalised industries (Treasury, 1978) switched the focus of control to the EFL, the cash limit on external financing. During the recession of the early 1980s there was much public debate as to whether restrictive EFLs, designed to hold down the PSBR as a means of controlling money supply growth, were frustrating profitable nationalised industry investment and thus needlessly exacerbating the recession (Treasury and Civil Service Committee, 1981). The specific question of the conditions under which nationalised industries might have access to private finance was the topic of a National Economic Development Council report, prepared by a tripartite Committee chaired by Sir William Ryrie, then the Second Permanent Secretary of the Treasury (Ryrie, 1981).

Despite their origins having been specific to the nationalised industries, the Ryrie rules were subsequently taken to be a statement of the Treasury's position on the use of private finance across the public sector. In a speech on private finance for roads, John Major, then the Chief Secretary, stated that:

... the view often prevails that 'the Treasury' or 'the Ryrie Rules' are a huge stumbling block to greater private sector participation in the infrastructure. The Ryrie Rules are thought to be incomprehensible, and to hamper private finance by setting impossible hurdles ... (Major, 1989, p. 1)

David Willetts MP wrote in 1993 that:

Ten years ago, as a junior Treasury official, the author helped to formulate and enforce the Treasury's rules on private finance for public projects. The Treasury's objective then, though not always openly stated, was to stop such schemes. The notorious Ryrie rules were a tease—the conditions they set for private financed projects were not intended to be met in practice (Willetts, 1993, p. 5).

In that same speech in Glasgow to the Institute of Directors (Major, 1989), John Major formally retired the 'obsolete' Ryrie rules. The second retirement came when the then Chancellor of the Exchequer used the occasion of his 1992 Autumn Statement (Treasury, 1992a) to announce 'important changes' (Treasury, 1992b, p. 1) in the rules governing the use of private finance by public sector organisations (Treasury, 1992b,c). Although the sequencing of these changes is itself of interest (Heald, 1993), the exposition here concentrates solely on the cumulative effect:

- (1) the value-for-money criterion has been modified, by the delineation of categories of privately financed projects which will no longer be tested against hypothetical public sector alternatives and by restricting its application only to the public sector contribution to privately led projects;
- (2) there has been a substantial relaxation of the Treasury's declared stance on additionality, from the 'normal presumption' of a one-for-one reduction in public sector allocations (unless there is an explicit policy decision to the contrary) to the post-1992 situation in which only the public sector contribution is scored against the public sector allocation. Even this leaves open long-term feedbacks on allocations, with the Treasury netting off forecast levels of private finance when determining allocations for planning years;
- (3) there has been a loosening of the rules on how leases are scored against allocations; and
- (4) Higher Education Institutions (HEIs) can now borrow on the security of Exchequer-funded assets; these borrowings, which might be large, will be outside the PSBR and may establish a precedent.

The following presentational change has been made:

- (5) the Treasury no longer volunteers the argument—though it confirms the argument when directly questioned—that the private sector will be tapping virtually the same pool of finance as itself, albeit more expensively, in order to finance privately financed public projects.

The following substantive ruling has remained unchanged:

- (6) the Treasury continues to insist that there is a genuine and significant transfer of risk from the public sector to the private sector.

IV ADDRESSING THE KEY ISSUES

This section addresses issues identified above as fundamental to policy evaluation: modifications to the value-for-money criterion; additionality; measurement of efficiency gains and additional financing costs; determining whether risk has been transferred; and erosion of public expenditure controls.

Modifications to the Value-for-Money Criterion

The first issue concerns the reference comparison. The objective of investment criteria in the public sector has been to achieve 'best' value for money for the taxpayer/citizen. For this to be achieved, there requires to be an unrestricted choice of alternative projects, including those which are privately financed and those which are conventionally Exchequer-financed. A classic statement of the Ryrie rules presented the choice between conventional and private finance in the following terms:

The use of private finance instead of public finance for a specific project is justified if, and to the extent that, it provides the *most cost-effective solution*. Publicly and privately financed investment options should therefore be compared using standard investment appraisal techniques. When comparing public and private finance options, the appraisal will take account of differences in financing costs; and the fact that transferring to the private sector the risk of project overruns, or a failure to secure the benefits of the investment, may provide a strong incentive to the private contractor to achieve greater efficiency than would be achieved by the public sector. The risk of losses—unprotected by public sector guarantees—is at the heart of market disciplines and the assessment of these extra incentives provided for the private contractor is a key element (Treasury, 1988, para 10, italics added).

The wording here is important: it stressed the search for the 'most cost-effective solution' which must necessarily involve a comparison of the privately financed project against the best available publicly financed alternative.

The successive 'retirements' of the Ryrie rules in 1989 and 1992 modified this value-for-money criterion, most particularly by setting up different categories of project which will be treated differently. The 1989 retirement differentiated two categories:

- 1 'where the private sector takes full responsibility for success or failure of the project: enterprises like the Channel Tunnel—*where the private sector is genuinely in charge*, and in competition, with all the benefits, and risks, that brings and where the return does not depend on income assured by Government contracts, subsidies or guarantees'; and
- 2 'where capital costs are privately financed but the taxpayer's interests are still directly or indirectly engaged. For example, for one reason or another the Government may carry the ultimate liability if the scheme goes wrong' (Major, 1989, p. 3, italics in original).

For category 2, where 'we must safeguard the taxpayer's interests as well as the user's', privately financed projects must 'offer better value for money than the publicly funded alternative' (Major, 1989, pp. 34). The 1992 retirement sub-divided category 2 into 2A and 2B:

- 2A '... if the private sector is wholly responsible for a project which needs Government approval and can recoup all its costs by charges at the point of use, comparison with a theoretical public sector alternative will not be needed ... Under the current rules a comparison has generally been required if a project is one the Government might have undertaken itself' (Treasury, 1992b, p.1); and
- 2B where this condition does not hold.

The value-for-money test was significantly weakened by this two-stage process: projects in category 1 have been reassigned to the private sector, and those privately financed projects falling in 2A will no longer be tested against hypothetical public sector alternatives. Thus, one might envisage an implied certification procedure, whereby the Treasury agrees with a policy ministry's assessment that the public sector alternative to a category 2A project would 'never' be financed.¹ This modification may be

¹ Something like this had already occurred in the case of the Skye bridge:

The bridge received the blessing of Highland Regional Council only after the Scottish Affairs minister, Lord James Douglas-Hamilton, said that there was no possibility of a toll-free bridge for at least 20 years (Johnston, 1989). The Skye bridge and the Birmingham Northern Relief Road (BNRR) have been cited as specific examples of 'projects' which met whatever replaced the Ryrie Rules and therefore proved acceptable following that retirement, between 1989 and the Autumn Statement 1992' (Beith, 1993, Q.43; Dorrell, 1993, Q.43).

characterised as a willingness to accept 'good' rather than 'best' value for money. Clearly, the delineation of categories 1 and 2A might result in a significant expansion of privately financed infrastructure sustained by tolls on use.

The traditional formulation of the value-for-money test seems now to have been effectively abandoned. The guide to the PFI, published just after the November 1995 Budget (Treasury and Private Finance Panel, 1995, p. 21), contains a diagram which shows that a test against a public sector comparator is not required if that would not be 'available in a similar timetable'. For all practical purposes, a test against a comparator is no longer required for projects in category 2B provided that the department or public body can plausibly claim that there is no available public capital allocation. The only safeguard is that the project will be put out to competitive tender. The resulting PFI project is the best of the alternatives which were left in the comparison, but not necessarily the best value for money. There is an obvious question—which ought to be worrying departments and Accounting Officers—as to whether the National Audit Office and the Public Accounts Committee will accept that this is a legitimate narrowing of options. In any case, the credibility of the public sector comparator will be undermined by the loss of in-house expertise consequent upon collapsing capital budgets. Moreover, a public sector manager is likely to claim that a PFI project is best value for money, provided that his/her organisation would be better off with, say, a PFI hospital than no new hospital at all.

The second dimension of policy change is that, 'where the private sector is a major partner', the value-for-money test will not refer to the project as a whole (that will be the private sector's responsibility) but only to the public sector contribution to the project (where that occurs):

If the public sector secures good value for money for the contribution that it makes to a project where the private sector is a major partner, then that should satisfy our prudential criteria. That is the major change that we sought to introduce and we are seeking to introduce as a consequence of what the Chancellor said in November (Dorrell, 1993, Q. 6).

The Government's remit thus narrows, from an earlier focus upon the economy as a whole to an exclusive concern for public funds. This narrowing of the Government's value-for-money test, from the project as a whole to the government's own contribution, is clearly a significant move, though one which has not been made anything like as explicit in Treasury guidance as it was in the then Financial Secretary's evidence to the Treasury and Civil Service Committee.²

The third issue concerns the nature of the benefits which flow from particular projects, notably concerning the extent to which they yield cash flows to the infrastructure operator. The issues can most readily be focused by identifying four possibilities: A, publicly financed untolled road; B, privately financed untolled road (remunerated via shadow tolls); C, privately financed tolled road; and D, publicly financed tolled road. Although tolling is regarded as a means of facilitating private finance, the effects should be distinguished. The current thrust of transport policy is to move from A to C. Although economic appraisal should make six pairwise comparisons, the 1992 establishment of project categories 1 and 2A means that only alternative bids for C are now judged relevant.³ A consequence of tolling is that projects which primarily yield non-monetary flows of benefits, such as time savings to non-users or environmental benefits, may be neglected, as greater priority becomes attached to projects whose benefits can be transformed into revenues. The pattern of infrastructure spending might significantly change, with greater emphasis being placed upon the revenue-raising potential of schemes and away from cost-benefit considerations (such as time savings not capturable by tolls, and environmental costs and benefits). Ownership will affect tolling policy, as the private operator is explicitly encouraged to maximise profitability (Cope, 1993) whereas public operators have traditionally subordinated profitability to perceived wider economic, social and political benefits. In order to mitigate some of the effects of tolling and ownership change, the Government might use capital grants to signal its valuation of the social and environmental benefits attached to particular schemes or designs. For example, the accepted tendered design for the Skye bridge has been much criticised on aesthetic grounds; it would have been possible for the Scottish Office to offer a capital grant to cover the difference between the capital cost of the commercially chosen bridge and an aesthetically preferable bridge. A reluctance to make such capital grants is partially explained by the fact that these are scored against public expenditure allocations in the year in which grant is paid.

² The current edition of the Treasury's Green Book on investment appraisal methodology (Treasury, 1991) which predated this narrowing of the value-for-money criterion, provides no guidance on how the value for money of a government contribution should be assessed. It is difficult to envisage how this can be done in isolation from an assessment of whether the project as a whole is economically viable.

³ By accident of timing, information is available for the BNRR concerning the loss of benefit due to the decision to adopt tolling:

Under the old policy the Government, before deciding to proceed with BNRR, assessed the economic benefits of the proposed scheme and compared it with a publicly financed tolled road and a publicly financed untolled road. This assessment showed that, on a conventional COBA [cost-benefit analysis] assessment the MEL [Midland Expressway Limited] scheme gave discounted overall benefits of £195m at 1988 prices amounting to a ratio of present benefits to present costs of 2 (£385m over £190m). A publicly financed untolled scheme gave broadly comparable figures. The 1988 public untolled scheme gave discounted overall benefits of £350m (a ratio of 3, or £525m over £175m) (Department of Transport, 1994, para 16).

Such C:A and C:D comparisons are no longer made. The Department of Transport 1994, (para 19) advised the public inquiry that 'The best guide to the benefits of private finance in terms of additional resources is to consider the effects of proceeding now with BNRR as a public untolled scheme'.

The fourth issue concerns the distinction between free-standing facilities and those which constitute parts of larger integrated networks. When free-standing, the credibility of the bankruptcy threat is substantially enhanced. However, private owners of such infrastructure assets may possess substantial monopoly power. The difficulties inherent in long-term forecasting of the usage of long-lived assets raises particular problems; the Government has emphasised that infrastructure contracts should be put out to tender, but has not yet clarified whether price regulation might be envisaged.⁴ When part of a network, the privately financed link may be vital to network efficiency, thus weakening the credibility of the bankruptcy threat. When a tolled facility runs parallel to an inferior untolled facility, there is the question of whether assurances have been given to the private promoter that the untolled facility will neither be upgraded nor reprovided.⁵

ADDITIONALITY

Additionally is the term used in public expenditure contexts in order to pose the question whether a policy initiative leads to higher expenditure than would have occurred in its absence. Statements about 'additionality' are notoriously difficult to evaluate, because there is no counterfactual benchmark of what would otherwise have happened; this has been a fraught issue regarding European Union aid to projects and programmes in disadvantaged regions. Whether additionality is perceived to be desirable depends upon how the policy problem has been defined, and which constraints are perceived to be binding; for example, whether there is a 'shortage' of public finance for 'worthwhile' projects. Moreover, the Treasury has always explicitly linked the issue of additionality to the need to control the size of the public sector and to determine priorities rationally within pre-established totals. In the particular context of private finance for public projects, the key issue is whether recourse to private finance leads to higher spending in that 'policy' area, or is instead accompanied by offsetting reductions in public finance. An inhibition against the use of private finance has been the concern of government departments and public sector managers in general that recourse to private finance as a means of increasing capital expenditure would be frustrated by offsetting reductions by the Treasury to their public sector allocations. There are therefore two aspects: the continuing desire of the Treasury to ensure that public finance is directed towards the areas which have the highest return, and the incentive effects of offsetting private finance against public expenditure allocations.

There has been strong Treasury opposition to what might reasonably be characterised as non-policy driven additionality. In those areas of the public sector where there is a mixture of public and private provision, the investment expenditures of competitive private sector suppliers will shape the Government's decisions 'over a period of time, [about] how much the public sector needs to do in the same area' (Treasury, 1988, para 15). Strengthening Treasury reassurances after 1989 that there would be (some) additionality (Treasury, 1993d) were clearly designed to counter the view that '... there is no point in promoting privately financed roads because the Treasury will simply claw it back by reducing public expenditure' (Major, 1989, p.5). Nevertheless, the 1996-97 Red Book (Treasury, 1995b) demonstrates clearly that programmes deemed particularly suitable for the PFI are also those likely to suffer most from the cutbacks in public sector net capital spending. On transport, for example, the PFI has become substitutional rather than additional, with the public allocation cut in anticipation of growing PFI spend (p.121).

Measurement of efficiency gains and additional financing costs

The case for recourse to private finance hinges pivotally not only upon the existence of efficiency gains but also upon their magnitude being sufficient to offset the higher financing costs. The UK Government borrows more cheaply than private borrowers:

while we cannot ignore the fact that the Government can raise money relatively cheaply because it is a large low-risk borrower, we must also take account of the benefits that tend to go with private finance, such as improved efficiency, low costs, and reduction in the risks falling on the taxpayer ... (Major, 1989, p. 4)

The Treasury has not attempted to quantify the efficiency gains through better construction and operation which are believed to be achievable through the use of private finance for infrastructure projects because:

... the size of the efficiency gains would depend on the particular characteristics of individual projects. The use of private finance would sharpen incentives to control risk and achieve an adequate rate of return (Treasury, 1993a, p. 13).

⁴ 'It may in some cases be appropriate to impose separate regulatory controls...' (Treasury, 1992c, para 14). Policy is developing on a case-by-case basis. Whilst tolls on the BNRR are unregulated 'since there are alternatives—the local toll-free roads and the government operated motorway network' (Department of Transport, 1993, para 6), tolls on the Dartford crossings are linked to the RPI since the 'undertaking ... represents a local monopoly' (Department of Transport, 1994, para 4).

⁵ The Scottish Office instructed the nationalised Caledonian MacBrayne to withdraw its ferry service from the date of the opening of the Skye bridge.

Ministers and civil servants assert that there will be efficiency gains because of the inherent greater efficiency of the private sector, and that these efficiency gains will more than offset higher financing costs. Measurement is held not to be required because it is taken as a prior assumption that there will be efficiency gains; the question of whether these will be sufficient to offset higher financing costs is thus never directly addressed.

The efficiency rule is easy to state, though undeniably difficult to implement and audit. The present value of efficiency savings on construction and operating costs must exceed the present value of higher financing costs. For this efficiency rule to be operationalised, comparisons must be made between the privately financed project and a hypothetical public sector project. Naturally, the assumptions built into these comparisons will affect the results, though the fact of rendering them explicit will itself be beneficial, since exposure will test their credibility. *Ex post* project audits are also required, though there is the obvious difficulty that the chosen project has been implemented whereas the rejected project has not. A degree of caution on the Treasury's part has thus far been detectable. It has insisted that 'all proposals to use private finance to fund capital expenditure that would otherwise be the responsibility of the public sector should be referred to the Treasury', unless: that capital expenditure would be an insignificant part of total cost; the public sector's period of use of the assets would be substantially shorter than their expected lives; or the proposal would fall within the limits of delegated authority, as for leasing. Even where Treasury approval is not required, the use of private finance should be supported by a full investment appraisal following prescribed procedures (Treasury, 1989, as amended 1992, paras 29.1.16 and 29.1.17). It is unclear whether such an approach will survive the refocusing of the Treasury's expenditure divisions to a more 'strategic role' (Southgate *et al.*, 1994).

The Treasury cannot or will not quantify the additional financing costs consequent upon financing infrastructure projects such as roads, bridges and tunnels by private finance rather than by government borrowing, or quantify the interest rate differential:

Any additional borrowing costs would depend on the characteristics of the projects concerned, including the risks involved. They could therefore only be assessed on a case-by-case basis (Treasury, 1993a, p. 13).

Spackman (1991, p. 22) quoted Melliss (1991) for the conclusion that 'Bond finance for large private sector bodies typically costs up to a percentage point more than public borrowing'. This result relates to bond finance secured on the general revenues of government and large private borrowers, whereas much private finance in public projects is implicitly of a non-recourse nature, its security depending upon the success of particular projects. Given the confidentiality which attaches to loan arrangements, systematic evidence about the additional cost of private finance can only be produced by the Treasury or, with a considerable time lag, the National Audit Office. There may be cases in which the Treasury does not know the private promoter's financing costs, only total costs. For project comparison purposes, this suffices. Nevertheless, there remains the concern that the private promoter's cost of capital, due to a perceived 'closeness' to government sheltering it from risk, may be less than the Treasury's assessment of the opportunity cost of capital.

Given the present momentum of the PFI, there is a crucial need for evidence about value for money. The PFI has been given a very hard sell by its proponents, with undocumented claims being made (eg at the PFI 'roadshows') that there have been spectacular savings in the region of 20–25 per cent compared with the public sector comparator. The two key issues at this juncture are: whether claims of efficiency gains can be substantiated in independently conducted post-audits of projects; and the provision of firm evidence about the costs of capital relevant to various kinds of PFI project (which will depend, *inter alia*, on debt structure and the extent of risk transfer).

Determining whether Risk has been Transferred

The constant feature within Treasury policy on private finance has been the insistence that risk must be transferred to the private sector because such a transfer is the mechanism which secures efficiency gains. In order to demonstrate that risk has genuinely been transferred to the private sector, it is necessary to show that such a transfer is not undermined by mechanisms which allow the private lenders to evade risk. Such mechanisms include government guarantees of private borrowing, contracts for lifetime output, guarantees against financial loss from operations, and funding devices (such as the structuring of grant systems). The Treasury (1993b, p. 13) has explicitly recognised that the structuring of grant finance so as to avoid private lenders facing risk is the equivalent of a government guarantee. Whilst explicit government guarantees are currently rather unlikely, the possibility that risk transfer is frustrated by other mechanisms deserves careful attention. It is necessary to distinguish between the formal position as legally defined and the informal reality as defined by economic, social and political considerations. For example, the subsidiaries of multinational companies may borrow without a parental guarantee, and a public authority may borrow without an (explicit) government guarantee, but, in the event of default, the parent or government would ponder carefully the reputational effects of lenders losing money, and the effect on their own capital market ratings. Implicit guarantees may therefore be attached, even when

explicit guarantees are absent or indeed vigorously denied. It becomes a matter of judgement as to whether the present Government and its successors would allow default and bankruptcy.

In cases where some risks have clearly transferred, some residual risk may attach to the public authority. A private firm which has lost all its capital may abandon a project. There is a spectrum of possible outcomes, running from government being afforded the opportunity to acquire a privately financed asset at a distress price, to it becoming embroiled in the potentially expensive task of having to secure project completion through other means. It is clearly relevant whether the project is free-standing or part of a network, and whether the public authority has continuing/reverted statutory obligations to fulfil. Cases may arise when the consequences of 'doing nothing' are judged to be politically unacceptable, resulting in the failing firm being rescued either by direct government intervention or via a funding/purchasing agency. There is also the question of what assurances are given to the private sector concerning compensation which would be payable in the event of fundamental policy change: for example, less requirement for prison places due to more lenient penal policy, or lower traffic growth due to an environmentally induced increase in petrol taxation. Such protection from future exigencies might greatly exceed the insulation available in the 'conventional' private sector. In turn, the front-loaded public expenditure costs of policy change might be greatly increased.

When capital grants finance a substantial part of the capital cost of a marketable asset and the private lender is allowed to secure loans on the full asset value, there is a ready-made non-transparent way of sheltering the private sector from risk. Grants can be structured in ways which create a huge divergence between the formal and the effective incidence of risk, as in the case of Housing Association Grant paid from the Housing Corporation to housing associations. Less clear-cut, delivery organisations with private sector status borrow money secured on specialised assets whose value heavily depends upon anticipated government grants and charges met by government. Certain organisations, funded by grant-in-aid rather than on the basis of Votes or EFLs, had been prohibited from borrowing privately on the security of Exchequer-financed assets. In November 1992, the Government ended the prohibition of borrowing by HEIs against the security of Exchequer-financed assets (Department for Education, 1992, p.4). Whilst this relaxation then only applied to HEIs, it undoubtedly creates a powerful precedent for other parts of the quasi-public sector (eg Grant Maintained Schools).

Another important change in 1992 was the softening of the Treasury line on leases:

The public sector will have greater opportunity to use leases where they offer *best value for money*. The capital value of leased assets apart from property is at present usually set against spending allocations unless the lease meets only a short-term need. *In future, the criterion will in all cases be based on risk*, which is also the principle underlying the relevant accounting standard. Departments and nationalised industries will be able to enter into operating leases and count only the leasing payments against their provision, provided the *great majority of the risk* stays with the private sector. This change should give a new impetus in areas such as contract energy management (Treasury, 1992b, p. 2, italics added).

In terms of public expenditure controls, the crucial point has been that the capital value of leased assets (except for property assets or non-property assets covering only a short-term need) has been chargeable against spending allocations, whether these be voted capital expenditure in the case of central government departments or the National Health Service, credit approvals/capital allocations in the case of local authorities, or EFLs in the cases of nationalised industries, public corporations or trading funds. Given that the public sector can borrow more cheaply than the private sector, this treatment for public expenditure control purposes removed one of the two main attractions of leasing, namely, to circumvent spending limits. The other motive remained, namely to exploit tax treatments of leases which are available only to the private sector lessor.⁶ How a leased asset is scored in terms of public expenditure allocations is often more important to a public sector organisation than the financial accounting treatment; there is an important distinction between being disallowed (i.e. not permitted) and being scored against spending allocations.

The Treasury's continuing adherence to the transfer-of-risk test is of paramount importance. Nevertheless, there are important participants in the policy process who publicly challenge this view. Hancock (1993), a former permanent secretary and now a merchant banker, has disputed the transfer-of-risk test:

One especially restrictive notion is that the public sector should not borrow at commercial rates—which are generally higher than the rate at which the Government can borrow—unless private finance secures benefits not otherwise attainable. This rule sounds reasonable but, in practice, prevents much-needed investment. The Government has not, until recently, been will-

⁶ The consequent loss of tax revenue would increase the PSBR and then feed back into more onerous spending limits, though not necessarily on a £ for £ basis for the programme areas where such leases have been used. The loss of tax revenue will be net of capital allowances which would have been paid on private sector projects displaced by the additional public sector project.

ing to acknowledge that the 'extra-value-for-money test' makes no sense if Exchequer funds are not available as an alternative.

... the way in which the new [1992] guidance is currently drafted implies that the central test of acceptability is the degree of transfer of risk to the private sector. This is not central; what is important is that the taxpayer is getting best value for money. There is no a priori reason why this should be secured by imposing the greatest risk on the private partner. The smaller the risk transferred to the private sector, the finer will be the terms on which the private sector will be willing to put up the money.

Hancock thereby proposed that the public sector should continue to carry the risk whilst delegating responsibility for raising finance to the private sector. Moreover, he postulated a 'shortage of public finance' as a result of macroeconomic constraints which do not affect private finance, a view which has already been shown to be unsupported by detailed argument or evidence.

Yet there has been a detectable shift in the language of Treasury documents, from implicitly presenting risk transfer as an all-or-nothing phenomenon towards references to risk-sharing. Whilst continuing to emphasise that there must be risk transfer, Sir John Cope, then the Paymaster-General, vigorously denied that 'the Government is seeking to transfer *all* risks to the private sector' and declared that 'we are looking for a *sharing* of risk, with the public and private sectors each taking on those risks which they are best placed to manage' (Cope, 1993, paras 16 and 18, italics in original). Ernst & Young (1993) attempted to disaggregate project risk into component parts as the basis for a discussion of which components should be transferred: front-end risks consisting of pre-bidding risk, bidding risk, planning risk, environmental risk and underwriting risk; and post-financing risks consisting of construction risk, operating risk, end user or market risk, political and regulatory risk and financial risk. The Labour Opposition has joined with City commentators, contending that the 'Government has proved characteristically inflexible in its approach to risk' (Brown, Cook and Prescott, 1994, p. 9); their document does not endorse the importance of risk transfer.

Erosion of Public Expenditure Controls

There are substantial dangers that recourse to private finance will be used as a means of undertaking hidden public borrowing and expenditure:

A cynic might ... interpret the government's recent promotion of private finance as a creative means of hiding the true extent of the PSBR (Institute for Fiscal Studies, 1993, p.62).

Private finance should not be used simply to get around public expenditure controls, for example to defer payments to later years because direct public funding is constrained (Treasury, 1989, as amended 1992, para 29.1.15).

... we are not interested in pure funding vehicles, and sale and leaseback arrangements, whose sole purpose is to get round our public expenditure controls. They will not pass any genuine value for money scrutiny. Nor should they. We have made it clear that we disapprove of local councils who lease parking meters. There is no room for that sort of creative accounting in Central Government (Major, 1989, p. 5).

Without a significant transfer of risk to the private sector, schemes for private finance look like an attempt to circumvent budgetary controls on public expenditure, whether by creative accounting around definitions or by retiming the scoring of expenditure.

In the 1980s, local authorities resorted to a range of private funding vehicles in order to evade public expenditure control; these unconventional means of finance involving private parties became known as 'avoidance instruments'. The only knowledge which the Treasury has of the extent of use of such instruments comes from anecdotal evidence and from approaches by local authorities facing financial pressures as a result of their use; there are no separate returns to central government of local authorities' obligations under such instruments. Peak use of avoidance instruments may have occurred before the 1987 general election, when it was reported that local authorities had massive liabilities from which they were looking for release had there then been a change of government. Such subversion of central government controls was ended by the *Local Government and Housing Act 1989* which introduced a new capital finance system in England and Wales designed to prohibit avoidance instruments; the 1980s' schemes of extended credit were still permitted, but the incentive to undertake them was removed as they now scored equally with conventional borrowing against public expenditure constraints. Although the amount of outstanding liabilities is unknown, the passage of time since the implementation of the new capital finance system on 1 April 1990 and the reluctance of financial institutions to renew existing arrangements mean that this is a disappearing phenomenon. Most of the new growth of private finance is concentrated in the quasi-public sector.

Outside the Treasury, private finance is typically viewed as a substitute for public finance which is not available because of macroeconomic constraints (Ernst & Young, 1993). Yet, if the macroeconomic

effects are not measurably different, recourse to private finance does not relax any constraint on the availability of finance which genuinely originates from macroeconomic considerations. EFLs may frustrate public investment at the margin, thus imposing an opportunity cost in terms of foregone returns. However, at least in principle, the Treasury ought, in the light of the macroeconomic gains to be derived from stringent fiscal control, to be setting EFLs so as to equalise marginal returns. Similarly, the Treasury would have to reduce EFLs or equivalent allocations by an amount equivalent to the use of private finance in order to maintain its chosen macroeconomic stance. The use of private finance therefore does not release macroeconomic constraints, despite the claims of its advocates:

If the [private finance] initiative succeeds, it will produce more investment than the Government can afford in much-needed capital assets such as community health centres, day surgeries, roads, railway carriages, signalling equipment and bail hostels. *There is, fortunately, a limit to the amount of tax that the Government is willing to impose; and public borrowing is already too high.* If some public investments are privately financed, and added to what the Exchequer is able to fund, the consumer of public services will benefit (Hancock, 1993, italics added).

This list of 'much-needed capital assets' includes those for which charges are not levied upon 'consumers', and which must therefore be financed by taxes or public borrowing, both of which are stated to be constrained. In such circumstances, private finance can only alter the time profile of public expenditure scoring. Although user charges do provide a means of servicing the private finance, taxpayers may resist paying both an existing level of taxes and newly introduced user charges.

This evident circularity has encouraged the view that the Treasury's use of rules is insincere, using them primarily to block things which the Government does not want to happen on other grounds. This apparent lack of even-handedness in application naturally increases the willingness of opposition politicians to consider redefining those rules (Brown, Cook and Prescott, 1994). Moreover, due to their timing, recent developments concerning private finance can be characterised as a hidden form of activist macroeconomic policy:

... the construction industry is in a truly dreadful state and you have got to think of some ways in which it can be resuscitated and to think of some more or less respectable argument for providing them with what may be rather more expensive finance ... the irony is that by the time you have finally worked out both the principles and practice of this system of private financing it is highly likely that the cycle of economic activity will have changed and once again you will have to think of some apparently important principle which will then make it more difficult for private finance because you will be told by those who manage the economy that this type of financing is inappropriate in circumstances of some strength of the economy (Budgen, 1993, QQ. 8-9).

These quotations illustrate a clash of perceptions as to the true purpose of recourse to private finance, relating in part to how the PFI has been presented and in part to the conflicting interests of participants. Perceptions as to the rationality of public expenditure constraints depend crucially upon the vantage point of the perceiver; that is just as true now of the central government departments and quasi-public sector bodies who are main users of private finance in the mid-1990s as it was of local authorities in the mid-1980s. Irrespective of judgements about the microeconomic gains, there is a compelling case for securing transparency as public expenditure control systems have an inherent fragility.

23 January 1996

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APPENDIX 18

Memorandum submitted by HM Treasury

MONITORING THE REVENUE CONSEQUENCES OF PFI

The particular role of the Treasury's Private Finance Unit has been to concentrate primarily on getting PFI established and working across the public sector. Individual Treasury expenditure teams work with their respective departments to ensure that each of them takes full account of the forward revenue consequences of PFI projects for which they are responsible in their public expenditure plans. This was done most recently in the run up to the last Budget. While PFI contracts have expenditure implications beyond the 3 Survey years this is by no means unique to this way of delivering public services and something departments are used to taking into account.

Nevertheless, as PFI begins to take hold, the Treasury recognises the importance of monitoring more systematically by department the aggregate expenditure implications into the future of agreed PFI contracts. The Treasury will be putting new arrangements in place before the next public expenditure survey is completed.

Mr Hogg mentioned monitoring arrangements operated by Newchurch for the NHS. These provide a wealth of detail about PFI activity in the health field, including revenue consequences. However, their primary purpose is not to provide comprehensive information on future expenditure obligations.

5 February 1996

APPENDIX 19

Memorandum submitted by Ms Diane Dawson, Corpus Christi College, Cambridge

1 THE COST OF CAPITAL

In April 1989 the Government announced they "... have decided that the discount rate to be used in the non-trading part of the public sector should be based on the cost of capital for low risk purposes in the private sector. In current conditions this indicates a rate not less than 6 per cent in real terms." Treasury analysis (Spackman, 1991) suggested a likely public sector cost of capital at 4 per cent or more and private equity at 7 per cent at most. The last review by OFWAT of the cost of capital to the water companies (private sector but extremely low risk, difficult to distinguish from gilts) put the cost of private sector capital at 5-6 per cent. NHS Trusts are expected to show a 6 per cent return on capital.

The fact that the State can borrow at lower rates than private companies is obviously true but the implications of this fact for the economic consequences of substituting private for public capital in the NHS have generally been misunderstood. First, it does not follow that a higher cost of capital leads to higher NHS service costs. If public procurement policies prevent organisations using public sector capital

from securing the most efficient scheme, it is possible total project costs with private finance will be lower even though one element of cost, the cost of capital, is higher (see Section 2 below). Second, it does not follow that substitution of private for public capital leads to less investment in public services. The old "crowding out" debate assumed all projects with a positive net present value when discounted at the cost of capital would be undertaken. Where the public cost of capital was lower than the private this assumption implied the marginal return on investment in public sector projects was less than that on private sector projects and any move from public to private finance would reduce investment in public sector projects until returns were equalised. This "crowding out" analysis is not relevant to the current PFI debate. It ignores the non-price rationing of capital in the public sector that arises from arbitrary limits on the PSBR. Where it is the case that not all projects are to be undertaken that have a positive NPV when discounted at the cost of capital, all projects should be ranked and the rate of return on the last project that it will not be possible to finance used as the relevant discount rate. We do not know what this effective marginal rate of return is in the UK public sector. It may be significantly higher than the rate of return required by the private sector (logically it must be higher if private sector firms are willing to undertake projects the public sector rejects or postpones given the PSBR constraint).

The discussion of PFI in terms of differences in the cost of capital has been something of a red herring. The real issues are those of total project cost and capital rationing.

2 TOTAL PROJECT COST

Construction costs and annual cash flows may not be independent of the sources of finance. Where this is true a difference in the cost of capital per se may be irrelevant. For example, if on a twenty year £1m project a public sector supplier requires a 6 per cent return and a private sector supplier a 15 per cent return, the annual cash flow required from the purchaser must generate an annual surplus of £87,000 for the public sector supplier to recover capital and earn 6 per cent and an annual surplus of £160,000 for the private sector supplier to earn 15 per cent. If the private producer can produce at costs £73,000 p.a. or more below the costs of the public supplier, the contract price tendered by the private sector supplier can be below the price the purchaser would have to pay the public supplier. It is obviously important to ask *why* costs may differ as in this example. The argument that has recently been put forward by the Minister is roughly as follows:

With private finance, design and construction of a building takes into account future running costs—e.g. to secure an improvement in fuel efficiency may require higher capital expenditure but that up front expenditure will result in lower running costs for the lifetime of the building. The sum of these two elements results in a higher NPV for the project than would have been the case if possible changes in running costs had not been allowed to influence design.

Since taking account of running costs in the design of a building is such an obvious requirement of seeking value for money in the public sector, we must ask why it is necessary to have private finance to achieve this and why we cannot do it with public finance.

The answer, unfortunately, is simple. The Treasury (short for public expenditure control rules and procedures) does not permit public authorities to minimise project costs by in effect capitalising cost savings. This year's capital allocation is independent of future revenue allocations. Authorities that voluntarily used their current capital allocation for fewer more expensive projects are unable to appropriate the later cost saving for use elsewhere in their services. The private sector is allowed to do this. Even where an authority attempts to rise above this incentive structure and puts forward capital projects based on securing "a low full life cost, rather than a lower construction cost"¹ the project would probably be rejected because public sector guidelines on allowable capital costs (£m²) would be exceeded. The Treasury handbook on PFI published with the November 1995 budget pointed out that "Public bodies which procure large capital assets using public funds typically have detailed manuals specifying, for example, the designs, materials and components which should be used. (p.41)" It stresses that PFI projects are free of these procurement procedures. Project design can look to innovative, cost savings solutions to problems that reflect local circumstances and needs.

In sum, the Minister in his 21 November speech was being disingenuous. The PFI removes the "strait-jacket" of one set of Treasury rules, the "Ryrie rules", to enable public authorities to avoid *other sets* of Treasury rules and procedures on the condition that they go private. The statement made in his speech, "Traditional building projects create an incentive for the builder to build as cheaply as possible as the long term maintenance of the building remains the client's responsibility" is untrue. Construction companies build to the contracts they are given. If the purchaser (public sector under Treasury guidelines) wants low construction costs, that is what they get; if another purchaser wants low life costs, that is what they get. Construction companies building on spec, without a contract, seek to anticipate the demands of the purchaser. Private sector purchasers seek low full life costs and therefore efficient operation is built into the design; where Treasury/NHS Estates guidelines do not allow government departments to pay now for the future savings, efficient operation is not built into the design. If we wish to enable the NHS

¹ The terminology is that used by the Minister in his 21 November 1995 speech to the Royal College of Physicians.

to undertake "low full life cost" projects we must *either* use PFI *or* change Treasury procedures to permit the adoption of value for money criteria in public capital programmes. We return to this issue below.

3 RISK SHARING

With major capital projects such as redevelopment of a hospital (or part of a hospital) the risk and degree of risk sharing depends (roughly) on four factors:

- (A) Is the site, presently owned by a NHS Trust, to be given to or sold to the private finance consortium or is the freehold retained by the NHS?
- (B) What is the duration of the leasing agreement: is it for the expected life of the facility or for a shorter period?
- (C) What are the terms determining the annual leasing payments from the NHS Trust to the private consortium: are the terms an annual sum independent of Trust income or is the payment a percentage of the income earned by the Trust?
- (D) How much risk pooling has the private consortium been allowed through "bundling" of NHS contracts and use of NHS sites for non-health related commercial development? (Note: the offered mix of NHS and non-NHS commercial development might better be analysed in terms of planning gain. The Treasury has long opposed this when used by local authorities!)

At one end of the risk sharing spectrum, the private consortium is allowed the site free of charge (freehold retained by the NHS Trust) on which it builds all or part of a hospital complex which it leases back to the NHS Trust in, say a 20 year agreement (= expected life of the facility) at a fixed annual payment. If the annual lease payment has been agreed before construction, risks associated with construction are borne by the private consortium; all risks of changes in demand and technology over the next twenty years (rendering the premises uneconomic or redundant) are borne by the NHS. This distribution of risk could have been achieved without PFI by "the traditional" system of putting a contract for construction of all or part of a hospital out to tender and ensuring that the contract agreed was a fixed price contract.

PFI was designed to go beyond this "simple" contracting for buildings only. A hallmark of current PFI policy is the "bundling" of contracts. Tenders may be for the buildings and equipment and ancillary services *and* clinical support services. (Note: this is slightly anomalous in that the competition guidelines issued this time last year by the Department of Health say NHS contracts should be "unbundled" to encourage competition!) In these cases, where the contract has been for a bundle of services, risk sharing still depends on the duration, terms and pricing of the contract. If a contract for a bundle of services is let on the basis of a fixed annual lease payment, all the risk of future labour, fuel, maintenance and other operating costs departing from forecast are borne by the private consortium and will be reflected in the risk premium on the contract price. For these more complex contracts (with their long term labour cost elements) a fixed annual leasing payment is less likely to emerge from negotiations than something like an initially agreed annual payment that is adjusted on an RPI+/-X basis for the say, 20 year expected life of the buildings. Such terms would reduce the risk exposure of the private consortium relative to the fixed price long term contract but would not alter the demand side risk of the NHS.

Whatever the terms agreed for sharing risk of changes in operating costs of buildings and other services provided by the private consortium, if the contract/lease for the building is a long term contract approximating to the life of the buildings, the risk of changes in demand or technology are still borne by the NHS. The most serious concern is that NHS resources that should be redeployed to maximise patient benefit are locked into less desirable uses. Technical change (drug therapies that reduce demand for operating theatre capacity) or population movements (reduced demand for treatment at the Trust with the PFI contract) or purchaser dissatisfaction with the quality of care at the Trust are all examples of situations where purchasers should redeploy their NHS resources but will be prevented by contractual relations from achieving this. This highlights one of the great unknowns of PFI: who has contractual relations with whom? Does a private consortium enter into a contract with an individual Trust and leave itself vulnerable to a future fall in demand for the services of that Trust or does the consortium require a contract from purchasers? Even with "traditional" capital finance, the NHS Executive has required Trusts to show that purchasers are willing to commit themselves to using proposed new facilities. Contracts between NHS Trusts and private consortia will be legally binding but contracts between NHS Trusts and NHS purchasers are not.

If the private consortium only has a contract with the Trust and the intention of purchasers to move purchasing power away from the Trust would render the Trust (with the PFI lease) financially un-viable, would the Secretary of State allow this to happen, dissolve the Trust and let the creditors, including the private consortium compete for a share of the assets of the defunct Trust? Not likely. The Secretary of State would merge the incipiently insolvent Trust with some other, transfer both assets and liabilities and the private consortium would continue to receive its annual income. In this sense the critics of PFI are right—the NHS becomes locked into paying for something over time that they do not want. But, to put the issue in perspective, the situation described above is not all that different from the reluctance of the

Department of Health to write off past capital projects that circumstances now dictate as inappropriate—purchasers are pressured into continuing to purchase from Trusts even when the purchasers consider it in the interests of patients to redirect funds elsewhere. At least with an NHS owned asset the NHS can decide to sell it whereas escaping from a lease may be expensive.

If the contract between the private consortium and NHS Trust is short-term (e.g. 5–10 years for a building with a 20 year life), the private consortium assumes part of the risk of demand changing but the NHS is now exposed to the risk that when the contract comes to be renegotiated the consortium has a more profitable use for the facilities and will not renew except at a considerably higher cost. For example, a consortium may have put up buildings on a site shared with or adjacent to an NHS hospital. When the contract comes to be renegotiated in five years time the consortium decides that use of the facilities for offices or non-NHS long stay nursing care beds is far more profitable than the rent that can be obtained from the acute Trust. The Trust loses the facilities it has been using. To assess the likelihood of this kind of situation arising we need to know about the ownership of the site and the terms on which the site was made available and any conditions in the lease that limit either party in what they can or cannot do at the time of contract renegotiation.

Where sites owned by the NHS are leased to a private consortium the ground lease can include covenants limiting the purposes to which the site may be put. In the case outlined in the previous paragraph, if the site was owned by the Trust and covenants restricted use to NHS purposes, then the private owners of the building would not be allowed to convert it into non-NHS use. If the land is not owned by the NHS, or the ground lease does not restrict future land use, the risks outlined above are very real. Leases that restrict the future use of a site will be less attractive to private investors than those that give the investor the opportunity to take advantage of changes in future market conditions and we would expect most PFI contracts to contain the option of change of use. Given processes for the allocation of annual funds for revenue expenditure, NHS Trusts and their purchasers assume the real risk of funding that cannot afford to pay the cash price required for contract renewal. Until we have more information on the terms and duration of contracts being agreed in PFI schemes, it is not possible to say anything about how risks are being created or changed in the NHS.

The same points are relevant when contemplating the consequences for a Trust of a private consortium going bankrupt. If the bankruptcy occurs after completion of the building, the status of the lease with the NHS Trust is unaffected. The creditors of the consortium cannot "reclaim" the buildings and turn out the NHS Trust (the tenants). The creditors only have the right to collect the rent. If the private consortium had gone bankrupt in the middle of construction, the project simply goes back into the public finance queue unless another private consortium can be found. If the NHS did not own the freehold of the site concerned, the bankruptcy may allow a different developer to acquire the assets of the defunct company and develop the site for some non-NHS use.

4 PUBLIC SECTOR VALUES

Ham (BMJ 2/12/95) asks "can public sector values survive Britain's private finance initiative?" What public sector values does he have in mind? Reference is often made (implicitly) to the Morrisonian view that permeated thinking on the post-war nationalisation programme: if an industry was owned by the state rather than by private individuals or institutions, employees and managers would work harder, be more concerned about the quality of their work and care more for the people who used their services (railways, coal, steel, electricity, gas, hospitals etc). It is doubtful that today many people would argue that state ownership *per se* leads employees to deliver a better service to the user. When he says we must ensure "that public sector values are not sacrificed in the pursuit of private profit" perhaps he meant that the quality of services tends to be higher if organisations are publicly owned than if they are privately owned but there is no clear evidence of this.

A somewhat different, and more important, argument has been put forward that is not related to the ownership of assets but to the "commercialisation" of activity. If the ethos of an organisation changes so that financial incentives and penalties replace good will and voluntary, co-operative behaviour, people may become less willing to engage in the kind of extra effort needed for unplanned changes in activity that any efficient organisation requires. Some have argued that the NHS though state owned is losing this kind of goodwill because of the "commercial pressures" of the internal market. Yet another possible meaning of "public sector values" relates to the perception of the public. Charities and voluntary groups may raise funds for equipment and provide voluntary services for hospitals that "belong" to the NHS but may be willing to do the same for "privately owned" facilities. Finally, the fear reflected in Ham's article may reflect the view that as the State extracts itself from the production of a service, its commitment to provide a tax financed service distributed with respect to need rather than willingness to pay will slowly diminish. (Recent experience with rural and unsocial hours bus services may be a relevant example here).

5 THE PSBR, THE CITY AND PUBLIC EXPENDITURE

The objective of the Private Finance Initiative is to remove capital expenditure on the NHS from the PSBR. The NHS is not the only public service where the Government is seeking to withdraw (albeit gradually) from responsibility for capital projects required by services that will continue to be provided

tax financed and free at the point of use. Debates about changes in the PSBR are often treated by the media as if they presage real economic impacts. This is the way PFI was presented in the recent budget. No macroeconomic model exists that suggests an increase in the PSBR to finance a hospital has any real effects on the economy different from a private consortium raising the same funds to build the hospital when in both cases the costs of the hospital will be recovered through taxation. Clearly it is not a question of the old crowding out debate. Just as with the privatised utilities, the Government (and City) are saying that it is a good thing if capital spending on sewage treatment plants or hospitals rises—as long as it does not appear in the PSBR. This is not economics, it is the sociology of lemmings in dealing rooms. If the Government announces a reduction in the PSBR because Wimpey has agreed to takeover financing the hospital building programme, “confidence is improved in the City; the pound rises!” Note that the cost of health services has not necessarily changed. Where there is direct comparison—i.e. a project that would have been financed by the public sector is *replaced* by a privately finance project, the private sector need only bid marginally below the public sector cost to secure the contract. *But this is not the type of case that requires the PFI.* Projects the PFI will enable to proceed are those that would not have been undertaken (at least in the current period) if finance had been restricted to the public sector—PFI is designed to allow projects to go ahead that capital rationing would not have allowed to go ahead if financed on the PSBR.

PFI is *not* analogous to compulsory competitive tendering (CCT). With CCT public sector units (DLOs in local authorities or departments in the NHS) had to compete against private sector suppliers for a contract *that would definitely be* let independently of which party put forward the lowest acceptable price/quality offer. PFI is designed to allow the private sector to provide a facility that the public sector would not be allowed to provide under two important circumstances. First, where public expenditure planning controls do not permit the trade-off of running and capital costs and second, where non-economic reasons for limiting the finance of capital projects by borrowing (PSBR) means projects would not go ahead *even if* they represented value for money. To the extent that existing Treasury controls on public expenditure programmes lead to under-capitalised, more expensive services than with existing technical knowledge and prices could be obtained, PFI may reduce the cost of public services. To the extent that long term contracts for facilities reduce the flexibility of NHS adjustment to changes in the demand for services, PFI may reduce the cost-effectiveness of the NHI. At present we can do nothing but speculate.

6 PRIVATISATION

Those who see PFI as an important step leading to the “privatisation” of the supply of NHS services are basically correct. There can be no logical distinction between a PFI project where the NHS guarantees to purchase a given number of sessions from a privately financed scanner with accompanying buildings and radiographers (which has already occurred) from one where the NHS purchases A&E cover from a local private hospital. The Chancellor said as much in his budget speech: “The government chooses the quality services the public require and then goes out and acquires those services from private companies with the finance and expertise to deliver.” If privatisation means the organisation of the production of services by private companies and at the sale of those services to the NHS, PFI is essential to the process: it in effect says any service that requires capital investment must look to the private sector. Competitive tendering is being extended to clinical services (Stonehaven are there better examples?) As PFI is about the bundling of contracts, there is nothing to rule out a company simultaneously bidding for both the PFI and clinical services contracts. To rule this out would be to deny the Government’s PFI logic: if the same company must run buildings and services they will reduce the costs relative to the situation where two separate contracts are let. (Note; this is true if a private sector company is responsible for producing the service; if it is a public sector organisation the government insists that “debundling” the contracts increases efficiency.) If contracts are to be put out to competitive tendering for PFI type projects, clinical services or anything else, they must be open to companies in all EU member states. Most European countries have financially strong health care companies just as capable of competing for those contracts as some of the US health care companies interested in the UK market. NHS Trusts, with their restricted access to capital and forbidden to generate surpluses to invest in new ventures will be crippled in this competition. As they are forced to take on private sector “partners” to gain access to capital, it will be difficult to distinguish them from private sector firms.

January 1996

APPENDIX 20

Supplementary Memorandum submitted by the Department of Transport

COST OF CAPITAL

1. The TSC requested a note (Question 325) on the relationship between the Government’s cost of capital and discount rates, and how the Department of Transport applies these in appraising PFI schemes.

2. The cost of capital to central Government used in appraising expenditure decisions is currently set at 6 per cent in real terms (Annex G of Economic Appraisal in Central Governments—A Technical Guide to Government Departments). The 6 per cent rate is based on the pre-tax long-term rate of capital for low risk purposes in the private sector. This allows for an efficient comparison at the margin between the costs of in-house provision and private sector service provision.

3. The same rate of 6 per cent real is also used as a discount rate in the public sector, although there are some exceptions to it (see below). Discount rates are used in investment appraisals to compare costs and benefits over time to reflect the taxpayers' preferences for enjoying benefits earlier and costs later.

DISCOUNT RATES FOR APPRAISING PFI SCHEMES

4. For PFI projects where services are sold to the public sector and for joint ventures, DOT appraise projects in accordance with the guidance given in annexes E and G of the Treasury Green Book.

5. For the majority of public sector projects, the 6 per cent real rate is applied. It is normally used when the public sector is the purchaser of goods or services supplied by the private sector. In some cases, central government output is sold in commercial markets. Such bodies selling output often have to make a required rate of return (RRR) of 8 per cent. This is the return required to be earned by the industry on the assets which it owns so as to provide a level playing field with private sector companies. It is based on the expected real return on assets in industrial and commercial (ICC) companies (excluding the North Sea), but is set lower than the expected ICC return over the long-term to reflect amongst other factors, the relatively low risk of many public sector activities. The 8 per cent is greater than the 6 per cent because it is an average, as opposed to a marginal return on an individual project.

6. To be consistent with their RRR, projects for these bodies have been appraised using a discount rate of 8 per cent. This has been the case in the past for railways investments. As the Department of Transport moves from being a supplier of services to a purchaser of services, the occasions on which a 6 per cent discount rate is used have increased.

7. To ensure consistency between rail and road appraisals, the same discount rate of 8 per cent is used to appraise both publicly financed roads and Design Build Finance Operate (DBFO) contracts.

DISCOUNT RATES AND RISK

8. Central government discount rates are not adjusted to take account of variability risk, in the sense of the possibility of more than one outcome occurring. Adjusting the discount rate for different degrees of risk could distort the choice of project. Annex C of the Green Book sets out guidance on dealing with risk in publicly financed projects.

9. Note this is separate from the issue of optimistic bias, where the expected value of public sector costs is estimated as unduly optimistic. The Department would argue strongly that full account is taken of risks in estimating the values of the costs and benefits in roads appraisals that it carries out. Public inquiries of individual road schemes need to be convinced that schemes are economically justified and appraisals are scrutinised closely to ensure that this is the case.

PRIVATE AND PUBLIC SECTOR COSTS OF CAPITAL

10. The cost of capital to private sector participants in PFI projects may be different from that used by the public sector when appraising the project. The private sector cost of capital will be reflected in the private sector bid and, hence, in the Government's assessment of its value for money.

COST OVERRUNS ON ROAD SCHEMES

11. The Committee asked for further information on the difference between bid and outturn prices for conventional procurement of roads construction (Questions 353–355 refer).

12. The National Audit Office (NAO) reported on contracting for roads in November 1992. Part 3 of their report, on controlling the cost of contracts, is attached for reference. [Not printed] They sampled 120 contracts each worth more than £1 million and estimated a cost increase of some 27 per cent over tender prices, the main reasons being attributed to unforeseen ground conditions and changes or other problems with design following contract signature. The 40 per cent or so mentioned in the hearing refers in fact to proportions of the value of the identified cost increase accounted for by ground conditions or changed Departmental requirements. At that time, virtually all of the Department's contracts for road building were on a re-measure basis, which permitted detailed design change post-signature and attributed the risk of unforeseen ground conditions to the client rather than contractor. An extract from the Treasury minute, published on 19 October 1993, is attached. [Not printed] This recorded the measures taken and intended by the Department in response to conclusions of the Public Accounts Committee on the NAO report. It foreshadows the intention, since carried into effect, to introduce a Design and Build form of contract for much of the Departmental's road construction work. The current work on Design Build

Finance and Operate contracts extends that concept to include responsibility for post-construction maintenance.

13. As explained in answer to Question 321, the Highways Agency within the Department of Transport has undertaken a thorough review of its contracting arrangements. Attached is a copy of the recent consultation document (17 January) seeking comment on 23 recommendations for implementing or trialling changes in contracting practice and methods. [Not printed]

DONCASTER MBC

14. The Committee asked about this scheme (Question 358) and the Department undertook to make enquiries. The reference is understood to relate to proposals being jointly considered by Doncaster Metropolitan Borough Council, South Yorkshire Passenger Transport Executive and Railtrack for improving the Doncaster railway station site and access arrangements for buses, cars and pedestrians. Earlier proposals put forward by consultants are believed to have been rejected in favour of a more modest scheme. The intention appears to be to attract interest from developers. The Department has no direct involvement in progressing the scheme. It is for the interested parties to decide how to take matters forward.

15. The current scheme is costed at around £13 million. Government funding, if sought and agreed, would be through local transport package funding and subject to the established procedures for economic appraisal and value for money assessment.

7 February 1996

APPENDIX 21

Supplementary Memorandum submitted by the Department of Health

REVENUE CONSEQUENCES OF PFI

Revenue consequences of PFI schemes depend on a range of factors which vary with individual schemes and cannot be precisely quantified until Full Business Case approval stage. Forward estimates are therefore very broad aggregate figures.

Revenue consequences over the next 3 years of NHS PFI projects in England are estimated as:

1996-97	£ 7 million
1997-98	£10 million
1998-99	£10 million

Figures for the next 3 years reflect schemes already agreed. Schemes now being approved, such as the South Buckinghamshire NHS Trust redevelopment, will have revenue consequences starting in the year 1999-2000 and later.

The rentals on PFI facilities are unlikely to be significantly more, in total, than NHS capital charges would have been on the publicly funded alternative. This is because, if they were significantly greater, the PFI option would be likely to fail the value for money test and so would not be approved.

Further assessments will be made as contracts are agreed.

COSTS OF PRIVATE FINANCE UNIT

The NHS Executive Private Finance Unit (PFU) was set up following the launch of the PFI to take forward implementation of the initiative in the NHS. The PFU currently has 17 staff, including a number on secondment from the private sector. Estimated costs of the PFU for 1995-96 are around £600,000. Costs associated with scrutiny of Business Cases for major capital investments are incurred for public capital schemes and PFI projects alike. These functions are carried out by staff in regional offices and, for certain schemes, NHS Executive Headquarters.

PFI PROJECT AT SOUTH BUCKINGHAMSHIRE NHS TRUST

This PFI project will involve extensive rebuilding at the Amersham Hospital site and the creation of a new wing at Wycombe General Hospital.

Only three of Amersham's existing buildings will be retained: a 19th century listed building; the Mental Health Unit, opened in 1991; and the Dermatology Unit which opened in 1994. The project will include the construction of a new main entrance, outpatients department, a day hospital for the elderly, an x-ray unit and a creche.

The new wing at High Wycombe will be four storeys high and will include two trauma and orthopaedic wards, operating theatres and a private patients unit. The private sector consortium, Healthcare Group, will lease land from the Trust, construct the new buildings and provide and manage support services along with the capital facilities for the Trust. No clinical or clinical support services are included in the contract with the consortium. The contract will run for a maximum period of 60 years. After that time, ownership of the new buildings will pass to the NHS Trust.

The minimum period over which the Trust has agreed to buy services from the consortium will be 15 years. After this, the Trust will have, at its discretion, the right to withdraw from part of the facilities. After 25 years there is a break clause, at which point the Trust can completely terminate the contract without penalty. Prices have been set for further lease periods, if the Trust should choose to exercise its option to extend the contract. The Healthcare Group consortium includes Taylor Woodrow, Independent Care, Nexus Financiers, and Granada Total Facilities Management.

An NHS capital scheme was also considered by the Trust. Both private and public proposals would have met the Trust's basic requirements, but the PFI option was chosen because if offered more new building, built to a higher specification, in a shorter time.

Risks in the areas of design and construction, facilities management, and income generation are passed to the private sector consortium. These risks would have been retained by the NHS under the publicly funded alternative. The PFI scheme also makes better use of the natural contours of the High Wycombe site. The new wing is closer to the existing buildings than the publicly funded proposal. And, by making use of the slope of the site, it has entrances at ground floor level to each of the four floors—thus improving access, particularly for disabled people.

The private sector consortium intends to spend more capital than the publicly funded scheme would have done. The PFI scheme will include at Wycombe a private patients unit, and at Amersham more new build in order to concentrate the NHS facilities and release more of the site for alternative commercial development. The extra income generation that these design changes will produce will be shared with the NHS, making the PFI scheme more cost-effective.

EXAMPLES OF SMALLER PFI PROJECTS

Attached is a report on some examples of PFI projects which have been approved since the PFI was launched in 1992. The report gives details of the projects and how they benefit the NHS.

PFI TERMINOLOGY

A variety of different acronyms are used to describe PFI schemes. The one most often used in the NHS context is DBFO (Design, Build, Finance and Operate). This means that the PFI partner is responsible for designing the facility—based on the requirements specified by the NHS; building the facility—to time and to cost; financing the capital cost—with any return to be recovered through continuing to make the facilities available and meeting the NHS's requirements; and operating the facility—that is providing facilities management and other support services.

Other abbreviations used in connection with PFI schemes, and listed in the glossary to the booklet recently produced by HM Treasury and the Private Finance Panel, *"Private Opportunity, Public Benefit"*, have a broadly similar meaning. BOO (Build, Own and Operate) and BOOT (Build, Own, Operate and Transfer) are distinguished by whether or not the newly built asset is transferred from the private sector to the public sector at the end of the contract.

13 February 1996

APPENDIX 22

Supplementary Memorandum submitted by BMI Healthcare

This supplementary memorandum is submitted with the intention of providing information and insight, additional to our written evidence (12 January 1996), which may assist the Treasury Select Committee in its inquiry into Private Finance Initiative (PFI) issues in healthcare. It has been prepared to take into consideration the evidence and responses given to the Committee's questions by Stephen Dorrell, Secretary of State for Health and Michael Jack, Financial Secretary to HM Treasury.

1. ISSUES

1.1 Monitoring procedures

We believe there would be value in looking at management contracts over a substantially longer timescale, in the order of 25 years plus (para 3.2.iii.b refers in our original memorandum). This issue was

mentioned briefly in Mr Jack's oral evidence, but has not been covered sufficiently. There should be more flexible periods of time in order to properly reflect the investment, which would entail a reworking of the financial management structure.

This would however, be dependent on improved monitoring procedures. Although Michael Jack touched on the subject of monitoring in his oral evidence to the Committee, we believe it needs more discussion.

1.2 Bidding procedures

The other area we believe needs examination is that of the cost of bidding procedures. In our original paper (para 3.4.1) we referred to this problem which is the significantly higher costs incurred in tendering for health sector PFI contracts. If a solution to this problem is not found companies may be unwilling to tender for contracts in the future.

As with any project in the public domain, there is a danger for the private sector that projects may be cancelled on political grounds. The issue of compensation in these circumstances needs to be addressed.

1.3 Training (refers to 3.4.3 in our original memorandum)

As part of the training process to which Mr Jack has referred, we believe that it is important that any courses for NHS Trust management, civil servants and Treasury officials should involve the use of modules developed in conjunction with private sector partners with experience of PFI negotiations. Before the format of the training courses is too firmly set, input from the private sector seems essential. There is also a need for the training modules to be established as part of a continuous professional development within the NHS trust management and the Treasury.

February 1996

APPENDIX 23

Supplementary Memorandum submitted by the Department of Health

MONITORING THE REVENUE CONSEQUENCES OF THE PRIVATE FINANCE INITIATIVE

Estimated revenue consequences of NHS Private Finance Initiative (PFI) schemes for the next three years were set out in the Department's previous supplementary memorandum.

While PFI contracts have expenditure implications beyond the Public Expenditure Survey (PES) period, so too do non-PFI contracts and other investment decisions. Planning for future revenue expenditure is discussed with the Treasury as part of the annual PES process and when individual projects are submitted for approval. Nevertheless, with the growth of the PFI, the Treasury has recognised the importance of monitoring more systematically each Department's aggregate future expenditure on agreed PFI contracts. The Treasury will, therefore, be putting new arrangements in place, before the next PES round is completed.

APPROVAL OF PFI PROJECTS

NHS Trusts have to prepare business cases for all major capital developments. These must demonstrate the need for investment and that the preferred capital solution will provide value for money. Business cases are required to compare publicly and privately funded options to assess which option will deliver the scheme objectives most cost-effectively.

A fundamental principle of Government Accounting is that no public expenditure, or commitments to spend, can be properly incurred without the approval of the Treasury. In practice, the Treasury delegates to Departments authority to enter into commitments and to spend within defined limits. It is the responsibility of the Department's Accounting Officer, in this case the NHS Chief Executive, to ensure that prior Treasury approval is obtained in all cases falling outside the Department's delegated authority, and to ensure that approval of expenditure commitments within delegated authority follows the same principle of value for money.

The delegated limits above which Trusts must obtain successive levels of approval for business cases are shown in Annex A. Some thresholds vary according to the size of Trust and whether the scheme is publicly or privately financed. All full business cases where private finance is the preferred option and where the capital value is over £10 million are scrutinised by NHS Executive Headquarters and the Treasury. Both the NHS Executive and the Treasury also scrutinise a sample of smaller PFI schemes. Schemes over £50 million must be approved by Ministers.

The Chief Executive has produced a note on the responsibilities of the NHS Accounting Officer for the Public Accounts Committee. A copy is at Annex B.

NHS TRUSTS—BORROWING POWERS AND CONTROLS

Borrowing Powers

NHS trusts are established under Section 5 of the NHS and Community Care Act 1990 (the 1990 Act). Schedule 3 of the 1990 Act deals with borrowing and lending. Specifically it provides that

- (a) trusts may borrow temporarily and longer term from the Secretary of State or from any other person;
- (b) they may not mortgage or charge their assets as security;
- (c) they may not borrow in non-Sterling currency without express permission;
- (d) Secretary of State may guarantee the loan from a person other than the Secretary of State; in which case he must lay a statement before each House of Parliament, and if a payment is made in respect of such a guarantee, a further statement shall be made to the Houses.

It also specifies that the aggregate of all the borrowing of English NHS trusts shall not exceed £5,000 million, or £10,000 million if an order is made with the consent of the Treasury. This figure does not include any sums loaned to trusts as part of their initial loans (defined in Section 9(4)a of the 1990 Act).

CONTROLS

Legal position

Section 10 of the 1990 Act provides that:

- 10-(1) Every NHS trust shall ensure that its revenue is not less than sufficient, taking one financial year with another, to meet outgoings properly chargeable to revenue account.
- (2) It shall be the duty of every NHS trust to achieve such financial objectives as may from time to time be set by the Secretary of State with the consent of the Treasury and as are applicable to it; and any such objectives may be made applicable to NHS trusts generally, or to a particular NHS trust or to NHS trusts of a particular description.

Further duties are set out in Schedule 2.

- 6-(1) An NHS trust shall carry out effectively, efficiently and economically the functions for the time being conferred on it by an order under section 5(1) of this Act...
- 7-(1) For each accounting year an NHS trust shall prepare and send to the Secretary of State an annual report in such form as may be determined by the Secretary of State.
- (2) At such time or times as may be prescribed, an NHS trust shall hold a public meeting at which its audited accounts and annual report and any report on the accounts made pursuant to subsection (3) of s15 of the Local Government Finance Act 1982 shall be presented.

Thus, particular statutory provisions apply to NHS trusts to ensure that they:

- do not mortgage or charge their assets (Schedule 3);
- obtain value for money (Schedule 2 6(1));
- “break even” (section 10(1)); and
- prepare annual accounts (Schedule 2, 7(1)).

The effects of the relevant statutory provisions are to constrain trusts' powers to borrow from the private sector. Any borrowing from the private sector must not be secured borrowing. Any borrowing from the private sector must offer better value for money than borrowing from the Secretary of State. Therefore NHS trusts can very rarely borrow from the private sector other than for short-term overdraft.

The Secretary of State also has the power to set further specific financial objectives, should these prove necessary.

GUIDANCE IN THE NHS TRUSTS FINANCE MANUAL

The NHS Trusts Finance Manual gives comprehensive guidance on NHS trusts' financial procedures and monitoring. It explains that trusts have three core financial obligations:

- (a) to achieve an annual financial target of a real pre-interest return of six percent on their average relevant net assets;
- (b) to break even on an Income and Expenditure basis;

- (c) to meet, or come within agreed limits of flexibility, the External Financing Limit set by the NHS Executive.

The second of these has statutory force, while the other two do not. There are, nevertheless, other controls exercised through management arrangements. These are summarised below.

Borrowing and Lending

Constraints resulting from statutory provisions were explained above. General principles and management arrangements are set out in the Finance Manual. Further constraints are that trusts' borrowing must not be in advance of need, for onward investment at higher rates of interest, or for speculative purposes. Interest rate swaps, futures, options, or analogous transactions are not permitted.

External Financing Limits

The main control on borrowing is the External Financing Limit (EFL), which is set by the NHS Executive each year for each trust. The EFL set for a trust is a real limit and trusts should ensure that they do not exceed it. Trusts which identify during the year that they will exceed their EFL are required to report that to their NHS Executive Regional Office. If justified the Regional Office might arrange brokerage from a trust with the opposite problem (ie one which expects not to use all the borrowing power allowed by its EFL). Otherwise the trust will be instructed to take action to ensure expenditure is kept within the EFL. Trusts are permitted to undershoot their EFL and carry forward the spending power to the following year.

Temporary Borrowing

Borrowing for working capital purposes forms part of a trust's EFL. However, a trust may have working capital needs which temporarily take its borrowing requirement over its EFL. In such circumstances the NHS Executive gives the trust a temporary borrowing limit for a limited period.

Annual Financial Plans and Business Plans

The NHS Executive requires that the financial performance of NHS trusts is monitored on a regular basis. In order to allow this monitoring to take place, trusts must prepare an Annual Financial Plan, as part of its business plan, which is then sent to the NHS Executive Regional Office for approval. The financial plan contains a profile of expected financial performance for the Income and Expenditure Account over each of the year's four quarters, and this is then monitored.

Financial Control

The Finance Manual sets out a number of key responsibilities for trust financial control. The trust as a whole, including both executive and non-executive members, is responsible for ensuring that sound financial management is maintained. The Board is responsible for ensuring high standards of financial stewardship and, *inter alia*, that adequate Standing Orders and Standing Financial Instructions are adopted and adhered to.

The NHS Executive has issued model Standing Financial Instructions (SFIs) which cover all aspects of financial management and control. The SFIs detail the financial responsibilities, policies and procedures to be adopted by the trust. They are designed to ensure that its financial transactions are carried out in accordance with the law and Government policy in order to achieve probity, accuracy, economy, efficiency and effectiveness. They identify the financial responsibilities which apply to everyone working for the trust and its constituent organisations.

In particular they confirm that all directors and employees, severally and collectively, are responsible for:

- (a) the security of the property of the trust;
- (b) avoiding loss;
- (c) exercising economy and efficiency in the use of resources; and
- (d) conforming with the requirements of Standing Orders, Standing Financial Instructions, Financial Procedures and the Scheme of Delegation.

AUDIT

Section 98 of the National Health Service Act 1977 (accounts and audit) provides a further control on NHS trusts and other NHS bodies.

In summary, this section imposes a statutory requirement for NHS trust accounts to be externally audited. The Secretary of State is required to transmit them to the Comptroller and Auditor General who is under a duty to examine and certify them, and lay copies of them together with his report on them before both Houses of Parliament.

The auditors are required to confirm that the accounts give a true and fair view of the state of affairs of the trust. All borrowing within a year, and loans outstanding at the year end, are disclosed in the accounts. Trusts are also required to disclose how they fared in meeting their EFL. Therefore all key financial targets reported in the annual report are independently audited. The audit would pick up any instances of loans being taken out that did not represent best value for money.

ACCOUNTABILITY

Annex B, on the responsibilities of the Accounting Officer, which describes the arrangements for performance monitoring and securing value for money, is also relevant here.

21 March 1996

ANNEX A

DELEGATED LIMITS FOR CAPITAL SCHEMES

Delegated limits for publicly funded construction project

TOTAL CAPITAL COST	APPROVING AUTHORITY
more than £250,000	Outline and full business cases to regional office for approval if Trust turnover is:
more than £600,000	less than £30m
more than £1m	£30m-£80m
more than £1m	more than £80m
more than £1m	Outline and full business cases to regional office for approval
£10m-£25m	Full business case to NHS Executive HQ for random sampling; if sampled needs HQ approval to proceed.
more than £25m	Full business case to NHS Executive HQ for approval
more than £50m	Following NHS Executive HQ approval, full business case to DH Ministers for approval
more than £100m	Following Ministerial approval, full business case to HM Treasury for approval

Delegated limits for privately financed projects

TOTAL CAPITAL COST	APPROVING AUTHORITY
more than £250,000	Outline and full business cases to regional office for approval if Trust turnover is:
more than £600,000	less than £30m
more than £1m	£30m-£80m
£1m-£10m	more than £80m
£1m-£10m	Outline and full business cases to regional office for approval. Full business case to NHS Executive HQ for random sampling; if sampled needs HQ approval to proceed
more than £4m	If sampled by NHS Executive HQ then also goes to HM Treasury for approval
more than £10m	Outline and full business cases to regional office for approval. NHS Executive HQ and HM Treasury approval of all full business cases required
more than £50m	Following NHS Executive HQ approval, full business case to DH Ministers for approval

ANNEX B

NOTE PREPARED FOR PUBLIC ACCOUNTS COMMITTEE

THE NATIONAL HEALTH SERVICE IN ENGLAND
RESPONSIBILITIES OF THE ACCOUNTING OFFICER

INTRODUCTION

1. The Chief Executive is responsible for and directly accountable to the Secretary of State for the management and overall performance of the NHS in England. He is also the Secretary of State's principal policy adviser on all matters relating to the NHS.

2. The Chief Executive is the Accounting Officer for NHS expenditure including hospital and community health services, family health services, some central health services, the drugs bill and NHS Trusts' external financing. The Department of Health's total gross expenditure in 1996/97 is expected to be some £36.3 billion—the Chief Executive is the Accounting Officer for £34.6 billion.

3. In their Eighteenth Report (1994/95 Session), the Committee of Public Accounts requested a statement from the Chief Executive on:

- how he fulfils his responsibilities as Accounting Officer under the current regime in the NHS;
- those matters for which he regards himself as personally accountable and those for which he is not;
- whether there are now areas within the NHS where he is not in a position to make direct personal interventions on matters for which he has overall responsibilities as Accounting Officer;
- and if so, the way in which he exercises those responsibilities.

This note addresses these issues. However, it should not be read in isolation and the Committee is asked to consider two important background papers the first of which is included here.

Annex 1 The structure and functioning of the NHS

The NHS is a huge and complex organisation and the Chief Executive exercises his responsibilities within the statutory framework set by Parliament. Since the inception of the NHS, successive Governments have delegated responsibility for the delivery of services to local statutory bodies and, for family health services, to independent contractors. The vast majority of decisions that commit resources are taken on a day to day basis by clinicians working at local level. Annex 1 describes the structural arrangements in the NHS, comments broadly on their legislative origins and sets out the existing systems of accountability, contracting and resource allocation. It is based on the position which will apply from 1 April 1996 when the Health Authorities Act 1995 takes effect.

Annex 2 Department of Health: Statement of Responsibilities and Accountabilities

The NHS Executive is an integral part of the Department of Health. The Department has been subject to a great deal of organisational change in recent years and this statement (published in May 1995) explains how the Government's responsibilities for health (and social care) in England are discharged by the Department and the NHS, and who is accountable for what.

These Annexes and the HM Treasury memorandum 'The Responsibilities of An Accounting Officer' provide the context for this note.

ACCOUNTING OFFICER RESPONSIBILITIES

4. The Chief Executive must ensure that effective management and financial systems are in place to achieve the objectives set for the NHS by the Secretary of State. In particular, he is responsible for:

- the regularity and propriety of expenditure, including the keeping of proper accounts by the NHS;
- value for money, including prudent and economical administration, avoidance of waste and extravagance, and the efficient and effective use of resources.

5. The size and complexity of the NHS means that it can only operate on the basis of a devolved system of management, albeit within a tight framework of public and parliamentary accountability. The principles of devolution were re-inforced by the NHS and Community Care Act 1990—which separated purchasing and provision of services at local level—and the Health Authorities Act 1995 which abolishes Regional Health Authorities and establishes Health Authorities as the single statutory authority at local level.

Accountable Officers

6. The principles of devolution are also reflected in the management arrangements for Health Authorities and NHS Trusts set out in Annex 1. In line with this, and recognising the fundamental importance of public and parliamentary accountability in the NHS, the Chief Executive with the agreement of HM Treasury, has designated all Chief Executives of Health Authorities and NHS Trusts as "accountable officers"—ensuring that they are answerable to Parliament through him for the efficient, effective and proper use of all the resources in their charge.

7. The Committee has received copies of the memorandum sent to all Chief Executives setting out their responsibilities and accountabilities. In cases of serious management failure or unacceptable conduct in a Health Authority or an NHS Trust, the Accounting Officer would expect the appropriate Chief Executive to accompany him to a hearing to answer personally to the Committee. The Accounting Officer has made it clear that, in such cases, the actions of the Chief Executive concerned would be considered in the light of relevant guidance issued by the NHS Executive. This does not apply to the chief officers of NHS Executive Regional Offices (to be known as Regional Directors after the abolition of Regional Health Authorities) since there is now a formal line of managerial accountability between them and the Accounting Officer within the NHS Executive.

DISCHARGE OF ACCOUNTING OFFICER RESPONSIBILITIES

8. The Committee asked the Accounting Officer to set out those matters for which he regards himself as personally accountable and those for which he is not. The overall position is set out in paragraphs 1–4 (above) and in Annex 2. There are two main processes in place which enable the Accounting Officer to discharge these responsibilities: (i) regularity and propriety and (ii) performance management and value for money.

Regularity and propriety

9. The detailed arrangements now in place take account of Sir Adrian Cadbury's report on corporate governance in the private sector. Codes of Openness, Conduct and Accountability have now been implemented in the NHS, and copies are in the Library. The Code of Accountability is particularly relevant in this context. Key measures to ensure effective stewardship and financial control at local level include:

- issuing model Standing Financial Instructions and other guidance on financial control in Health Authorities and NHS Trusts;
- establishing Audit and Remuneration Committees to strengthen the role of non-executive members of NHS bodies;
- requiring each Health Authority and NHS Trust to submit audited accounts and to publish annual reports and accounts;
- strengthening internal audit through a major initiative in the NHS.

10. The NHS and Community Care Act 1990 extended the remit of the Audit Commission to include all Health Authorities, NHS Trusts and GP Fundholders. The work of the Audit Commission and the statutory auditors it appoints is of great importance to the Accounting Officer. External audit across the NHS is carried out to the standards set in the Audit Code of Practice approved by Parliament. This covers both the propriety and regularity of individual bodies' expenditure and the value for money represented by it. The NHS Executive receives copies of management letters and any statutory reports from auditors; it also scrutinises all audit certificates, paying particular attention to any qualified opinions. Detailed audit at local level therefore provides the Accounting Officer with an independent assessment of local systems and the opportunity to intervene if significant problems arise. The NHS Executive and the Audit Commission are working together on a managed audit approach, to ensure that a co-ordinated programme of internal and external audit is in place in each Health Authority and NHS Trust.

Performance management and value for money

11. The Chief Executive sets objectives for the NHS based on Government policy and the overall aims of the Secretary of State. Explicit processes for monitoring and reviewing the performance of Health Authorities, NHS Trusts and GP Fundholders are in place. The key measures are:

- setting direction and performance requirements annually through the Priorities and Planning Guidance, distinguishing between medium-term priorities and baseline requirements;
- requiring Health Authorities to publish annual purchasing plans and an annual report. Authorities are held to account managerially for delivery of their plans through 'corporate contracts' with the NHS Executive, whose Regional Offices are responsible for monitoring and reviewing progress;
- similarly, GP Fundholders are required to produce practice plans and reports on an annual basis to enable Health Authorities to monitor progress.

- requiring NHS Trusts to prepare annual business plans and to publish an annual report. The Regional Offices are responsible for monitoring the performance of NHS Trusts, particularly to ensure they meet their statutory financial duties. Trusts are also responsible to Health Authorities and GP Fundholders for delivering high standards of health care through contracts.

12. The Chief Executive keeps the overall performance of the NHS under review and a wide-ranging a system of quarterly monitoring has been developed in the past two years. Key results are published in the Quarterly Review. Areas of concern are followed up through the regional offices.

13. These arrangements are supported by information flows designed to inform managers whilst avoiding excessive bureaucracy. To minimise information demands on the NHS, all new information requirements have to be supported by a business case which requires Ministerial consent. Central returns are reviewed every three years to test their validity. An Efficiency Scrutiny is currently looking into the burdens of paperwork in NHS Trusts and Health Authorities and is due to report in March 1996. A similar scrutiny has already been carried out for general practitioners. In a devolved system of management it is neither necessary nor appropriate for the NHS Executive to collect information on all the activities of individual Health Authorities and NHS Trusts. As a result, the Accounting Officer will not routinely collect information on very detailed areas of NHS activity or finance unless it is required for general management purposes.

14. In addition to direct-performance management by the NHS Executive, the relationship between purchasers and providers drives ongoing improvements in efficiency and effectiveness. The role of the NHS Executive is to ensure that the whole system works in the interests of patients and taxpayers. It does so by:

- developing policies, plans and systems which provide incentives to improve performance;
- providing comparative information to help Health Authorities, NHS Trusts and GP fundholders assess their relative performance;
- identifying, disseminating and seeking to ensure implementation of best practice across the NHS.

The NHS Executive carries out substantial work in each of these areas.

SCOPE FOR INTERVENTION BY OR ON BEHALF OF THE ACCOUNTING OFFICER

15. A devolved NHS relies on capable local management. The aim is to minimise direct intervention by the NHS Executive but this is sometimes necessary eg where there is serious management or financial failure, a requirement for structural change, difficult operational pressures or persistent poor performance. The NHS Executive is also able to issue guidance on behalf of the Secretary of State. The Regional Offices of the NHS Executive work on behalf of the Chief Executive and maintain regular professional and managerial contact with Health Authorities and NHS Trusts, the aim being to resolve difficult issues at the earliest possible stage. In exceptional circumstances, it is possible to take action within the statutory framework:

- for Health Authorities: the Secretary of State has powers to issue directions if they fail to carry out the functions legally conferred on them and to vary remuneration or conditions of service for individual members of staff.
- for NHS Trusts: in cases of serious failure, the Secretary of State has powers to require the resignation of the Trust board and to appoint new directors. The Secretary of State also has power to dissolve an NHS Trust in the interests of the health service and to transfer its staff, property, rights and liabilities to another NHS Trust, a Health Authority or to himself.

The existence of these powers is normally sufficient to induce Health Authorities and NHS Trusts to resolve difficulties without the need for coercion—their very existence reduces the need for formal interventions.

16. In certain circumstances, the Accounting Officer could withdraw accountable officer status from the Chief Executive of a Health Authority or an NHS Trust. This is likely to be a rare occurrence and the Accounting Officer would be required to act reasonably and with due process to avoid possible legal challenge. Parliament has not established an employment relationship between the Accounting Officer and NHS staff and any disciplinary action is for the employing authority concerned. It would therefore be for the Chairman and the Board of the Health Authority or NHS Trust concerned to decide whether or not a Chief Executive's contract of employment should be terminated in these circumstances.

CONCLUSION

17. The arrangements set out above are consistent with the statutory and policy framework set by Parliament and the Secretary of State. They enable the Accounting Officer to discharge his responsibilities for proper management of the NHS. In particular, he has established:

- effective systems for the proper stewardship of public funds backed by appropriate accountability codes and mechanisms, and
- the means to set the overall strategic direction and performance standards for the service backed by the management information required to ensure that progress is being made.

18. The management of local issues continues to be the responsibility of Health Authorities and NHS Trusts. Both are statutory bodies with clearly defined roles and responsibilities. The Accounting Officer does not expect to have detailed information on every aspect of their activity on a routine basis but the quarterly monitoring information is wide-ranging, he is in regular touch with Regional Directors who track performance on his behalf and he visits different parts of the NHS on a regular basis.

19. The Accounting Officer has formally recognised the chain of accountability which passes from local managers through him to Parliament by designating the Chief Executives of Health Authorities and NHS Trusts as accountable officers. He expects them to answer personally for the efficient, effective and proper use of all the resources in their charge. However, he retains overall responsibility for the management and performance of the NHS and expects, as now, to be the main respondent to enquiries by the Committee of Public Accounts.

NHS Executive

February 1996

ANNEX I

THE NATIONAL HEALTH SERVICE IN ENGLAND STRUCTURE AND FUNCTIONING

INTRODUCTION

The NHS operates in an environment which is influenced by demographic change, changes in the pattern of disease, rapid advances in science and technology, heightened public expectations and finite resources. We address these issues in three ways:

- (i) By pursuing national policies which aim to improve health and health services—these include Health of the Nation (which sets national targets for improving health in five key areas), Caring for People (which releases resources from institutional care to fund an appropriate spectrum of care for patients within their local communities) and the Patients Charter (which establishes national and local standards of service which respond to the views and needs of individual patients).
- (ii) By strengthening the scientific and education base of health services—through a national research and development programme, a commitment to the continuous education and development of staff and a focus on clinical effectiveness. The R & D programme has improved foresight capacity and created systems to disseminate research data. Research is now being used systematically to address service problems and to devise better approaches to the prevention and treatment of disease.
- (iii) By developing the capability of local management—the NHS has been structured in a way which separates the responsibility for purchasing based on the health needs of local populations from the provision of services. Finance and decision making is delegated to a local level.

This background note focuses on the third of these issues. It relates to the NHS in England. Other parts of the United Kingdom—Scotland, Wales and Northern Ireland—follow a similar model with local variations.

1. The NHS in England is a tax funded system operating in the public sector. The revenue budget for 1996/97 is £34.6bn and capital spending is likely to be £2bn. Access to the NHS is available to all and is free at the point of delivery. The NHS employs almost one million people and the NHS Estate has been valued at £24bn.

THE PURPOSE OF THE NHS

2. The purpose of the NHS is reflected in legislation. It is to secure through the resources available the greatest possible improvement to the physical and mental health of the people of England by:

- promoting health;

- preventing ill-health;
- diagnosing and treating disease and injury, and
- caring for people with long term illness and disability who require the services of the NHS.

3. In seeking to achieve this purpose the NHS, as a public service, aims to judge its results under three headings:

- equity: improving the health of the population as a whole and reducing variations in health status by targeting resources where needs are greatest;
- efficiency: providing patients with treatment and care which is both clinically effective and a good use of taxpayers' money;
- responsiveness: meeting the needs of individual patients and ensuring that the NHS changes appropriately as those needs change and as medical knowledge advances.

MEDIUM TERM PRIORITIES

4. In pursuit of this purpose and these results, the NHS is pursuing six medium term priorities at the present time:

- developing primary care;
- improving mental health services;
- developing services for people who need both health and social care—mainly the very old and people suffering from chronic illness;
- improving clinical and cost effectiveness;
- giving greater voice and influence to the public and the people who use the NHS, and
- developing employment practice at local level to ensure improved systems of workforce planning, education and training and pay and reward.

These objectives and the policies from which they are drawn are set out in detail in the Priorities and Planning Guidance for 1996/97.

THE ORGANISATION OF THE NHS

5. The NHS operates within a tightly defined system of parliamentary and public accountability. The Secretary of State for Health is responsible for the overall well-being of the service. He delegates responsibility for managing the service to the NHS Executive which is an integral part of the Department of Health. The NHS Executive comprises a headquarters and eight regional offices, each covering an average population of 6.1m people. The NHS Executive is responsible for developing a strategic framework for the NHS, securing and allocating resources, the stewardship of public funds and the development of health service policy. The funding and provision of health services is separated at operational level in a model defined in the NHS and Community Care Act 1990.

Health Authorities

6. From 1 April 1996, there will be 100 Health Authorities in England responsible for assessing the health needs of their local populations and purchasing health services in line with national and locally agreed priorities. Each Health Authority is responsible for an average population of 500,000 people. The average Health Authority budget in 1996/97 will be £229m. The legislative basis for the new Health Authorities is set out in the Health Authorities Act 1995.

General Practitioners

7. There are more than 26,000 General Practitioners (GPs) in England providing general medical services and family health services in primary care settings. GPs have the status of independent contractors. Approximately half of all GPs are funded to purchase a range of secondary care services including elective surgery and outpatient services, specialist clinical services and drugs. These GP Fundholders cover 53 per cent of the population and work in conjunction with Health Authorities. In 1995/96 total GP fundholder budgets amounted to £3.7bn (averaging about £1.8m per fund).

NHS Trusts

8. There are 430 NHS Trusts in England responsible for the provision of services. These include major teaching hospitals, district general hospitals, networks of community based services and ambulance services, with income levels ranging from £2m to £275m. NHS Trusts derive their income mainly from Health Authorities and GP Fundholders. The NHS Trusts reported 10.5m inpatients and day cases

and 10.4m first outpatient attendances in 1994/95. There were 11.9m first attendances at Accident and Emergency Departments.

Private Sector provision

9. The private sector makes a relatively small contribution to health services in this country. However, the independent sector provides most nursing home beds on a contract basis to Health Authorities and Local Authorities who have the lead responsibility for funding the provision of social care.

ACCOUNTABILITY

10. Health Authorities and NHS Trusts are governed by unitary boards, usually comprising an equal number of executive and non-executive directors working under a non executive chairman. They operate within clear codes of openness, conduct and accountability.

11. Health Authorities account to the NHS Executive through a well developed business planning and performance management system. GP fundholders are accountable to the NHS Executive who control exit and entry to the fundholding scheme and make final decisions on budget allocations. However, most day-to-day management contact for fundholders is through Health Authorities.

12. NHS Trusts have a great deal of operational and managerial freedom. They are employers in their own right and are able to employ staff on local terms and conditions. NHS Trusts can buy and sell property and accept money, land and other property on trust. NHS Trusts are required to produce an annual report and accounts which include a well defined core of statistical data necessary to support the process of public accountability. The Regional Offices of the NHS Executive monitor Trusts on their key financial duties which are: to stay within their external financing limit which controls their overall expenditure; to achieve a pre-interest real return of 6 per cent on the value of net assets; and to break even on their income and expenditure accounts (see paragraphs 18 and 19 below).

CONTRACTING

13. Health Authorities and GP Fundholders contract with NHS Trusts to provide services to their local populations. The current value of these contracts exceeds £24bn. The contracts incorporate a specification of services described in terms of quality, cost and volume. There are approximately 3,800 contracts (not including GP fundholder contracts) operating in the NHS.

RESOURCE ALLOCATION

14. The NHS Executive following the principles set by the Secretary of State allocates resources to Health Authorities on a capitation basis, taking account of the age distribution, health needs and geographical difference in the cost of providing services to local populations. All such spending is cash limited and relates mainly to hospital and community health services. By contrast the funding of family health services is demand led, and Health Authorities are funded as required, mainly to meet the cost of remunerating general practitioners, other contractors operating at primary care level (dentists, pharmacists and opticians) and the cost of drugs dispensed outside the (cash-limited) GP fundholding scheme. NHS Trusts earn their income mainly through contracts.

Revenue

15. In 1996/97 Health Authorities will receive allocations of some £23bn for Hospital and Community Health Services. £21bn is allocated by the population related formula and a further £2bn is given for special purposes eg for AIDS related services.

Capital

16. The vast majority of capital investment is made by NHS Trusts. Each Trust is permitted to spend a set amount, broadly equivalent to the depreciation charged in its accounts, for the maintenance of its existing estate and routine replacement of equipment. For major capital developments NHS Trusts have to prepare business cases for approval by the NHS Executive. These must demonstrate the need for investment and that the preferred capital solution will provide value for money. The process for securing capital funding is tightly managed and details are set out in the Capital Investment Manual. Where approval for publicly funded investment is given, the permitted capital expenditure for the trust is increased. The actual cash to pay for the capital expenditure is generated through the NHS Trusts' trading activities, or borrowed (see paragraphs 18 and 19 below). Some capital investment is now funded through the Private Finance Initiative (para 20).

Central Budgets

17. The NHS Executive retains control of central budgets, amounting to £2.7bn in 1996/97, to ensure that medium and long term investment is not eclipsed by the immediate pressures of caring for patients. Over £1.7bn is spent on the education and training of doctors, nurses and other staff and £0.4bn on research and development.

NHS Trust Financial Regime

18. NHS Trusts have been set up to own their assets. These assets are funded by loans and equity from Government. Trusts earn their income from contracts to provide patient services to Health Authorities and GP fundholders. Trusts are required to set their prices to recover:

- revenue costs such as staff, consumables and other overheads
- capital charges consisting of depreciation and a real return of 6 per cent on assets employed.

They use this income to meet their operating costs, make new capital investment and remunerate their debt to the Exchequer.

19. To enable trusts to remunerate their debt without affecting resources for patients, additional funding (trust debt remuneration or TDR) is added to NHS mainstream resources. The requirement to make the 6 per cent return on assets means that Trusts charge more for their capital than the amount of TDR they need to pay back to the Exchequer. The surplus along with the depreciation the Trust has charged (together known as internally generated resources) are available for capital investment. If permitted capital expenditure exceeds the internally generated resources, the Trust can borrow the balance—its External Financing Limit (EFL). If it is less the Trust repays debt and invests any balance until it is required for future capital expenditure.

Private Finance Initiative

20. The Private Finance Initiative has been set up to give the NHS access to private sector capital, skills and expertise and provides a new source of finance to support capital development. The Private Finance Initiative aims to secure best value for money for the public sector and to transfer risk from the NHS to the private sector. This scheme is in the early stages of its development—to date 47 schemes, each with a capital value of £1m or over, have been approved by the NHS Executive (and other smaller schemes have been approved locally) with a total capital value of about £200m.

21. The use of private finance has improved cost effectiveness of NHS services in a number of areas and has resulted in the acquisition of new diagnostic facilities, investment in non-clinical support services and the development of low dependency clinical accommodation. A number of major development schemes costing £25m or more are currently under consideration including the provision of major district general hospitals. The PFI process is subject to a rigorous approval system and the same tight disciplines which apply to public capital investment.

CONCLUSION

22. The NHS has undergone significant structural and systems change in the past 5 years. Devolution of responsibility has been accompanied by improved control of public money, improved efficiency and greater responsiveness to patients. The contracting process (particularly the GP Fundholding scheme) and the NHS Trust financial regime is sometimes complex to operate. The potential for streamlining the bureaucracy of the contracting system and updating the Trust financial regime, whilst retaining the advantages of sound financial management and the incentives for good performance which have been developed in the new system, is currently being explored.

23. The structure and systems which have been established are a means to an end, not an end in themselves. Following a period of considerable change, the NHS is now focused more clearly on its main purpose of improving health and the development of health services.

February 1996

With the financial system in a state of crisis, it is not surprising that the government has been set up to open their assets. These assets are limited by the government's ability to provide services to health authorities. The government has been set up to open their assets. These assets are limited by the government's ability to provide services to health authorities. The government has been set up to open their assets. These assets are limited by the government's ability to provide services to health authorities.

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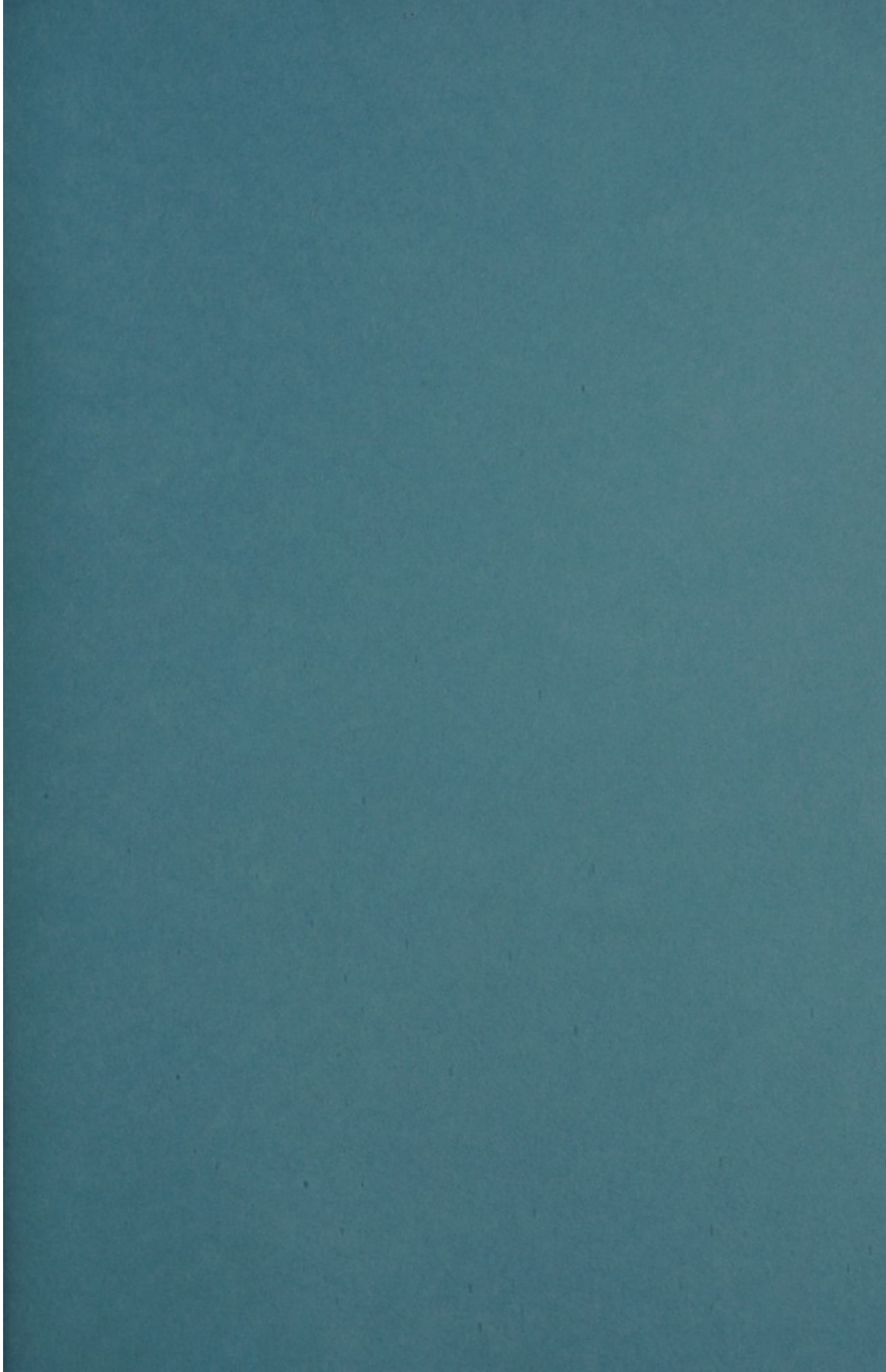
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