HOUSE OF COMMONS SESSION 1999–2000

TREASURY COMMITTEE

Fifth Special Report

THE PRIVATE FINANCE INITIATIVE: THE GOVERNMENT'S RESPONSE TO THE COMMITTEE'S FOURTH REPORT OF SESSION 1999–2000

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The Treasury Committee

The Treasury Committee is appointed to examine on behalf of the House of Commons the expenditure, administration and policy of the Treasury, the Board of Inland Revenue and the Board of Customs and Excise (and any associated public bodies). Its constitution and powers are set out in House of Commons Standing Order No. 152.

The Committee has a maximum of twelve members, of whom the quorum for any formal proceedings is three. The members of the Committee are appointed by the House and unless discharged remain on the Committee until the next dissolution of Parliament. The present membership of the Committee, and the date of appointment of each member, are as follows:[1]

Mr Nigel Beard MP (*Labour, Bexleyheath and Crayford*)	21 February 2000
Mrs Liz Blackman MP (*Labour, Erewash*)	16 July 1997
Mr Jim Cousins MP (*Labour, Newcastle upon Tyne Central*)	16 July 1997
Mr Edward Davey MP (*Liberal Democrat, Kingston and Surbiton*)	22 November 1999
Mr Michael Fallon MP (*Conservative, Sevenoaks*)	5 July 1999
Mr David Kidney MP (*Labour, Stafford*)	2 March 1998
Mr James Plaskitt MP (*Labour, Warwick and Leamington*)	29 November 1999
Mr Giles Radice MP (*Labour, Durham North*)	16 July 1997
Mr David Ruffley MP (*Conservative, Bury St Edmunds*)	30 November 1998
Mr Brian Sedgemore MP (*Labour, Hackney South and Shoreditch*)	16 July 1997
Sir Michael Spicer MP (*Conservative, Worcestershire West*)	16 July 1997
Sir Teddy Taylor MP (*Conservative, Rochford and Southend East*)	16 July 1997

On 17 July 1997, the Committee elected Mr Giles Radice as its Chairman.

The Committee has the power to require the submission of written evidence and documents, to examine witnesses, and to make Reports to the House.

The Committee may meet at any time (except when Parliament is prorogued or dissolved) and at any place within the United Kingdom. The Committee may meet concurrently with other committees or sub-committees established under Standing Order No. 152 for the purposes of deliberating, taking evidence or considering draft reports. The Committee may meet concurrently with the House's European Scrutiny Committee (or any of its sub-committees) or the Environmental Audit Committee for the purposes of deliberating or taking evidence. The Committee may exchange documents and evidence with any of these committees, as well as with the House's Public Accounts and Deregulation Committees.

The Committee has power to appoint one Sub-committee, which has similar powers to the main Committee, except that it reports to the main Committee, which then reports to the House. All members of the Committee are members of the Sub-committee, and the Chairman is Sir Michael Spicer.

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the internet at www.parliament.uk/commons/selcom/treahome.htm. A list of Reports of the Committee in the present Parliament is at the end of this volume.

All correspondence should be addressed to The Clerk of the Treasury Committee, Committee Office, 7 Millbank, London SW1P 3JA. The telephone number for general inquiries is (020) 7219 5769; the Committee's e-mail address is: treascom@parliament.uk.

[1]Previous members of the Committee: Mr Malcolm Bruce (*Liberal Democrat, Gordon*) (discharged on 31 July 1998); Dr Vincent Cable (*Liberal Democrat, Twickenham*) (appointed on 31 July 1998 and discharged on 22 November 1999); Mr Charles Clarke (*Labour, Norwich South*) (discharged on 9 November 1998); Mr Tony Colman (*Labour, Putney*) (discharged on 2 March 1998); Mr Quentin Davies (*Conservative, Grantham and Stamford*) (discharged on 15 June 1998); Mr Nick Gibb (*Conservative, Bognor Regis and Littlehampton*) (appointed on 15 June 1998 and discharged on 30 November 1998); Ruth Kelly (*Labour, Bolton West*) (discharged on 9 November 1998); Sir Peter Lloyd (*Conservative, Fareham*) (discharged on 5 July 1999); Dr Lewis Moonie (*Labour, Kirkcaldy*) (appointed on 9 November 1998 and discharged on 21 February 2000); Jacqui Smith (*Labour, Redditch*) (appointed on 9 November 1998 and discharged on 29 November 1999). Except where otherwise stated, these members were appointed on 16 July 1997.

FIFTH SPECIAL REPORT

The Treasury Committee has agreed to the following Special Report:

THE PRIVATE FINANCE INITIATIVE: THE GOVERNMENT'S RESPONSE TO THE COMMITTEE'S FOURTH REPORT OF SESSION 1999–2000

On 23 March we published our report on the Private Finance Initiative as our Fourth Report of Session 1999–2000 (HC 147). We have now received a reply from the Government, which is set out below.

THE GOVERNMENT'S RESPONSE TO THE FOURTH REPORT ON THE PRIVATE FINANCE INITIATIVE BY THE TREASURY COMMITTEE

(a) When the aim was to reduce the Public Sector Borrowing Requirement—particularly when there was a large deficit—PFI was an attractive means of increasing investment. However, the new fiscal framework has made it easier to provide publicly-funded investment, because such investment has no effect on the golden rule, and could be increased significantly without exceeding the Chancellor's chosen guideline that debt should not exceed 40 per cent of GDP. In the new framework, the case for PFI as the main means of obtaining extra investment is very much weaker. The main justification should now be the prospect of obtaining better value for money (paragraph 23).

The Government fully endorses this approach and the Chief Secretary to the Treasury has made clear publicly many times that value for money is the primary rationale for PFI. Most recently, *Public Private Partnerships—The Government's Approach* confirms (page 17) that PFI should only be used where it offers better value for money compared to public sector investment. This is also reflected in guidance to departments.

(b) We agree with the CBI's analysis that PFI projects would be likely to be successful where they genuinely combine capital and service requirements; where the risks are primarily commercial; where scope for innovation exists; and with skilled and committed public sector management (paragraph 26).

The Government also shares the view that successful PFI projects depend on the right combination of key factors to drive value for money in projects. It particularly agrees on the importance of skilled and committed public sector management. It is a priority task for the Office of Government Commerce to work with departments and Partnerships UK to improve the skills and competencies of public sector staff involved in all procurement activity including PFI.

(c) We recognise that the risks which are appropriate for transfer may vary from contract to contract. In the course of approving future contracts we expect that commissioning authorities will set out clearly the risks that are being transferred, how they have been valued and justification for their transfer. When risk is transferred to the contractor, we expect to see arrangements in place to make sure that the contractor may not escape liability for that risk by returning liability to the commissioning authority or to some other public body. For example, we are particularly concerned that the private sector should not be able to minimise operational risk through reduced service specifications once the contract has begun (paragraph 30).

Taskforce Technical Note No 5 (How to Construct a Public Sector Comparator) identifies the contents of a Public Sector Comparator and provides guidance for departments on the treatment and assessment of risk.

The Government shares the Committee's concern about the public sector taking back risk it is paying the private sector to manage and would be extremely concerned if this were done at the cost of reduced service specification. Provided the contract terms are right (and use of the Taskforce guidance on Standardisation of PFI Contracts facilitates this) and the public sector properly manages the contract over the whole life of the project, it should be possible to avoid such situations arising. As discussed above, improving public sector management during the negotiating phase as well as during the construction and operational phases is important in avoiding this pitfall.

(d) The Public Sector Comparator should contain a clear statement of the risks which have been quantified and included in it; and there should be an independent element in its construction and in the evaluation process. The possibility of comparisons with other private sector projects should be pursued wherever such information is available; such comparisons will be particularly valuable when the Public Sector Comparator is unreliable because it reflects a course of action which is unlikely to take place (paragraph 38).

The Public Sector Comparator is intended to provide an objective benchmark to test value for money and contains a quantified statement of risk. In response to the Committee's comments, however, the Government will consider how to improve the clarity of the treatment of risks and benefits in the construction of the Public Sector Comparator and the assessment of value for money.

(e) We accept that there is a trade-off between competition and the length and cost of negotiations. The best way to ensure competition is for the authority to clarify as early as possible in the process the outputs which are wanted, to avoid the need for too many changes as the negotiations proceed (paragraph 41).

The Government shares the view that clarity and precision of output specifications early in the process lead to greater speed of subsequent implementation, greater competition, better value and better outcomes in terms of service provision. The Government has made this clear to procuring authorities.

In addition, the Office of Government Commerce will consider with departments and Partnerships UK whether further guidance on preparing output specifications is needed.

The Gateway review process being developed by the Office of Government Commerce, through which all major projects will have to pass to ensure they are on track, will help to ensure that before any project goes out to tender a fully developed and sustainable service requirement has been prepared.

(f) We welcome the Government's new commitment that departments should evaluate PFI projects after they have been implemented. This evaluation should include both costs and service delivery, with comparisons against conventional procurement. Research in this area might also usefully be undertaken by the National Audit Office as part of their value-for-money investigations. We also strongly support the suggestion of a central system to collect information on each PFI project to enable the comparisons to be made. In order that PFI can be used in the areas where it offers the greatest gains in value for money, the research should also establish which types of projects are most suitable for PFI, and also which are the particular features that make a project suitable for PFI, such as its size, the expected life of the asset, the type of risks involved and the relationship of PFI services to non PFI services (paragraph 47).

The Government would welcome research by the National Audit Office in these areas.

For the Government's part, the Gateway process referred to above will cover the evaluation by departments of the extent to which operational projects continue to deliver value for money in the provision of the contracted services, and whether such services are still consistent with departments' operational requirements.

Whilst the Committee's recommendation for a system to collect information on each PFI project has resource implications, the Government accepts the need to satisfy itself that projects continue to deliver value for money. The Office of Government Commerce will consider with Partnerships UK cost-effective ways of ensuring that lessons from on-going projects are passed back to departments considering new projects.

(g) We welcome the reference in *Public Private Partnerships: The Government's Approach* to the possibility of the public sector benefiting from innovative approaches developed in PFI deals, and expect that, as part of its work, the new Office of Government Commerce

will monitor PFI projects systematically for features which can be transferred effectively to publicly-funded projects (paragraph 49).

The creation of the Office of Government Commerce was intended to and should facilitate the exchange of ideas and best practice across all forms of procurement. The Office will also continue the practice of the Treasury Taskforce of encouraging departments to produce case studies of particularly successful PFI procurements from which others may learn.

(h) The promotion of PFI projects has clearly led to a considerable and welcome increase in investment in hospitals. It is important to be able to demonstrate that value for money has been achieved; in the short term it is essential to construct valid Public Sector Comparators, and these should be supplemented in the longer term by comparisons between PFI hospitals and conventionally procured hospitals. We recommend also that the National Audit Office studies and reports on the issue of whether PFI procurements have resulted in more, fewer or the same number of beds as conventional procurements (paragraph 54).

[*This recommendation is for Department of Health.*]

(i) It is right that workers who are transferred as part of a PFI contract should not lose out as a result, and we welcome the recent changes which have gone further towards ensuring this (paragraph 64).

[*This recommendation does not call for comment.*]

(j) We recommend that the research referred to in paragraph 47 should include research on staffing trends within PFI contracts. We wish to guard against the development of two-tier employment status as between employees covered by the TUPE regulations and newly-recruited non-TUPE employees (paragraph 65).

The Government agrees with this recommendation, and believes that dedicated and committed staff are central to the long term success of partnerships. The Office of Government Commerce will work with departments to assess how staff relations in PFI projects develop over time.

(k) The Treasury's guidance emphasises that value for money, rather than accounting treatment, should be the "key determinant" of whether a PFI project should go ahead. It is essential that this should be demonstrably the case in practice. The introduction of Resource Accounting and Budgeting is intended to ensure better-informed decisions about capital and current spending, and it would be perverse if this were negated by the treatment of PFI projects. The Government should account each year for the current and capital PFI liabilities separately and ensure that its new public spending controls under Resource Accounting and Budgeting recognise that the main justification for PFI is improved value for money (paragraph 73).

A feature of PFI that the unitary charge paid by departments for services provided under PFI contracts is not broken down into elements for capital and service payments. This enables the private sector provider to determine its own mix of capital, maintenance and operational costs in a manner that best enables it to offer value for money over the life of the project. The Government is therefore not able to accept the recommendation that it should account each year for current and capital PFI liabilities separately.

The Government is committed to reporting biannually to Parliament aggregates of estimated capital spending by the private sector over the next three years, and estimated annual payments under PFI contracts over their lives. Details of these arrangements have been published in Taskforce Policy Statement No 5 (Provision of Information to Parliament).

(l) We welcome the appointment of Partnerships UK as a successor to the Taskforce. There is, however, the risk that because obtaining its advice is optional, a central store of experience will be available only to those who use it. It will be important for this store of experience to be available within the new Office of Government Commerce. We want to

see established and published a proper relationship between Partnerships UK and the Office of Government Commerce with the latter having an overriding duty to promote competition. There is a danger of conflict of interest if PUK provides financial assistance in PFI projects on which it has advised; and there is also the risk that financial support for some projects and not others would discriminate unfairly. We therefore recommend that PUK should not have power to provide financial assistance to PFI projects, whether by taking equity shares or otherwise (paragraph 86).

The Government welcomes the support for the Office of Government Commerce and Partnerships UK.

The Committee suggests the Office of Government Commerce should have an overriding duty to promote competition. Whilst the Office of Government Commerce is concerned to ensure competition in procurement, its fundamental role is expressed in the following vision statement: *"Working with civil government as a catalyst to achieve best value for money in commercial activities."*

In implementing its proposals on Partnerships UK and the Office of Government Commerce the Government was very aware of the need to maintain access to Partnerships UK's store of experience for those who do not use its services. Arrangements are being put in place in order to ensure that the Office of Government Commerce can continue to access the experience and skills available in Partnerships UK, for instance in the context of PFI guidance or contract standardisation.

But importantly, Partnerships UK will have greater resources, more staff, new and innovative products and access to private sector capital which mean it will be able to assist the public sector on a greater number of PPPs and more effectively than the limited resources of the Treasury Taskforce previously allowed.

In some cases Partnerships UK will provide development funding in order to get PPP deals off the ground. Financial assistance of this sort will not be allowed to conflict with Partnerships UK's core mission of assisting the public sector. To ensure this is always the case, the provision of financial assistance will require the agreement of all parties both public and private sector.

But Partnerships UK's activities will extend beyond traditional PFI projects. Reflecting its role as a catalyst for the PPP market it will focus on newer and more innovative forms of PPP such as wider markets PPPs. It is in these newer PPPs in particular that we would anticipate the potential for benefit from the public sector taking an equity stake in a new venture. An equity stake for Partnerships UK would, therefore, help to align interests because the deal Partnership UK does for itself will be the same deal it does for the public sector.

The decision to work with Partnerships UK on a particular PPP will be entirely at the discretion of the public body sponsoring the PPP. In choosing those PPPs where it makes sense to involve Partnerships UK, the public body will no doubt make an assessment of the complexity or importance of the project, its own ability to deliver the PPP and what Partnerships UK can offer. So the public sector must decide for itself whether PUK will add value in any particular project. For its part PUK will select the projects it agrees will help fulfil its public sector mission, for instance large, complex or innovative projects.

Partnerships UK's corporate structure has been carefully designed in order to balance its public sector mission with private sector disciplines. For instance an Advisory Council will oversee Partnerships UK's activities and assess its effectiveness in delivering on its mission. Partnerships UK's financial targets will also be set to enable it to fulfil its public mission and at the same time offer a fair return on capital.

HM Treasury
30 June 2000

LIST OF TREASURY COMMITTEE REPORTS

[*The Special Report listed after each main Report contains the Government's observations on the Report. Where a House of Commons Paper Number has a suffix –I, the evidence is published in one or more volumes separate from the Report*]

Session 1997–98

First, Accountability of the Bank of England (HC 282) (Third Special, HC 502)
Second, The Barnett Formula (HC 341) (Fourth Special, HC 619)
Third, Confirmation Hearings (HC 571) (—)
Fourth, The 1998 Budget (HC 647) (Fifth Special, HC 877)
Fifth, The UK and Preparations for Stage Three of Economic and Monetary Union (HC 503–I) (Sixth Special, HC 905)
Sixth, The Monetary Policy Committee of the Bank of England: Confirmation Hearings (HC 822–I) (—)
Seventh, Bank of England: Operation of Accountability—One Year On (HC 993) (Seventh Special, HC 1111)
Eighth, The New Fiscal Framework and the Comprehensive Spending Review (HC 960–I) (Eighth Special, HC 855)
Ninth, The Mis-Selling of Personal Pensions (HC 712–I) (First Special, Session 1998–99, HC 140)

Session 1998–99

First, Office for National Statistics (HC 43–I) (Second Special, HC 267)
Second, The World Economy and the Pre-Budget Report (HC 91–I) (Third Special, HC 339)
Third, Financial Services Regulation (HC 73–I) (Fourth Special, HC 347)
Fourth, The 1999 Budget (HC 325) (Fifth Special, HC 536)
Fifth, The Monetary Policy Committee of the Bank of England: Confirmation Hearings (HC 476–I) (—)
Sixth, Inland Revenue (HC 199) (Sixth Special, HC 746)
Seventh, Public Service Agreements (HC 378) (Seventh Special, HC 849)
Eighth, The Monetary Policy Committee—Two years on (HC 505) (Eighth Special, HC 850)
Ninth, Demutualisation (HC 605–I) (Ninth Special, HC 880)
Tenth, Valuation Office Agency (HC 420) (First Special, Session 1999–2000, HC 197)

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First, Research Assistance for Monetary Policy Committee Members (HC 43) (—)
Second, HM Customs and Excise (HC 53) (Second Special, HC 442)
Third, The International Monetary Fund (HC 72) (Fourth Special, HC 628)
Fourth, The Private Finance Initiative (HC 147) (Fifth Special, HC 706)
Fifth, The 2000 Budget (HC 379) (Third Special, HC 572)
Sixth, Government's Cash and Debt Management (HC 154)
Seventh, The Monetary Policy Committee of the Bank of England: Confirmation Hearings (HC 520–I)

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