The Scottish Parliament

FINANCE COMMITTEE

AGENDA

21st Meeting, 2001 (Session 1)

Tuesday 6 November 2001

The Committee will meet at 10.00 am in Committee Room 1 to consider the following agenda items:

1. **PFI/PPP Inquiry (in private):** The Committee will consider its lines of questioning for agenda item 2.

2. **PFI/PPP Inquiry:** The Committee will take evidence from—

   Professor Michael Mumford, The Management School, University of Lancaster;

   Matthew Farrow, Head of Policy, CBI Scotland;

   Amanda McIntyre, Head of Modernising Government, CBI

3. **Items in private:** The Committee will decide whether to take agenda item 4 in private, and whether to consider lines of questioning for future evidence taking sessions in relation to its PFI/PPP inquiry in private.

4. **Adviser on the Budget Process:** The Committee will consider potential candidates for appointment as adviser to the Committee on the Budget Process.

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The papers for this meeting are:

Agenda item 2

Paper by Professor Peter Jackson, Adviser to the Committee on PFI/PPP inquiry	PRIVATE PAPER

Agenda item 3

Paper by Professor Michael Mumford	FI/01/21/1
Paper by CBI Scotland	FI/01/21/2

Agenda item 4

Paper by the Clerk	PRIVATE PAPER

Public sector accounting

Extending the Private Finance Initiative

What is the PFI? Asks Michael Mumford


Michael Mumford

From 1979, successive Conservative governments in Britain introduced privatisation, compulsory competitive tendering for local authorities, executive agencies to run many day-to-day government functions, and finally in 1992 the Private Finance Initiative (the PFI). Under the PFI, public agencies, rather than buying major new assets, seek private suppliers to finance the purchases, own the assets and supply their services under long term contract.

Between November 1994 and May 1997, the Treasury required every public project proposal to be "tested" to see whether a PFI contract could be adopted instead. The new Labour administration endorsed the PFI in 1997, while ending compulsory testing.

While governments claim that the PFI shifts risk from public to private sectors, there has been little explanation of why this should benefit taxpayers or the economy. After all, private firms pay more for their capital than government does, and they need to charge for taking commercial risks and investing funds. Moreover, negotiating PFI contracts is costly. Finally, critics claim that the PFI is merely a way to reduce the Public Sector Borrowing Requirement—mere "off balance sheet financing". However, there are good economic reasons for the PFI, where circumstances are suitable (discussed below).

Seven billion pounds worth of PFI contracts have been signed to date, although half this figure relates to the notorious Channel Tunnel link. AMEC is upgrading and maintaining a 55 kilometre M4/M5 link road in Gloucestershire; John Laing is negotiating the £250 million Norfolk and Norwich hospital; London Underground has retained GEC Alsthom to provide a fleet of new trains for the Northern Line; the Ministry of Defence is contracting for new facilities in Shropshire to train helicopter pilots; and Siemens is supplying a computerised database for the Home Office Immigration and Nationality Department. On a similar scale, Jarvis has agreed with Dorset County Council to build and maintain new premises for the Colfox School. In each case, positive discounted net present value is expected, even at commercial costs of capital.

Why should the PFI offer benefits?

PFI projects make economic sense in the same circumstances as private sector outsourcing agreements. "Downsizing" helps companies to save costs by forming supply chains with specialist external suppliers of inputs.

Traditional economic analysis

cannot explain why changing the "organisational architecture" in this way adds value, but a newer branch of economics, Transaction Cost Economics (TCE), emphasises the need to save costs that arise when transacting parties have "asymmetric information" (unequal knowledge), particularly in deals for major fixed assets suited to only a limited range of purposes. TCE also warns of "opportunism"—the risk that people will act dishonestly, using guile.

The main aim of TCE is to explain when firms are better off carrying out production themselves (as "core" activities), and when they are better off buying inputs instead, either day-today from well traded markets or under long term contracts. PFI contacts operate over many years; they exclude finance leases (under PFI rules), but consist of comprehensive service agreements with detailed specifications..

PFI service suppliers need: (a) scope to exercise their specialist skill and effort in designing and constructing facilities; and (b) continuing incentives to maintain supplies over the contract duration.

Under conventional asset purchases, public agencies forecast the services they need to provide in future years and the resources required to meet those needs; then they define the necessary capital projects, specifying facilities and placing orders to have them built by private constructors (whose responsibility largely ends once the assets are in commission).

Under the PFI, by contrast, the constructor has prime responsibility for designing and building the assets (to meet client's service requirements) and continues to own and operate them over their economic life. Projects are designed to control and reduce lifetime costs, which suppliers have to bear.

It takes different skills to construct buildings than it does to maintain reliable services, so suppliers usually form consortia of specialist firms, collaborating together to ensure that contract services are delivered on

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schedule. Purchasers do not begin to make any payments until these services commence, so suppliers have an incentive to avoid delays.

In my study of the PFI, I identified six sources of cost saving that these contracts may be able to offer, compared with conventional projects:
(a) Clearer definition and specification of user needs (since public agencies are forced to think hard about what they need before committing themselves for thirty years);
(b) More careful lifetime design and costing by the constructor (who must live with the consequences, rather than transferring ownership to the client);
(c) Speedier construction and commissioning (since service payments only begin after completion, and penalties may also be imposed);
(d) More effective monitoring of contracts (since supply consortia have incentives to monitor delivery systems, while clients only have the easier task of checking service quality and scheduling);
(e) Incentives that better align effort with risks and rewards (well-focused goals on the part of suppliers can be translated into incentive schemes); and
(f) Decision-making that better exploits asset compatibility (parties own only those assets that they need to own for operational efficiency, and responsibility can be better matched with authority).

A way to improve the PFI

Where the PFI is weak at present is in its excessive bureaucracy. Current contracts include as much detail as possible, in order to identify, allocate and price every responsibility. This is feasible in the case of contracts for services that are unlikely to change over several decades, like motorway provision; here it is improbable that technical change will make the facilities obsolete within the contract period, and patterns of service requirements are predictable. But where services are likely to become out of date, it makes no sense to form comprehensive ("complete") contracts, which are very costly to negotiate and to renegotiate when conditions change.

Nearly everyone I interviewed while writing the book (see below) agreed on the need for less formal, "relational" or "incomplete" agreements, more like partnerships than contracts enforceable by the courts. As explained in the book, incomplete contracts are not fully spelled out in advance. They depend on reliable mechanisms for frequent discussion and renegotiation, informally more often than formally. Parties must maintain a balance of powers, so that each sees future collaboration as producing benefits that outweigh the costs. This means balancing commitments amongst parties as well as benefits from future dealings. The government's main role in this would be to provide fair and impartial arbitration.

At present the PFI is damaged by private sector suspicions that the government can always change the rules to suit public interests, while public purchasers view private bidders as unimaginative and profoundly risk-adverse. Better partnership relations need genuine power sharing, not more regulation. Adopting relational contracts may make it more difficult to raise externally, but it would suit smaller projects such as schools and social housing schemes, and it would expand the scope of the PFI.

Michael J. Mumford of the International Centre for Research in Accounting, Lancaster University, was an ACCA Council Member for 15 years until 1997. His book, *Public Works—Private Finance: the Principles of the Private Finance Initiative*, is to be published by Richard Griffin (1820) Ltd. in March 1998 at £40.

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PFI and Public Private Partnerships – CBI response to The Scottish Parliament's inquiry

1. CBI Scotland welcomes the Finance Committee's Inquiry into PFI/PPP and is pleased to give evidence. We are mindful of the need to improve the quality of public services and the need to secure better value for money from public expenditure. We believe that PPP/PFI has a key role to play in meeting these objectives.

2. In July 2000 HM Treasury figures reveal that in Scotland some 52 projects with a capital value of £1.63 billion (average project £31m) had been signed. The PFI mechanism by placing risks where they can be managed is ensuring a greater level of programme and budget certainty to the public sector and is delivering value for money. For example, the A74/M6 DBFO project for the then Scottish Office having a capital value of £120 million achieved a £36 million financial saving and a 9 month time saving against the public sector comparator. In health, Scotland is already successful in attracting private investment to carry out the large-scale rebuilding that is needed. NHS private finance deals with a combined capital value of £66.3 million are up and running, contracts have been signed on projects worth around £440 million and a further £95 million worth of deals are in the pipeline.

3. The PFI is now a well established and proven method of procuring public services:

   - PFI/PPPs, used appropriately, provide better value for money and, superior service performance than the conventional capital procurement alternative. PPPs also help to improve Government planning and in the development of competitive businesses.

   - PFI/PPPs is a key part of the solution to radically improving public services, especially in the areas of education, transport (including public transport) and health.

   - Key success factors for the effective delivery of PFI/PPPs include political commitment, selection of the right projects, appropriate skills and good Departmental preparation.

   - The expertise developed in this form of procurement in Scotland is creating valuable export opportunities for Scottish Firms.

4. Despite the many benefits of PFI/PPP, it is a matter of concern to the CBI that the initiative is still viewed in a generally negative vein by the public at large. We believe that it is important to address this issue through public review and debate. The submission has been structured around the general questions set out in the Inquiry's call for evidence.

The funding of capital expenditure through the PFI and PPP

5. To deliver the necessary investment to address Scotland's infrastructure deficit the Parliament will need to seek appropriate and innovative solutions which deliver better value for money (including superior service performance) than traditional forms of procurement. Public Private Partnerships (PPP) have the potential to deliver:[1]

- **Better value for money** through whole life costing, innovation, incentives for making public capital work harder and for better asset design. There is significant scope for net savings[2]

- **Guaranteed high quality service provision** over the lifetime of the project

- **Better Government planning** by reducing the political and fiscal risk to Government capital programmes which in the past have been subject to annual variations and where traditional procurement routes have led to cost overruns and 'goldplated' infrastructure but lacking adequate ongoing maintenance

- **Competitive businesses with export potential** by creating innovative team/joint venture solutions on complete 'design-build-finance-operate' packages:

6. The Private Finance Initiative is not just about the private sector financing capital projects in return for an income stream. It makes use of private sector skills and management to deliver a "capital and services package solution". Expertly used on appropriate projects, PFI can beat conventional procurement on value for money by a substantial margin. Sources of savings include

    - giving public sector customers and private sector suppliers both the scope and incentive to achieve best value for money over the lifetime of the project

    - commercial skills, management and innovation.

    - allocating risks where they are best managed

7. High calibre management of risk is essential. At a basic level, there needs to be stronger support in practice for optimum risk transfer to the private sector. In addition there is a need to explore the allocation of any particular risk between the parties, rather 100% to one or the other.

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[1] PPPs cover a wide range of potential activities and mechanisms, ranging from privatisations through joint ventures to contractual partnerships including PFI deals and strategic outsourcing of services. Characteristics they have in common include a strategic nature, risk sharing and the considerable operational freedom given to the private sector.

[2] Under the arrangements that currently apply, the Arthur Andersen/London School of Economics study showed that private finance initiative solutions are beating their public sector by 17 per cent on average.

Value for money and PFI/PPP

8. Better value for money, including the guarantee of high quality service provision, must be the reason for choosing PFI over conventional capital procurement. PFI should not be applied where it does not work. Shifting Government expenditure from capital to current spending is a consequence of PFI - neither good nor bad in itself in fiscal terms (particularly once resource accounting improves transparency) – but with implications for the Government's budgeting process.

9. The PFI can reduce the financial and political vulnerability of capital provision. Decades of under-investment have resulted from the need to constrain public borrowing and from political decisions favouring up-front budget savings at the expense of longer-term considerations. While resource accounting will provide better data for Government budgeting, it will not guarantee adequate capital provision. The PFI can be conducive to boosting investment by:

    - replacing "lumpy" public capital spending with a steady stream of service payments
    - encouraging a service-driven approach to investment decisions, which increases the incentive for timely capital spending, which benefits service quality and cost
    - protecting expenditure on maintenance, which has been particularly vulnerable historically, leading to a serious and costly backlog in the maintenance of national assets.

10. Long-term PFI contracts are sometimes criticised for constraining flexibility of Government/Scottish Executive decision making, by removing options that might exist under conventional procurement. For example, critics have argued that the PFI has led to declining numbers of beds in hospitals. The number of beds to be provided via the PFI hospital building programme has not been determined by private finance. However the latest wave of PFI deals will create between 2000 and 3000 more beds than currently exist.

11. In practice PFI projects can offer the opportunity of more flexibility. Most contracts include provision for the benchmarking/market testing of services at agreed intervals during the lifetime of the contract, thus ensuring ongoing value for money to the public sector from the delivery of key services with mechanisms in place for the sharing of any benefits that may arise. Rather than rejecting PFI on these grounds, the Government/Executive needs to manage the benefits and the risks that arise from long-term partnerships. Furthermore it is now accepted practice to build into PFI/PPP projects mechanisms designed to ensure that the public sector benefits from refinancing gains. [3]

12. Critics of PFI do not always take into account that long-term commitments also arise from a decision to build any facility conventionally. For example, hospitals built thirty years ago have required operational budgets ever since - to meet wage bills, contract payments and running expenses. Meanwhile, maintenance costs have arisen which may or may not have been met. An assessment of the existing education estate, with decaying buildings and inadequate maintenance, reveals that traditional procurement has not worked to the benefit of many users. Under PFI, these forward commitments are set – and therefore anticipated– further in advance. The capital costs are wrapped up with operational costs in the total service payments made to the PFI provider. Risks of cost overrun and delay typically lie with the private sector, not the taxpayer. It is up to the Government/Executive to use this information in its planning: aligning projects so far as possible with long term need and affordability; building flexibility into contracts to handle uncertainties over future demand; setting appropriate contract lengths.

[3] The Treasury issued guidance last year advising departments to ensure there is a 50:50 share of such gains

13. PFI can provide many additional benefits that arise from the improved management and innovation that can be introduced by the private sector. For example Glasgow City Council have signed a with 3ED to manage a need for significant capital investment, falling pupil rolls, surplus capacity within many schools, high levels of absenteeism, and low levels of attainment. The contract with 3ED will lead to eleven new secondary schools, eight schools extended, ten refurbished and one new primary school. All will be equipped with cutting-edge technology for pupils, a fully equipped library, and networked learning centre.

14. There will be investment of £220m in year one and a further £200m over the contract life. The cost is supported by revenue funding from the Scottish Executive of £14m a year, with the effect that there is no additional cost over the budget previously in respect of secondary schools (following the re-investment from the closed schools to realign the school roll with overall accommodation). Benefits include:

- Investment and building ahead of schedule
- pupil attendance increasing
- prospect of improved attainment
- ICT and e-agenda on-target

15. The Modernising Government initiative (including the systematic review of central and local government services) potentially provides an excellent framework for identifying where PFI will add value. Sometimes PFI can wrongly appear to be a separate and even competing initiative. Service reviews should explicitly embrace any related capital requirements. Furthermore, PPPs/PFI are key to the delivery of electronic government targets and again the e-government and PPP/PFI initiatives should be "joined up".

16. The CBI believes that the Scottish Executive's priorities should determine where resources are spent. The nature of the expenditure should then be determined by what mechanism would achieve best value for money. The Executive must decide on the route (or combination of routes) which gives the best scope for the private sector to add value and in all cases adhere to key principles such as whole life value for money and optimum risk allocation.

17. This approach will help to deliver world class public services in an efficient, effective and in many cases an innovative manner. At the same time we hope that the risks involved (e.g. in failure of projects to run) will be reduced through improved communications and clearer understanding of the issues. These risks can be further reduced by the use of experienced practitioners on the public sector procurement teams. It cannot be emphasised strongly enough how important it is to establish clear goals from the start and the best means to achieve these goals should then be followed and properly manager without preconceived notions that there is only one form of PPP or PFI that then has to be implemented.

Best value determinants of PPP

18. The concept of "value for money" is central to public procurement policy. Within the context of PPP/PFI, value for money is generally assessed by comparing the discounted cost of the public sector comparator with the discounted cost of the private sector bid. Where the discounted cost of the private sector bid is less than the discounted cost of the public sector comparator, then value for money is considered to have been achieved. This financial or monetary comparison is undertaken prior to the award of any PPP/PFI contract and is documented within the full business case. The public sector comparator is a risk adjusted costing of the approach that the public sector would take to the delivery of the service requirements underlying the project.

19. This type of monetary comparison is likely to remain an important feature of the assessment of value for money in PPP/PFI transactions. However, there are a number of issues associated with the construction and interpretation of this type of comparison that need to be addressed. Equally, there are a number of other ways or methods in which value for money can be assessed. These issues and methods are set out below:

    - the public sector comparator must be based on a realistic assessment of the cost of providing the required services to the required standard. Often the public sector comparator appears to be based on the provision of a lower quality of service;

    - the assessment of value for money should take account of those benefits associated with a PPP/PFI project that cannot be quantified in monetary terms, benefits such as faster service delivery, better service delivery and increased customer satisfaction. Often the assessment of value for money focuses too exclusively upon the monetary comparison between the public sector comparator and the private sector bid;

    - In sectors where there is an established track record of PPP/PFI deals achieving value for money against public sector comparators, the public sector could rely on effective competition as being the best and primary value for money test;

    - the monetary assessment of value for money could be undertaken using established benchmarks rather than a formal public sector comparator, particularly in sectors such as education where a significant number of PPP/PFI transactions have already been completed. The benchmarks used could include construction cost per square metre, life cycle maintenance cost per square metre and cleaning cost per square metre; and

    - the comparison between the public sector comparator and the private sector bid is undertaken prior to contract award. However, most PPP/PFI projects involve the provision of a service for up to 25 years and accordingly, it is important to ensure that value for money is delivered throughout the project life.

20. There are also wider benefits from making good use of PFI/PPPs so as to encourage a more pluralistic approach to the delivery of public services. Making good use of PFI/PPP is an important aspect of the public sector’s role as an intelligent client, encouraging improvements in the competitiveness of the private sector and of public sector in-house provision. Where public sector supply markets are genuinely contestable, and a competitive environment is used as a force for good, this acts to sharpen the performance of in-house providers as well as contractors. These sorts of gains (where the overall standard improves) will not be captured in an analysis of the differentials in performance between the PPP/PFI option and the public sector comparator. Yet these gains are substantial, including in terms of driving wider cultural change across the public sector.

The experience of PFI/PPP projects on public sector employees

21. Effective handling of staff issues is key to the success of PPP/PFI and in other forms of public procurement. The CBI has pushed for guidance at a national level and was involved in drafting guidance at a local and national level.[4] In each case we worked closely with the trade unions. We had been concerned that staff interests and service quality both suffered where contracts were too often awarded on lowest possible price, as opposed to best value for money (i.e. taking quality into account).

22. It is essential to have a clear understanding of what constitutes good practice in the handling of workforce issues in public sector contracting. There are various elements:

- Informing and motivating staff through the process, which is inevitably unsettling.

- Avoiding the use of "market-testing" or "Compulsory Competitive Tendering" style competitions, where the in-house team is invited to bid against the private sector. These types of competitions act against staff interests given that it is difficult to prepare the staff to transfer across to the private provider and for the staff to meet private bidders when the in-house team is in the competition

- Ensuring that the goal really is best value for money as opposed to lowest price. Essentially, "you get what you pay for": if the public sector client is aiming for a quality service, is skilled at securing this and is prepared to pay a fair price for it, then that client will inevitably be selecting a provider who manages the workforce well. The provider will only be able to deliver the service by managing the workforce and providing terms and conditions that recruit, retain and motivate the staff of the necessary calibre to do the work.

- Taking account of the commercially relevant workforce factors in procurement decisions (i.e. those issues that genuinely affect the cost and quality of the services being delivered). The relevant factors will vary from project to project, but in general terms this means that when inviting firms to bid and when awarding the contract, it is important to take account of those issues that relate to the service provider's ability to deliver the required service. For example, this could entail ensuring that a construction firm handles health and safety issues well. IT could mean discussing with bidders the current skills levels of the staff transferring and the implications for the training costs (and therefore for the bidder's price) of raising the skills levels to the required level.

- Ensuring that TUPE is applied consistently, so that staff generally transfer across on the initial outsourcing and on the subsequent re-letting of contracts. This is key for staff security and it offers better value for money, by removing costly risks from the process.

23. Poor practice in handling the workforce factors in procurement in the past has undoubtedly had damaging consequences, in terms of poor value for money to the public sector, staff resistance to a range of policies around contracting out and dissuading firms from being involved in public sector markets.

24. However, there are numerous examples of staff who have transferred to the private sector enjoying more favourable working conditions. This includes better organisation and management, which has led to higher workforce motivation and better performance. PPP/PFI creates an effective framework for securing these sorts of results. Furthermore in many contracts there are guarantees of no compulsory redundancies. In general, the staff

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[4] The Treasury Taskforce Guidance on PFI; the Cabinet Office guidance on Better Quality Services and on handling staff transfers; and the DETR statutory guidance on Best Value.

issues are more likely to be handled well in these types of strategic partnership deals than in small-scale short-term contracts. There, the temptation to award on lowest price is probably stronger (putting pressure on terms and conditions) and there is far less scope for discussion of long term continuous improvement, investment and training issues.

25. However we also recognise that in certain projects, especially those involving introducing Information and Communications Technologies, that there will be significant changes in both the skills set required and in overall level of employment required. However such changes are inevitable no matter which procurement route is taken or indeed whether the service is provided in-house. There needs to be greater acceptance politically, and throughout society, that such changes are required.

26. It is essential to distinguish between taking account of the commercially relevant workforce issues in procurement (which is essential to achieving value for money) and attempting to use public procurement to pursue a social policy agenda. This latter idea is fundamentally flawed. It is counter-productive because if is not a good way of achieving social policy goals and it jeopardises value for money.

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27. CBI Scotland believes that PFI/PPPs have a key role to play as part of the solution to helping to address Scotland's infrastructure deficit and in dramatically improving the quality of public services. We would be pleased to contribute any further information and provide oral evidence if required.