

**FINANCE COMMITTEE****AGENDA****25th Meeting, 2001 (Session 1)****Tuesday 27 November 2001**

The Committee will meet at 10.00 am in the Debating Chamber 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. **Items in private:** The Committee will decide whether to take agenda item 5 in private and also whether to consider its draft Stage 2 budget report in private.
3. **PFI/PPP Inquiry:** The Committee will take evidence from—  
  
Professor Andrew Bain, Department of Economics, University of Glasgow;  
  
Paul Brewer, Partner, PricewaterhouseCoopers.
4. **Resource Accounting and Budgeting Inquiry:** The Committee will consider the Executive's response to its report.
5. **2002/03 Budget Process:** The Committee will consider an issues paper on Stage 2 of the budget process.

David McGill  
Acting Clerk to the Committee  
Room G.6, Committee Chambers  
Tel. 0131 348 5215  
Email: [david.mcgill@scottish.parliament.uk](mailto:david.mcgill@scottish.parliament.uk)

The papers for this meeting are:

**Agenda items 1 and 2**

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

**Agenda item 3**

Paper by Professor Andrew Bain FI/01/25/1

Paper by PricewaterhouseCoopers FI/01/25/2

Background Paper by PricewaterhouseCoopers FI/01/25/2(a)

**Agenda item 4**

Executive response to RAB Report FI/01/25/3

**Agenda item 5**

Paper by Professor Brian Ashcroft, budget adviser to the Committee PRIVATE PAPER

**THE SCOTTISH PARLIAMENT: FINANCE COMMITTEE****Inquiry in to the Private Finance Initiative / Public Private Partnerships****Memorandum by Professor Andrew Bain****PREAMBLE**

I have been invited to comment on risk assessment and the costing of risk in the context of PPP projects. I do not have direct experience of PPP negotiations, but carried out a consultancy study of private capital funding of Universities, and was a member of a joint CVCP/DfEE group that considered the applicability of the Private Finance Initiative to capital projects in the Higher Education Sector. A short biographical note is appended.

**CAPITAL PROJECTS AND RISK**

1. Any capital project, whether in the public or private sector, involves financial risks. And the risks have to be borne by someone. If the project is financed and managed wholly within the public sector, it is ultimately the taxpayer who carries the risk; if wholly in the private sector it is the providers of finance – shareholders, bond-holders, or banks; if part-public and part-private, the risks are shared. Regardless of the source of financing the risks do not disappear, though they may be minimised by managing them properly.
2. For example, when a local authority builds a new school, there is a risk that the building cost may over-run the budget, that the work may be completed late, or the costs of maintaining and operating the building may be higher than expected. If any of these happens the local authority will incur extra costs, which have to be borne by the taxpayer. In the case of a comparable project in the private sector, e.g. when a company uses its own retained funds to build and operate a new factory, any additional costs have to be borne by the shareholders of the company concerned. However, when finance from sources external to the local authority (e.g. through a PPP deal) or the company (e.g. through bank finance) are involved, some of the financial risks may be carried by the external providers of finance, so that it is they, and not the taxpayer or company shareholder, who have to absorb any extra costs. Built into the cost of external finance is an implicit charge for taking risk of this kind.

**IDENTIFICATION, ASSESSMENT AND ALLOCATION OF RISK**

3. The terms on which private finance is made available (see below) reflect the risk of loss, or potential for profit, to which it is exposed. In general,

the greater the risk of loss, the higher the cost. In any private financing project that involves several parties it is necessary to identify the risk factors involved, assess their importance, and agree on the allocation of the financial consequences of any adverse experience amongst the parties.

4. Identification and assessment of risks obviously depends on the nature of the activity being financed. Take as an example the construction and operation of a new university residence building. Amongst the risks are: escalating building costs, failure of the contractor, unexpectedly high maintenance costs, lack of student demand for the accommodation. As the promoter of the project the university could, in principle, choose to carry all the risks itself, but it is likely to make sense for it to shed some of the risks (at a price) to a contractor appointed to construct the building, and perhaps also to banks which provide funding for the project.
5. In general it will be cost-effective to allocate risks to the parties best placed to control them and minimise any resulting costs. Costs are most likely to be avoided or reduced if the party who can control them has a financial incentive to do so. This can be achieved through the nature of the contracts entered into by the university with the other parties. Thus, a fixed price contract with a building contractor would enable the university to shed the risk of escalating building costs. A design and build contract would ensure that building costs were given full weight in the design of the building. A design, build and operate contract would free the university of the risk of unexpectedly high maintenance costs, and give the contractor an incentive not to cut corners when erecting the building. Shedding these risks may appear worthwhile to the university if a contract at an acceptable price can be negotiated. However, since the university is best placed to control student numbers, it is likely to be sensible for it to carry the risk of any shortfall in demand. It could do this by providing guarantees to the contractor and the banks that there will be enough students to fill the residence – in effect guaranteeing a future revenue stream for servicing debt, to cover the costs of operating the building, and out of which the contractor would also expect to earn a margin for profit. Failure of the contractor would affect both the university and the bank, but the university would be in a much better position to minimise the consequences than the bank, and could reduce the latter's exposure to risk by an undertaking that it would take over the contractor's responsibilities in the event of his failure: funding from the banks will be obtained on better terms if the university retains this risk itself.
6. At this stage it is worth pointing out that, even though PPP projects enable the public sector partner to shed major elements of financial risk, it is often not possible to shed responsibility, and the risk of consequential costs, completely. In the above example, if the university needs the residence for its students, and the contractor does not operate it satisfactorily, the university's sanction is to fire the contractor and take over operation (at its own expense) itself. No doubt it will have a claim against the contractor for reimbursement of its expenses, which it can if necessary pursue through

the courts. But there is no certainty that it will be successful in recovering any or all of the costs it incurs. Similar considerations apply to a hospital that purchases facilities under a long-term contract: at the end of the day the job has to be done, and if the contractor fails the hospital will have to make other arrangements itself. Moreover, while PPP arrangements enable the public sector partner to reduce its exposure to certain financial risks, this may be at the cost of some loss of flexibility in future: for example, it is likely to be easier to adapt or change the use of buildings that are owned outright than to renegotiate contracts when the facilities are owned by others and subject to long-term contractual arrangements regarding their use.

## **COSTING OF RISK**

7. As noted above, the financial risks inherent in any project have to be borne by someone - the providers of capital, taken together, in the private sector and the taxpayer in the public sector. In the private sector, the financial markets and institutions operate in a way which leads to a high proportion of the risk being concentrated on some of the capital (broadly, "equity" capital) and lower proportions being carried by other elements of the capital (broadly, "debt" capital). Shareholders provide the equity, banks and bond-holders the debt.
8. By and large debt providers have the first claim on any money that is available from a project, with equity providers taking what is left after the debt-holders' claims have been met. The loss ratios expected by debt-holders are generally very low – the expectation is that almost all loans and bonds will be serviced and repaid in full. The return on equity finance is much more variable – sometimes the value will be doubled and on other occasions it will fall to nothing. Consequently, the split between equity and debt in the financing of a project reflects its riskiness: if it is safe, debt providers can provide most of the funds and still be confident of getting their money back, but if it is risky most of the capital has to be equity. [In reality the financial markets and institutions provide a spectrum of assets, with varying degrees of exposure to risk of loss and possibility of reward, but the broad-brush distinction between equity and debt is nevertheless useful.]
9. The providers of capital expect to be rewarded for the risk they take. There is a risk-free return available in the financial markets, usually taken as the yield on government securities (gilts in the UK) on which the risk of default is regarded as negligible. Unless they receive some compensation for taking a risk of loss, investors would generally settle for a risk-free asset with the risk-free return. So corporate bonds and bank loans carry yields that are higher than the risk-free return, the yield margin depending on the perceived risk of loss, capital market investors' appetite for risk, and any running costs that are involved. At the present time high quality (i.e. low-risk) corporate bonds yield anything from a few basis points (one basis point = .01%) to perhaps 200 basis points over gilts, with "junk" bonds (i.e. bonds issued by companies that are thought liable to fail, or some

developing countries debt) at much higher yields. For the higher quality bonds professional rating agencies (e.g. Standard & Poor's) assess the risk of loss and award ratings that put the bonds into overall risk categories. The markets determine the risk premia (yield margin over gilts)– if investors generally become more wary, the risk premia increase.

10. Banks operate in a similar way, making their own professional assessment of the risk of loss attached to each category of loan. So loans secured by first mortgages on private residential houses carry a low margin (perhaps 0.25%) for risk, whereas loans for a speculative office development to be repaid from the proceeds of that development carry a much higher margin (say, 3%). In addition, in deciding what to charge for a loan, banks add a margin for costs and a margin for profit (which they need in order to compensate their shareholders for taking the risks inherent in their business), the latter being essentially what the market will bear. In most parts of their lending individual banks are open to competition from other banks – the house purchaser and property developer are both likely to shop around – and if other banks will do the same deal more cheaply they will take their business to them. But since all banks know that loans for property development are much riskier than home mortgages, the interest rates they charge all reflect this fact.
11. Bank loans or bonds issued in connection with PPP deals are negotiated on a one-off basis, so in the final stages of negotiation there is only limited competitive pressure. Nevertheless, the lenders will link the cost to the amounts and nature of the risks they are required to bear – the greater the risk the greater the margin included in the interest rate they charge - and the end-result will be a cost of funds that is not out of line with what other banks would charge for a similar deal.
12. Shareholders also have to be compensated for the risk that they take, and equity funding, e.g. the funds committed to a project by the contractor, is more expensive than debt. The equity risk premium has to be included in the cost of funds provided by contractors or others participating in PPP projects. Experts differ on the size of the equity risk premium in the long run: that is, the return that can be expected on average from equity investment in excess of what can be expected from risk-free investments. The most recent figure I have seen used in practice is 4%. Again, experts differ on the extent to which, on theoretical grounds, funding for investments whose outcome is highly uncertain should command a higher risk premium than more predictable investments: in practice investors in e.g. “venture capital” do look for, and in the past have been able to achieve, a higher return.
13. Not all investments turn out as planned, and the returns achieved are much more likely to fall short of the projected level than to exceed it. If firms are to have any realistic prospect of earning the average return on equity expected by the capital markets they have to build a higher projected return into each individual project that they undertake. A projected return on equity in the 12-15% range is by no means unrealistic

for relatively low risk projects – for the higher risk projects supported by venture capital firms a projected return of 30% or more would be typical. Again, it has to be stressed that these are the returns expected on the assumption that the investment is reasonably successful; and at the high risk end only a minority turn out as hoped. The upshot is that the equity element in funding for a PPP project will be significantly more expensive than debt funding.

- 14 With the passage of time the nature and degree of the risks inherent in a PPP project changes, as does the uncertainty about future revenues for shareholders and lenders alike. Take the university residence: once the building is complete and is operating satisfactorily, any building-cost over-runs have occurred and there is no further risk of delay. As a result the lenders have greater security for their loans and can be more confident that they will be serviced and repaid on schedule - the premium that was required initially to compensate for the risks becomes excessive. This may be reflected in the terms for loans negotiated at the outset, with an agreed reduction in interest rates after certain hurdles have been passed – something that is not unusual in project financing by banks. Alternatively, the project can be refinanced, with an increased proportion of debt permitting the release of some of the PPP participants' equity capital for other purposes, and with the debt carrying a lower rate of interest. While the latter may appear to give the private sector participants in the PPP an uncovenanted profit, in fact it is a predictable change in the cost of financing which should be factored into the negotiations at the time the deal is struck.

## **PRIVATE AND PUBLIC SECTOR FUNDING COSTS**

15. I have not addressed the question of whether the public sector should want to transfer financial risk to the private sector: the transfer of financial risk in a PPP project is part and parcel of the entire approach and has to be viewed in the context of PPP as a whole. I have, however, indicated that if responsibility for controlling the risk is best placed with the private sector there is a strong case for doing so.
16. There is no doubt that the funding costs for PPP projects are higher than for wholly publicly-funded projects. But to the extent that financial risks are genuinely transferred from the taxpayer to the private providers of funds, the public sector partners receive something of value for the difference. There is a general presumption that the value put on a service by a voluntary purchaser is not less than the price that has to be paid for it (otherwise the service will not be bought,) and if the public sector partners had any choice in the matter it would be reasonable to suppose that they obtained full value for the additional cost.
17. Clearly, the individual public sector partners do not have any choice. If they had, they might prefer to carry the financial risks themselves, possibly in the hope that cost over-runs (or revenue shortfalls) would be met by additional subventions from the Scottish Executive, thus reducing the

impacts on their own budgets. That option is not open to the Scottish Executive as a whole, which has chosen to transfer financial risks to the private sector and pay the market price for doing so.

18. The markets from which funds are drawn are subject to strong domestic, and indeed international, competition. There are no significant monopoly elements in these markets, so the going prices for funds can be regarded as fair. The task of negotiating what risks will be transferred and what the cost of funds will be in each individual case is left to the public sector partner, in the context of the particular contractual arrangements for that project, so the outcome will reflect the expertise and negotiating skills of the parties concerned: public sector partners who are inexperienced or poorly advised may end up paying over the odds. Nevertheless, against a background of competition amongst private sector firms to participate in PPP projects, it is reasonable to conclude that the public sector will generally obtain fair value for the additional funding costs involved.

## **BIOGRAPHICAL NOTE**

My career includes:

- Professor of economics at several Scottish universities for over 25 years.
- Six years as Group Economic Advisor at the Midland Bank
- Membership of the Committee to Review the Functioning of Financial Institutions (the Wilson Committee on the City) at the end of the 1970s, and Chairman of its Working Group on The Financing of North Sea Oil.
- Member of the Board of Scottish Enterprise 1991- 98
- Chairman of the Trustees of the Scottish Enterprise Pension & Life Assurance Scheme (since 1995)
- Member of the Competition Commission Appeals Tribunal (since 2000)
- Author of The Economics of the Financial System (2<sup>nd</sup> edition, 1992)

# **The Scottish Parliament Finance Committee**

*Inquiry into the Private Finance Initiative /  
Public Private Partnerships*

**Written submission from  
PricewaterhouseCoopers**

## Question 1

### (a) What are the advantages and disadvantages to the public sector in funding capital expenditure in this way?

We believe that appropriately designed Public Private Partnerships have the potential to generate substantial benefits for both consumers of public services and the economy as a whole. The scope of potential benefit will, however, depend on the type of project being undertaken and the exact terms of the contract governing the public private partnership.

The more significant potential benefits can include:-

- **Acceleration of infrastructure provision** – Public Private Partnerships provide an opportunity for the public sector to translate capital expenditure, which is normally scored as expenditure in the year in which it is incurred, into a flow of ongoing service payments. This enables the public sector to proceed with projects at times when the availability of public capital may be constrained, thus bringing forward much needed investment.
- **Faster implementation** – the allocation of design and construction risk to the private sector, combined with payments linked to the availability of a service, provides significant incentives for the private sector to deliver capital projects within short construction timeframes. This benefit can sometimes be offset by a longer procurement timetable but in areas where PPPs are well established, procurement timetables are shortening. The additional time taken in procurement often substantially reflects the greater depth of consideration given to project requirements and risks at an early stage, enabling more effective management of the project throughout its life.
- **Reduced whole life costs** – PFI projects, and many other Public Private Partnerships, require the private sector to be responsible not only for constructing the asset but also for maintaining and operating it over time. This provides the private sector with a strong incentive to ensure that it minimises cost over the whole life of a project, something that is inherently difficult to achieve within the constraints of traditional public sector budgeting.
- **Better allocation of risk** – a core principle of any Public Private Partnership is the allocation of risk to the party best able to manage it at least cost. The aim is to optimise rather than maximise risk transfer to the private sector, so that there is greater consideration and control of project risks across the whole life of the project to ensure that best value is received from the delivery of the required services. Typical risks include risk of construction cost overruns, inability to meet operating performance standards, difficulties in complying with environmental or other regulations, and the risks that revenues may not be sufficient to pay operating and capital costs.
- **Better incentives to perform** – the allocation of project risk should incentivise a private sector contractor to improve its management and performance of any given

project. Under most Public Private Partnership contracts, full payment to the private sector contractor will only occur if the required service standards are being met on an ongoing basis.

- **Improved quality of service** – UK and international experience suggests that the quality of service achieved under a Public Private Partnership is often better than that achieved by traditional procurement. This can reflect better integration of services with supporting assets, improved economies of scale, better planning of service standards at the outset of the project, the introduction of innovation or new technologies and service delivery, or the effect of the performance incentives and penalties typically found within a Public Private Partnership contract.
- **Generation of additional revenues** – the private sector may be able to generate additional revenues from third parties, thereby reducing the cost of any public sector subvention required. Additional revenue may be generated through the use of spare capacity or the disposal of surplus assets. This is a particularly strong theme in “Wider Markets Initiative” Public Private Partnership projects which are directed towards making the most effective use of public sector assets which have scope for further revenue generation.
- **Enhanced public service management** – by transferring responsibility for providing public services to the private sector, public sector officials act as regulators and focus upon service planning and performance monitoring rather than day to day management of public service delivery. Where these 2 disciplines are combined, there is often inadequate focus on service planning and performance monitoring. In addition, by exposing public services to competition, Public Private Partnerships enable the cost of public services to be benchmarked against market standards to ensure that the very best value for money is being achieved. For “soft” services such as catering and cleaning, the public sector can often incorporate these as an optional element in a PFI project and exclude them from the final agreement with the private sector if best value is not achieved by their inclusion.
- **Economic benefits** - Public Private Partnerships enable the public sector to proceed with a greater number of infrastructure projects by translating initial capital expenditure into a flow of ongoing service payments. This increased investment profile can help to stimulate the private sector and contributes increased employment and economic growth. There are good examples of Scottish based businesses which have become proficient in the Public Private Partnership approach exporting their expertise and earning significant income outside Scotland.

Potential disadvantages include the following:-

- **Inappropriate structure** – if not properly structured, Public Private Partnerships can result in a reduction in service quality and/or an increase in service cost. It is therefore essential that the structuring of a Public Private Partnership is considered in detail prior to commencing procurement and that decisions are based on a robust assessment of all relevant factors. This assessment must include the view of stakeholders and potential

service providers. Some of the early PPP projects in information technology provide examples of the consequences of inadequate preparation for procurement.

- **Stakeholder issues** – even though Public Private Partnerships are covered by specific legislation to protect the interest of employees, there is sometimes an adverse reaction from public sector staff and unions in relation to the transfer of their employment terms to a private sector company. Stakeholder issues require to be carefully managed throughout the process of developing, procuring and implementing a Public Private Partnership and the development of a robust communication strategy is essential.
- **Competition** – strong competition for a Public Private Partnership contract will encourage private sector innovation, efficiency and lowers costs. However, these benefits will be lost if there is only a limited number of potential private sector partners with the expertise or ability to deliver the services required. It is important therefore that the structure of the Public Private Partnership is attractive to potential bidders, and this can be tested through use of market sounding exercises.
- **Legal challenge** - Public Private Partnerships typically involve the award of multi-million pound contracts, and the cost to the private sector of bidding for these contracts is significant. There is therefore a greater risk of legal challenge from the losing bidders and it is essential that procurements are managed using well developed policies and procedures and that the decision making process is transparent.

**(b) What is the basis for the argument that private capital is required to obtain efficiency savings in service delivery?**

We consider that the principal drivers for the need to incorporate private capital are:

- **Incentives to perform** – having the entire capital tied up in a project at stake dependent upon performance provides a very strong performance incentive for the private sector. With the prospect of losing part or all of its capital for failure to deliver, the private sector cannot simply walk away from poor performance.
- **Facilitation of over-life view of assets and services** – the involvement of private sector capital maximises the imperative on the private sector to make efficient use of that capital and to optimise the balance between initial capital and costs incurred through the operating life of the asset.
- **Enforcement of risk disciplines** – providers of finance, particularly banks and institutional equity providers have a duty to place and manage their loans and investments effectively. They bring strong risk assessment disciplines and scrutinise projects in significant depth prior to committing. Currently, risk assessment skills in the public sector are not as well developed and, and even if these skills were equally developed, it is more difficult to maintain the enforcement of risk disciplines in the public sector – banks and equity investors will not invest if these matters are not properly addressed.

## Question 2

### What are the best value determinants of PPP?

Determination of value for money has traditionally focused on financial analysis of costs over the project life, comparing the costs of the annual charges of a PPP project with the costs associated with a hypothetical public sector procurement of equivalent services - the “public sector comparator”. We believe that this is the most appropriate practical way of confirming that the economic costs of obtaining the required services represent best value.

However, we would add two further observations. First, the hypothetical public sector procurement is often based on a traditional procurement option which simply does not exist because the funding to support it is unavailable. This is particularly the case for local authorities, where the majority of projects being procured as PPPs could not be undertaken, except possibly over an extended period, through capital consents. We believe that it is appropriate in these circumstances to compare the PPP project with the circumstances which would have prevailed had the PPP option not been available. In many cases, this would have meant provision of assets and services over an extended period of time in a considerably less efficient manner.

Second, we believe that, as experience of PPP projects in operation develops, it will be important to measure the extent to which expected service delivery benefits are achieved, and the costs of monitoring those benefits compared with benchmark levels. This would enable a more broadly based view of best value to be taken. At present, there is insufficient base data with which to undertake a complete analysis to establish benchmarks. Currently, this issue should be considered for each project as part of a post-implementation review of whether the project objectives have been achieved.

## Question 3

### How relevant are the assumptions used in assessing projects (e.g. discount rate, repayment period, risk transfer)?

We believe that the assumptions currently used in assessing projects are relevant but would make the following observations:-

- **Discount rates** – the discount rate presently used, of 6% applied to cash flows stated in real terms, is a broad cost of capital measure intended to cover a number of issues including
  - the public sector’s cost of capital
  - generic investment risks which are not captured in a project specific risk analysis
  - other project benefits to the Exchequer, including particularly tax revenues from the project company

It is not a precise measure, nor is it wholly transparent how each of the elements above are recognised within it. It has been set by HM Treasury as a best estimate. We understand that a review is currently being performed by HM Treasury which may result in a lower “headline” discount rate representing the cost of capital to government but with specific recognition given to the other factors which are included within the discount rate. This would lead to greater transparency but we would defer further comment on this until the outcome of that review is made available.

- **Repayment period** - projects involving the provision of capital assets will normally be appraised over the economic life of the underlying asset. PFI projects are normally compared with the public sector comparator over a period equal to the length of the PFI contract. The assets will normally revert to the public sector following contract expiry and the cash flows for the remaining life of the asset will be the same for either option.
- **Risk transfer** – it is relevant to consider, when preparing a public sector comparator, the potential value of those risks which would have been borne by the public sector under traditional procurement but which will be borne by the private sector operator under PFI. This can be a complex and challenging exercise where public sector organisations are looking at the risks associated with providing assets of a type, or on a scale, beyond their normal experience. In these circumstances it is often beneficial for them to seek external advice from technical advisers with wide experience of similar projects. Where organisations are appraising risks on projects beyond their normal experience there is often an “optimism bias” where the potential difficulties associated with the project are not fully understood.

The question is often raised as to how the private sector is able to undertake projects under a PFI structure and bear these risks without charging an amount directly equivalent to the value of risks transferred. In our experience the private sector is able to manage the risks in different ways from the public sector through, for example:-

- greater integration of design, construction and service delivery roles
- finalising design quickly against a given service specification, so costs from design change are minimal
- investing in more effective design and construction approaches because there is a greater potential pipeline of projects through which to recover the investment.

## Question 4

### (a) What are the costs of the capital programme?

The capital costs of a PFI project will typically include:-

- Costs of construction
- Financing costs through construction period
- Professional fees associated with provision of the capital asset

- Set up costs associated with the capital asset

### **(b) Is it possible to separate out capital charges from efficiency savings?**

In our opinion, separation of costs and benefits relating to the capital asset and those relating to service efficiency is possible for certain services which are not directly associated with the capital asset (e.g. in some accommodation projects, the catering service) but is not possible for those services directly associated with the provision of the underlying asset. A good example can be found in prison PFI projects, where prison design has a direct bearing on the effectiveness of the custodial service and the way in which staff are deployed. The achievement of effective operation and efficiency savings is as much dependent upon design as on other aspects of the operational regime. This principle applies to almost all PFI projects to some degree.

It is unlikely that a project procured, for example, as separate tenders for a design and build of an asset and for provision of maintenance and other related services would achieve as effective a result as an equivalent PFI project which brought the entire requirement under a single service specification. The benefits of integrated design, construction and operation would be lost and where poor performance of the service was attributable to the original design it would be more difficult, particularly in the long term, to require the design and build contractor to take full responsibility for service shortfalls attributable to their design.

## **Questions 5 & 6**

Representatives of our firm have participated in the preparation of the response of the Institute of Chartered Accountants of Scotland on these matters and we would refer you to this body's response.

## **Question 7**

### **To what extent is open consultation possible, given "commercial confidentiality" requirements?**

The public sector guidance relating to confidentiality of PFI contracts is incorporated within the Treasury Taskforce private finance publication "Standardisation of PFI Contracts" as supplemented by the "Code of Practice on Access to Government Information" published by the Cabinet Office. The Treasury Taskforce guidance states that:-

*"The recommended approach is that as much information in the contract as possible should be placed in the public domain and only information which is specifically identified*

*as commercially sensitive or sensitive for public interest (including national security) should be excluded.”*

The guidance deems information to be sensitive in its disclosure if it would cause:-

*“real prejudice to the interests (financial and legal) of the parties”*

The Code of Practice defines the information which government departments should release and incorporates certain exemptions. Amongst the exemptions is:-

*“Third parties’ commercial confidences – information including commercial confidences, trade secrets or intellectual property whose unwarranted disclosure would harm the competitive position of a third party”*

Within this framework, consultation is possible during the PFI procurement, provided that commercially confidential information, which during the procurement phase is likely to involve information regarding design, pricing and operational methods is kept confidential. Breaches of this confidentiality which resulted in information passing between bidders could potentially dilute the effectiveness of the procurement competition and reduce value for money to the public sector.

In our experience, open consultation on the detail of bidders’ proposals has been possible with groups representing stakeholders (for example representatives of teachers and school boards on schools projects) provided that those involved are aware of the importance of confidentiality. Wider consultation involving all employees, for example, is possible on the generic aspects of proposals but runs a high risk of breach of confidentiality if it involves commercially sensitive information.

Once the PFI contract is signed, increased disclosure should be possible although the Treasury Taskforce guidance recognises that the following contractual areas may be sensitive:-

- financial provisions i.e. price and payment mechanism
- balance of risk transfer and
- innovative construction or operational methods

## Question 8

### (a) What has been the experience of this form of investment on public sector employees?

Our involvement as financial advisors to PFI projects generally ends following signature of the PFI contract. Consequently we do not have detailed experience of the impact of PFI projects on public sector employees. Our contact with clients following contract close has mainly been with those employees who are either involved as users of the services provided under the PFI contract or in monitoring the provision of those services. In

general, the anecdotal feedback which we have from those employees is that there is often a period following the commencement of contract operations where the operator and users require to work out in more detail the practical requirements of day to day operation but that, following this period, the effect is beneficial in terms of users benefiting from improved service responsiveness and being better placed to undertake the core aspects of their role.

We understand that this area has been proposed as the subject for a study to be carried out by the Office of Government Commerce later this year.

**(b) Is the perceived effectiveness of PFI/PPP projects obtained at the expense of individuals who are providing the service?**

For the reasons noted at 8(a) above, we are not in a position to comment in detail on this issue although we are not aware of Scottish PFI projects which have been substantially dependent upon reduction in existing employee numbers or deterioration in their terms of employment to achieve efficiency gains.

We would, however, note that, in our experience, much of the effectiveness, in value for money terms, of PFI projects compared with public sector comparators comes from the sources of efficiency which we identified in question 1 above and are not directly dependent upon reduction either in employee numbers or remuneration. However, the relative importance of individual factors will vary significantly from one project to another.

# **The Scottish Parliament Finance Committee**

*Inquiry into the Private Finance Initiative /  
Public Private Partnerships*

**Background Paper from PricewaterhouseCoopers  
on the International Context of Public Private  
Partnerships**

## I Background to PricewaterhouseCoopers

- 1.1 PricewaterhouseCoopers (PwC) is the largest professional services organisation in the world and the largest firm of professional advisors in Scotland. PwC is also the world's leading firm of business advisors to the public sector on the development of Public Private Partnerships.
- 1.2 We are currently working on over one hundred significant projects across the public sector and we are especially active in relation to the public transport, roads, water and wastewater, education, healthcare and waste sectors. The strength of the market position of PricewaterhouseCoopers is illustrated by the table below.

Project Finance International League Tables Advisory Mandates Won in 1999 Global						
		1	2	3	Total	Overall*
1	PricewaterhouseCoopers	19	56	24	99	229
2	Macquarie	29	11	16	56	81
3	Deutsche	20	8	22	50	86
4	Ernst & Young	6	29	11	46	49
5	KPMG	0	20	19	39	112
6	Fieldstone	30	2	5	37	72
7	SG	19	1	15	35	54
8	BNP Paribas	24	1	9	34	39
9	Taylor de Jongh	17	8	6	31	53
10	Bank of America	13	4	14	31	53

Key:  
 1 - Privately owned sponsors    2 - Government or government-owned sponsors    3 - Bidders in a competition  
 \* - Mandates won, ongoing and closed in 1999

Source - Project Finance International, January 2000

- 1.3 We have played an important role in helping to shape government policy on Public Private Partnerships and in establishing best practice. Two of our partners served as members of the Executive of the Private Finance Panel and five of our managers have recently returned from secondment to either the Treasury Taskforce or the Public Private Partnerships Programme.
- 1.4 We are also responsible for providing Public Private Partnership training to the civil service in the United Kingdom.

- 1.5 We have worked closely with the Treasury Taskforce to develop policy statements on consultation with employees and the public sector comparator. We also developed the detailed technical guidance on the preparation of Outline Business Cases and the accounting treatment to be adopted for Private Finance Initiative transactions. In addition, we have recently developed detailed policy guidance on the use of Public Private Partnerships for the governments of Ireland, Israel and South Africa.
- 1.6 PricewaterhouseCoopers was named 'Advisor of the Year' at the Project Finance International Awards 2000, and was named 'PPP Company of the Year' by the Irish Business Employers Confederation (IBEC) at its Second Annual PPP Advisory Dinner in March 2001.
- 1.7 Our international presence means that we are able to bring the best experience to bear from ground-breaking projects all around the world. Our Public Private Partnerships advisory team has been involved in Public Private Partnership projects from the High Speed Rail Link in Holland to the Olympic Games in Australia, from the Pudong Waste Management Scheme in Shanghai to the Lahore Expressway in Pakistan.
- 1.8 In Scotland, we have a team of 12 supporting our work on Public Private Partnership projects located both in Scotland and, in certain key sectors, throughout the UK. Our Scottish team also exports its skills internationally, advising on projects as far afield as Australia (where we have a full time secondee) and Japan.

## II International Experience of Public Private Partnerships

### Use of Public Private Partnerships

- 2.1 Public Private Partnerships are increasingly being seen as an attractive approach to the provision of infrastructure projects and public services across Europe and the rest of the world. An ever increasing number of countries are embarking upon Public Private Partnership programmes that are leading to a radical redefinition of the roles of the public and private sectors in the financing and delivery of public services.
- 1.2 There is a growing acceptance around the world that Public Private Partnerships can be utilised to meet public sector investment needs in a wide range of sectors, in ways that offer good value for money for the taxpayer. An indication of the extent to which the Public Private Partnership approach has been adopted in other parts of the world is presented in the table that follows.

#### International Development of Public Private Partnerships

	Roads	Rail	Water	Waste	Power	Healthcare	Education	Prisons	Defence	Offices
✓ Deals closed □ Deals contemplated										
Australia	✓	✓	✓			✓	□	✓	✓	
Belgium	✓	□	✓	✓		✓	□			
Canada	✓	✓	✓	✓		□	□	✓	□	✓
Finland	✓	□				✓	□			✓
France	✓		✓						□	
Germany	✓	□	✓	□					□	
Greece	✓	✓				□	□			
Holland	✓	□	□							
Ireland	✓	□	✓	□	✓		□	✓		✓
Italy	□	✓	□	✓						
Portugal	✓	□	✓			□			□	
Scotland	✓	✓	✓	□		✓	✓	✓	✓	✓
South Africa	✓		✓			□	□	✓		
Spain	✓	✓	✓			✓				
United Kingdom (excl. Scotland)	✓	✓		✓		✓	✓	✓	✓	✓
United States	✓		✓					✓	□	

- 1.3 The table set out above is not comprehensive and is predicated upon data published as at January 2001. As there are a number of different definitions of the term Public Private Partnership, the above table includes those projects where the private sector has been involved in the construction and operation of a facility. It does not include more simple forms of private sector financing such as straight borrowing, finance leases or sale and leaseback transactions.
- 1.4 The above analysis also focuses on those countries that are currently most actively considering Public Private Partnerships and excludes a number of other countries that have only one or two projects in development or procurement.
- 1.5 Overall, the table demonstrates that the Public Private Partnership approach is being examined and deployed in a large variety of sectors and countries throughout the world. The country that is most active in the use of Public Private Partnerships is the United Kingdom, which has undertaken a large number of PPP projects under the auspices of its Private Finance Initiative.
- 1.6 In 1999, the Treasury Taskforce commissioned Arthur Andersen and Enterprise LSE to examine the value for money aspects of a range of projects undertaken under the Private Finance Initiative. The study examined twenty nine projects from a variety of sectors and concluded that procurement under the Private Finance Initiative had delivered, on average, a saving of **17%** when compared with the estimated whole life cost of implementing the projects through traditional procurement.
- 1.7 In this study, the primary drivers of value for money were identified to be risk transfer, the output based specification, the long-term nature of contracts (including whole life cost savings), performance measurement and incentives, competition and private sector management skills.

## Programme Development

- 1.8 International experience would suggest that at a macro level Public Private Partnership programmes are characterised by the following four phases of activity:
- **Preparation** – during which initial organisational structures are established to provide momentum to the Public Private Partnerships programme. Commonly, these initial organisations have taken the form of independent advisory groups comprising representatives of both the public and private sectors. The preparatory phase is characterised by policy development, legislative and organisational change, skills development, knowledge sharing activities and promotion and awareness campaigns;

- **Pilot projects** – the commencement of the preparation phase is often closely followed by the launch of a programme of pilot projects to establish best practice models. Commonly, the commercial skills and experience required to deliver good quality Public Private Partnership transactions does not exist within Government Departments at the time of the pilot projects, and therefore a central support unit may be required to work alongside the Departmental project teams. The experience of the pilot projects is recycled within government and is used to prepare best practice guidelines and case studies;
  - **Expansion** – if the programme of pilot projects is considered to be progressing well and delivering improved value for money, then the Public Private Partnership programme is likely to be extended to a larger number of projects across a wider range of sectors. During the expansion phase the commercial skills and experience of Government Departments continue to increase and the requirement for central support reduces; and
  - **Maturity** – a Public Private Partnership programme reaches maturity when a large number of projects have been successfully implemented in a broad range of sectors. Public Private Partnership policy and procedures are fully developed, and permanent structures are in place with the necessary skills to deliver projects and achieve best value for money. The aim should be for Public Private Partnerships to be an accepted and established form of public procurement within Government Departments, so that there is no longer a requirement for a central support function.
- 1.9 The institutional structures required to support the development of Public Private Partnership programmes are likely to change in nature and in role as the programme develops through the four phases identified above. During the initial preparatory phase, independent consultative and advisory groups, comprising representatives of the public and private sectors, have played a useful role in both the UK and Canada in terms of helping to promote the Public Private Partnership approach within the public and private sectors.
- 1.10 During the pilot project and expansion phases, more specialist commercial expertise is required to provide hands-on transaction support to Government Departments. This transaction support comes from two sources; a centralised unit within government that works alongside Government Departments at Project Board level, and/or external financial, legal and technical advisors that work alongside project teams and report to project boards.
- 1.11 Very few countries, if any, have reached the mature stage of development. The United Kingdom (including Scotland) is probably the closest, although it is currently too early to know whether the new structures that have been put in place (Partnerships UK and the Office of Government Commerce) will meet the requirements of the Public Private Partnership programme in the medium to long term.

## Sector Specific Experience

- 1.12 Public Private Partnerships are an established form of procurement for projects in a wide range of sectors. In particular, Public Private Partnerships are an increasingly common form of procurement for infrastructure projects in the water and wastewater, roads, public transport and accommodation sectors.
- 1.13 A short description of the extent of use of Public Private Partnerships in each of these sectors is set out in the paragraphs that follow. It should be noted that the accommodation sector includes projects in education, health and social housing.

### *Water and sewerage*

- 1.14 The global water industry is currently in a period of unprecedented change, driven by a growing demand for water for domestic, agricultural and industrial uses, and a requirement for substantial investment in new technologies and improved water infrastructure. A key feature of this change is the increasing involvement of the private sector in the provision of water supply and wastewater services.
- 1.15 Globally, the water services sector is still predominated by public sector provision. Currently, only 6% of the world's municipal water and wastewater systems are under private sector management. Involvement of the private sector is, however, increasing in many parts of the world as governments look to the private sector to introduce new technologies, skills and finance. For example, in England 100% of water supply systems are privately managed, in France 85%, in Spain 45% and in the United States 15%.
- 1.16 In Europe, the water and wastewater quality requirements arising from the European Union (EU) Drinking Water Directive and the Urban Wastewater Directive are acting as a catalyst for the liberalisation of the water industry. In order to meet the requirements of the Directives, many countries have to invest substantial amounts of capital in the development of new water supply and wastewater treatment facilities. The scale of these investments, combined with the need to introduce new technologies and skills, provide a significant incentive for countries to make use of private sector skills and finance to satisfy the requirements of the European Union.
- 1.17 The most common forms of Public Private Partnership that have been used in the water sector to date are Operating and Maintenance (O&M), DBO, DBFO and concession contracts. In addition, some governments or local authorities have in certain circumstances sold shareholdings in water service companies to the private sector.
- 1.18 Operating and Maintenance contracts are commonly used where there is not a requirement for significant capital expenditure, but there is a desire to introduce private sector management skills into the operation and maintenance of specific plants or service areas (e.g. in United States). The government retains ownership of the system assets and retains responsibility for financing all capital investment.

- 1.19 Design, build and operate and design, build, finance and operate contracts are used where the public sector wishes to retain overall control and ownership of its water systems, but where private sector skills are required to increase the capacity and improve the operational efficiency of core assets (e.g. in Scotland, Eastern Europe, United States and Australia).

#### **Almond Valley Waste Water Treatment Works**

In March 1999, the East of Scotland Water Authority awarded a £100 million Public Private Partnership contract to Stirling Water for thirty years. The objective of the project is to improve water quality in the River Almond, the Firth of Forth and the Esk Valley areas. The project provides an alternative to sewage sludge disposal at sea and will enable the achievement of the standards set by the European Commission. The project incorporates six different treatment works and the payment mechanism is based on flow measurement with payment bands related to price and volume.

- 1.20 Concession contracts are used where customers are charged for water and wastewater services, and where there is a desire to introduce private sector management skills into the management and operation of entire networks (e.g. in France, Spain and Portugal).
- 1.21 Initial indications from around the world suggest that the Public Private Partnership approach can generate significant cost savings. In the United States and Canada, Public Private Partnerships in the water sector are estimated to have generated cost savings of between 10% and 40% whilst in Scotland the average saving achieved on the Private Finance Initiative schemes is estimated to be over 20%. In Ireland, the experience of early Public Private Partnership projects such as Dublin Bay suggests that savings of around 25% to 30% are achievable.

1.22 Examples of projects that have been taken forward in Canada and the United States using a Public Private Partnership approach, are summarised in the following table.

### Example Projects in Canada and the United States

Project	Contract	Contract Term	Average Savings	Other Highlights
Haldimand-Norfolk Waste Water Treatment Works	O&M	5 years	\$1m per year (34% saving)	Worker relationships excellent. All staff received improved wage and benefit packages. Cost savings have been re-invested in water and wastewater infrastructure.
Edmonton Waste Water Treatment Works	O&M	8 years	\$0.4m per year (18% saving)	Capital improvements (\$5.5m) undertaken under separate contract. Plant consistently exceeds effluent quality standards.
Dartmouth Water Treatment Works	DBOF	20 years	17% on capex 10% on opex	New 91 Ml/d Water Treatment Works. Construction period of 18 months, 40% faster than the 30 month schedule expected by the contracting authority.
Moncton Water Treatment Works	DBOF	20 years	\$0.6m per year (15% saving)	New 25 MDG Water Treatment Works. Transfer of design, build, operation, maintenance and performance risks.
Milwaukee Wastewater System	O&M	10 years	\$14m per year (30% saving)	Sewage rates reduced by average of 15.5%. Employee grievances declined 33%. Training hours more than doubled. New bonus scheme introduced for employees. No layoffs during 10 year contract.
Indianapolis Wastewater System	O&M	10 years	\$25m per year (40% saving)	98% reduction in employee grievances. Salary increases 6% higher than City counterparts. New bonus scheme for employees. Sewerage rates at 1985 level.
Buffalo Water Supply System	O&M	5 years	\$4.4m per year (20% saving)	Secondment of 180 Water Board staff to private operator. No change to staff benefits or civil service status. Project won <i>Outstanding Achievement Award</i> . Water rates reduced by 8% instead of planned increase of 12%.

Source: PricewaterhouseCoopers, Toronto, 2000

## **Roads**

- 1.23 The Public Private Partnership approach is well established in the international roads sector and with it the idea that the user pays for access to good quality road networks. Countries that have completed Public Private Partnership transactions within the roads sector include Australia, Belgium, Canada, Finland, France, Holland, Iceland, Ireland, Portugal, Spain and the UK.
- 1.24 Private sector finance became an important element in road projects during the 1980's and its use was often underwritten by government guarantees. However, as markets have developed and the scope for risk transfer increases, it is becoming more usual to combine private finance with fixed subsidy to meet the overall financing requirement.
- 1.25 This approach is now commonplace and has been used to finance a significant number of toll roads and bridges around the world. Early examples include the second Tagus Bridge in Lisbon, the Queen Elizabeth Bridge in London, the N1 toll road in South Africa and the M2, M4 and M5 Tollways in Australia.

### **Australian Build, Own, Operate and Transfer Schemes**

During the last decade in Australia, a number of major urban arterial roads have been constructed using Build, Own, Operate and Transfer (BOOT) arrangements. In Sydney, the projects include the Sydney Harbour Tunnel and the M2, M4 and M5 Tollways. The largest BOOT project in Australia is the City Link in Melbourne and the total capital value of these projects is around \$3.5 billion.

Under the arrangements, private sector contractors have been awarded concessions to construct and operate roads for a defined period of time. Included in the contracts is the right to charge the users of the road a toll in order to recoup the costs of construction, maintenance and operation. At the end of the concession period the infrastructure assets are transferred to the public sector, typically at zero cost.

- 1.26 Research conducted by both the National Audit Office and the Construction Industry Council suggests that total cost savings of between 10% and 20% have been achieved on the highways projects procured under the Private Finance Initiative in the UK.

## **Public transport**

- 1.27 The organisation of local and regional public transport in Europe and across the world is in a process of transition. A common feature of change is the growing use of competition to deliver productive efficiencies and improved levels of service. The forms of competition used are varied, but can be broadly classified into concession based systems and open entry or deregulated systems.

- 1.28 Other than in Great Britain and Portugal, where open entry or deregulated systems have been introduced, European countries that have introduced competition have adopted concession systems. In concession systems, transport authorities retain the power to define minimum service levels. The transport authority uses competitive tendering to select the most cost effective and efficient operator to deliver the required services.
- 1.29 The introduction of competition and the award of exclusive contracts have resulted in increased regulatory costs. However, the introduction of competition has also resulted in significant operating cost savings and increased service levels. The operating cost savings and increased service levels experienced in various parts of the world as a result of competitive tendering are summarised in the table below (adjusted for inflation). The results relate primarily to bus transport.

### Impact of Competition on Operating Costs and Service Levels

Location	Sample Period	% Tendered	% change in service levels	% change in total costs	% change in unit cost per Km	Annual % change in unit cost
Auckland	1990-96	100	16.5	-21.2	-33.5	-7.6
Denver	1988-95	25	25.6	3.0	-18.0	-2.8
Indianapolis	1994-96	70	38.4	8.5	-25.9	-13.9
Copenhagen	1989-96	56	5.0	-18.5	-22.3	-3.5
Las Vegas	1993-94	100	243.0	135.0	-33.3	-33.3
London	1985-96	57	28.7	-30.0	-45.7	-5.4
San Diego	1979-96	37	46.6	2.7	-30.0	-2.1
Stockholm	1992-95	59	2.8	-18.5	-20.3	-7.3

Source: 5<sup>th</sup> International Conference on Competition and Ownership in Public Transport

- 1.30 Research conducted for the European Commission suggests that the introduction of competition can generate cost savings of 10% to 20% when only minimal restructuring of the industry is required. Savings of 35% or more can be achieved if significant restructuring is required and staff numbers or salaries can be reduced. The research also concludes that concession based systems are most effective in improving services and reducing costs simultaneously.
- 1.31 In addition, informal discussions with DG VII of the European Commission in 1999 and 2000 have confirmed that the Commission is preparing legislative proposals on the role of competition in public transport (and particularly bus transport).
- 1.32 The Commission's proposals are likely to require that all publicly run bus operations that have an exclusive right or are supported by government subsidy should be subjected to competitive tendering, resulting in the award of operating contracts with a finite length.

- 1.33 To date, competitive tendering of public transport services has primarily focused on the bus industry. Nevertheless, concession models have been used for the delivery of rail services in a number of countries including Great Britain, Germany, Italy and Sweden.
- 1.34 The franchising of rail services in Great Britain has delivered benefits in terms of increased passenger demand, improved service reliability and punctuality and lower fare prices.
- 1.35 However, the fragmented industry structure and complex contractual agreements have resulted in high transaction costs, a minimalist approach to investment by Railtrack and the Train Operating Companies, increased safety concerns, and inflexibility in responding to changing market requirements.

### ***Accommodation***

- 1.36 Throughout the UK, Public Private Partnerships have become a preferred method of providing new accommodation and related services for schools, colleges, hospitals, housing and government offices. Example projects include:
- ***Schools and Colleges*** – Colfox school in Dorset, the bundled schools projects in Falkirk and Glasgow, and three further schools PFI contracts in Scotland, Falkirk, James Watt and West Lothian Colleges.
  - ***Healthcare*** – Law Hospital, Hairmyres Hospital, The Royal Infirmary of Edinburgh, Norfolk and Norwich Hospital and East Ayrshire Community Hospital.
  - ***Housing*** – social housing in London and Birmingham and married quarters housing for the MOD in Lossiemouth, Yeovilton, Cosford and Shawbury.
  - ***Offices*** – project PRIME (management of DSS estate), Nottingham Health Authority Headquarters, Stretford Fire Station and Divisional HQ, Perth and Kinross Council HQ and Manchester Magistrates Court.
- 1.37 Research conducted by the Construction Industry Council throughout the UK suggests that total cost savings on accommodation related projects are typically in the region of 0% to 5%. The typical cost savings achieved by type of accommodation are summarised in the following table.

#### **Reported Cost Savings by Type of Accommodation**

<b>Type of accommodation</b>	<b>Typical saving in total cost</b>
Education	0% to 5%
Health	0% to 5%

Office accommodation	5% to 10%
----------------------	-----------

Source: Construction Industry Council

- 1.38 Experience in the UK suggests that one of the primary reasons for accommodation related PFI projects achieving lesser margins of value for money is a lack of opportunity for private sector innovation, particularly for the earlier projects in this area. However, more recent experience suggests that the opportunities for cost savings on accommodation projects can be improved if projects (e.g. schools) are bundled to create larger deals with greater scope for economies of scale and proportionately lower bid costs. Scotland has led the way in this and projects have achieved greater cost savings than those averages noted in the table above.

### Falkirk Schools

Falkirk County Council signed the first bundled schools contract in Great Britain in 1998 and the project consists of the provision of new accommodation and related services for five new secondary schools. A significant feature of the project was the fifteen month procurement timetable, which was achieved by using a full time project team involving both in-house staff and external consultants, and with input from the Treasury Taskforce. The main sources of value for money were identified as being the competitive tendering process that resulted from the size of the bundled project, the economies of scale generated through the bundling process, and the cost-effective transfer of risk to the private sector contractor.

## Key Findings

- 1.39 Public Private Partnerships are increasingly being used for the provision of public services across Europe and the rest of the world. International experience suggests that they can offer a long term, sustainable approach to improving infrastructure, enhancing the value derived from government assets and making better use of public money, whilst at the same time enabling the public sector to retain control of core areas of responsibility.
- 1.40 Public Private Partnerships are an established form of procurement for projects in a wide range of sectors including water and sewerage, roads, public transport and accommodation sectors.
- 1.41 The costs savings achieved through the use of Public Private Partnerships in these sectors are typically between 10% and 40% on water and sewerage projects, 10% and 20% on roads projects, 10% to 30% on public transport projects and 0% to 5% on accommodation projects.
- 1.42 International experience would suggest that the ability of a Public Private Partnership programme to deliver best value for money is dependent on two key areas:

- the environment for Public Private Partnerships within government; and
- the specific characteristics of projects.

1.43 In terms of the environment for PPP within government, international experience suggests that the key factors that support the successful delivery of a Public Private Partnership programme across government are as follows:

### **Key Success Factors for PPP Programmes**

Fast and efficient delivery of a PPP programme requires:

- Strong political commitment
- A Minister to champion and promote the PPP process within government
- A strong sustainable flow of Public Private Partnership projects coming to the market
- The establishment of a centralised support unit (usually within the Department of Finance), which:
  - has a cross-government mandate
  - is positioned where it will have greatest authority
  - draws on the experience and expertise of the public and private sectors
  - combines policy formulation and project support functions
  - establishes a consistent and co-ordinated approach to PPPs
  - develops policy guidance and standardised tender documentation
  - assists Departments to select, prioritise, scope and procure projects
  - recycles knowledge and experience within and between Departments

Ultimately, the aim should be to develop the skills and experience of Government Departments so that Public Private Partnerships become a standard approach to project delivery.

The role of the central unit is greatest in the initial stages of the PPP programme, and declines over time as policy and procedures are established within Government, and the capabilities of Departments to undertake PPP procurements are developed.

1.44 In terms of the specific characteristics of projects, international experience suggests that the key factors that support the successful delivery of a Public Private Partnership project are as follows:

### **Favourable Preconditions for Successful PPP Projects**

A PPP project is more likely to be successful and deliver better value for money if:

- The project has clear boundaries and measurable output performance, so that there is clear differentiation between private sector responsibilities and remaining public sector accountability;
- There is scope for innovation in design which enables the service provider to design away risks and bring new ideas to the way the service is provided;
- The project has a substantial operating content, which encourages the private sector to adopt a whole life cost approach to design and operation;
- There is scope for the service provider to find alternative uses for the asset provided;
- Any surplus assets intrinsic to the project are included in the package;
- The risks transferred to the service provider are commercial in nature and controllable;
- The project involves significant capital expenditure. PPP contracts are complex long-term arrangements and there may be significant costs associated with the transaction itself. This tends to make PPP more suitable for larger value projects;
- There is credible private sector interest; and
- Public sector management is committed to a PPP solution and sensitivities are manageable.



## SCOTTISH EXECUTIVE

---

**Minister for Finance & Local Government  
Angus MacKay MSP**

**Victoria Quay  
Edinburgh EH6 6QQ**

Mike Watson, MSP  
Convenor  
Finance Committee  
Room 4.6 PHQ  
Scottish Parliament  
Edinburgh  
EH99 1SP

**Telephone: 0131-556 8400**  
**[scottish.ministers@scotland.gsi.gov.uk](mailto:scottish.ministers@scotland.gsi.gov.uk)**  
**<http://www.scotland.gov.uk>**

**November 2001**

---

I refer to your letter of 23 October on the subject of your Committee's report on resource accounting and budgeting.

I am grateful for the Committee's report on this important and complex area.

Resource accounting and budgeting will play an important part in increasing the transparency and public understanding of the finances of departments and measuring their success in meeting their targets. I see this as essential to improving public confidence in the effective management of public finance.

I attach a memorandum responding to the specific recommendations in the report.

A copy of my letter and the memorandum has been sent to the Clerk.

**Angus MacKay**

**Finance Committee  
7<sup>th</sup> Report 2001  
Resource Accounting and Budgeting**

**Response by the Scottish Executive**

1. This memorandum responds to the main recommendations in the report in the order they appear in the report. The Scottish Executive has taken note of the other matters highlighted in the report and will ensure that these are given due weight going forward.
2. Resource accounting and budgeting (RAB) is undoubtedly a major change in the way central government conducts its business. In carrying out its study and presenting its report at what can arguably be called stage 1 of the change the Committee has made a valuable contribution to the ongoing development of RAB.

**Recommendation 1**

**It would be useful for a separate Scottish Assets Register to be kept and we therefore recommend that the Executive publish a list of the assets in Scotland which will attract capital charges. (paragraph 13)**

3. The Government published the first National Asset Register (NAR) in 1997. The register has been updated (to include entries up to 31 March 2000) and was published in July 2001. Included within that publication is a separate section dealing with Scotland. The NAR covers all central government departments together with their executive agencies, executive non-departmental public bodies, NHS bodies, other public corporations and nationalised industries. The 2001 version of the NAR shows the value of every asset (or group of assets) and provides a comprehensive description of all significant changes in the last 3 years.

**Recommendation 2**

**It is imperative that all levels of management with responsibility for resources and all staff responsible for budget considerations are fully conversant with the implications of RAB. We support the Deputy Minister's intention to review what is currently being done in this regard and to ensure that any missed needs are met. We recommend that he report the results of this review to the Committee. (paragraph 26)**

4. The Scottish Executive commissioned the Civil Service College to run a series of seminars for Finance staff to explain the context of RAB and explore its impact on the Scottish Executive and its relationships with its sponsored bodies; a majority of staff attended these seminars. The course content was supplemented by providing written and published material (e.g. "Resource Accounting" published by the Civil Service College) for personal study.
5. For the wider office seminars have been held for those in the Senior Civil Service and RAB training has been embedded within the office wide programme, particularly through

making available the inter-active course “Business Manager’s Guide to Management under RAB” developed specifically for the Scottish Executive by PricewaterhouseCoopers. This course provides an insight into the responsibilities of finance and non-finance managers in planning and managing resources in a RAB environment.

6. Training needs are kept under constant review and will be adjusted in the light of experience as resource accounting and budgeting evolves. The Scottish Executive's new Learning Strategy was launched in June 2001 and addresses the needs and options for upgrading skills and adapting to the demands and challenges of change; change in the global environment, change in expectations of the public, and change in the way Scotland is governed. The strategy sets out how the Executive plans to support people through learning to respond to the challenge of change over the next 3 years.

### **Recommendation 3**

**We understand that there is a requirement at UK government department level to sign a certificate confirming the extent of RAB training provided. This approach seems sensible to us and we recommend that the Scottish Executive adopt it. (paragraph 27)**

7. Implementation of RAB at the UK level was controlled via a Treasury led Trigger Point strategy that identified a series of critical milestones to successful delivery. While the Scottish Executive is no longer subject to the Treasury’s control in this respect it was decided to follow the programme as an aid to delivering the various aspects of RAB on time.

8. Trigger point 3’s purpose was to allow an overall view as to departments’ ability to implement RAB successfully. It required the Principal Accounting Officer to deliver a number of assurances to Treasury. In consultation with Audit Scotland it was agreed that for the Scottish Executive the Principal Finance Officer (PFO) should be required to deliver these assurances to the Permanent Secretary in satisfaction of the Trigger point 3 requirements. On the basis of the progress made, and the views expressed by Audit Scotland in their letter dated 26 May 2000, the PFO wrote to the Permanent Secretary on 30 May 2000 confirming, *inter alia*, that robust resource budgeting data had been provided for use in the 2000 review and in the shadow based resource estimates for 2000/1; and that in respect of RAB training a core competencies framework has been prepared which will form the basis of the training framework for staff.

### **Recommendation 4**

**We recommend that the continued effectiveness of the IT capability is monitored closely and that an evaluation of the requirement for IT related training and support is included the Deputy Minister’s review of training needs and evaluation of delivery. (paragraph 31)**

9. Following a review of the existing system’s capabilities, a contract has been awarded to deliver Oracle Financials which will enable the Scottish Executive to process RAB accounting requirements. A further IT project has been initiated to develop an extended core business system that will be integrated with the main accounting system and provide a reporting tool (for use internally and for reports to be published and laid before the Parliament) and links to the budgeting and planning process. As RAB changes and evolves,

the Scottish Executive will monitor the IT system effectiveness. IT training will be offered to all users of the replacement system depending on their specific needs.

### **Recommendation 5**

**It will be important to understand how capital charges are affected by the application of the Barnett formula when capital charges move from the annual managed expenditure (AME) element of the budget to the departmental expenditure limit (DEL) element of the budget. Accordingly, we recommend that the Scottish Executive publish an analysis of the capital charges figures for English and Welsh departments, compared with the equivalent departments in the Scottish Executive within 2 months of the publication of this report. (paragraph 44)**

10. An exercise has been undertaken to provide a comparison of Depreciation and Cost of capital charges between Scottish and England departments. The output of the exercise was not particularly informative due to differences in the make up of departments. It is expected that the recently issued guidance for the baseline conversion for SR2002 will reduce variations and make comparison more meaningful. The comparison will be pursued once the baseline conversion has been completed.

**The Scottish Executive  
Finance and Central Services Department - Finance**

**5 November 2001**