FINANCE COMMITTEE

AGENDA

28th Meeting, 2001 (Session 1)

Tuesday 18 December 2001

The Committee will meet at 10.15 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 items 3 and 5.

2. **Items in Private:** The Committee will consider whether to take agenda item 4 in private.

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

   Professor Allyson Pollock, School of Public Policy;

   Des Murray, Association for Public Service Excellence;

   Paul O'Brien, Director, Association for Public Service Excellence;

   Richard Blackburn, Director of Commercial Services, Dumfries and Galloway Council;

   Professor Paul Grout, Director, Leverhulme Centre for Market and Public Organisation, University of Bristol;

   Geoff Haley, Chairman, International Project Finance Association.

Not before 2.00 pm.

4. **PFI/PPP Inquiry:** The Committee will consider a paper by the Clerk.

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

   Tom Kelly, Chief Executive, Association of Scottish Colleges;

   Andrew Gordon, Chief Executive, Canmore Partnerships;

   Ian McDonald, Depute Director of Education Services, Glasgow City Council;

John Curley, Senior Education Officer, Glasgow City Council;

Keith Patterson, Partner, MacRoberts;

Sandy Bremner, Head of Public Private Partnership Unit, Miller Construction.

6. **Scottish Parliament Corporate Body - Scottish Parliament Building Project:** The Committee will consider a letter from The Presiding Officer and take evidence from—

Paul Grice, Clerk and Chief Executive, Scottish Parliament;

Robert Brown MSP, Member, Scottish Parliament Corporate Body;

Sarah Davidson, Project Director, Holyrood Project Team.

David McGill
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The papers for this meeting are:

Agenda item 1

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

Agenda item 3

Paper by Professor Allyson Pollock	FI/01/28/1
Additional Paper by Professor Allyson Pollock – Response to IPPR Report (in hard copy only)	FI/01/28/1(a)
Paper by the Association of Public Service Excellence	FI/01/28/2
Paper by Professor Paul Grout	FI/01/28/3
Additional Paper by Professor Paul Grout	FI/01/28/3(a)
Paper by the International Project Finance Association	FI/01/28/4

Agenda item 4

Paper by the Clerk	PRIVATE PAPER

Agenda item 5

Paper by the Association of Scottish Colleges	FI/01/28/5
Additional Paper by the Association of Scottish Colleges	FI/01/28/5(a)
Paper by Canmore Partnerships	FI/01/28/6
Paper by Glasgow City Council	FI/01/28/7
Paper by MacRoberts	FI/01/28/8
Paper by Miller Construction	FI/01/28/9

Agenda item 6

Letter from The Presiding Officer	FI/01/28/10

Capital investment in the NHS under the 1990 NHS and Community Care Act: the impact of moving from government grant to debt finance in an under-funded system

Allyson Pollock,
10 December 2001

Principles

1. The founding principles of the NHS are comprehensive care and services free at the point of delivery, delivered on the basis of equity. As a national health service it has neither local tax raising nor income generating powers. Indeed such powers would contravene the spirit of the NHS, returning health services to the inequitable situation which pertained pre-1948 - relying on the wealth of local areas and introducing regressive elements to its funding.

2. The goal of equity is achieved by using the mechanisms of risk pooling and cross subsidisation. Risk pooling and cross subsidisation were embedded in the structures for the funding and organisation of services. These structures have until 1991 shielded the NHS from the adverse consequences and extra costs of market forces.

3. From 1948 until 1991 funding for NHS capital investment was distributed as government grants, and planning structures were evolved to link planning, population needs, and funding. However, as documented by the official NHS historian Charles Webster, the NHS inherited badly run-down estate with enormous inequities in the pattern and distribution of services across the country.[1] From the outset, capital funding was inadequate and the new hospital building programme did not start until 1962 and was never completed.[2] In recent years net expenditure on capital investment has been negative, indicating that the NHS was consuming itself in order to pay for capital investment (fig 1).

4. The NHS brought all hospitals and health service facilities apart from GP practice premises under public control and ownership. No charge was made on capital as to do so would have aggravated the inequities in distribution.

The internal market and the switch to public debt finance

5. The implementation of the internal market and the purchaser-provider split in 1991 established shadow market mechanisms and structures which allowed NHS services to be priced, bought, and sold. The new pricing mechanisms also involved trusts having to establish the costs of treatment and account for the use and consumption of capital, known as capital charging. No longer funded by block grants administered by health authorities, NHS service providers had to win contracts from NHS purchasers. Hitherto, private sector provision to the NHS had been curtailed by the financial and organisational arrangements that protected services from the market. Now the intention was to put the public sector on the same footing as the private sector, thereby facilitating the entry of private sector providers.

6. An important consequence of the internal market was to undermine the principle of cross subsidisation by requiring a costing methodology which would allow each element of the

[1] Webster C. *The National Health Service: a political history*. Oxford: Oxford University Press 1998.
[2] Gaffney D, Pollock AM, Price D, Shaoul J. NHS capital expenditure and the private finance initiative - expansion or contraction? *BMJ* 1999;319:48-51.

service to be priced for the market place. This includes a cost for capital. However unlike factories products where the cost of raw materials and plant can be divided by the number of products, accurate costing for complex patients and treatments is impossible. Pricing also introduces new transaction costs and new inefficiencies by requiring the elimination of cross subsidisation and hence risk pooling mechanisms of services.

7. The introduction of capital charges ended the era of funding NHS investment using government grant. The government switched to debt finance, requiring NHS services to make a return on capital employed and paying the government as banker and shareholder. From 1991, NHS hospitals were established as trusts with three statutory duties all of which are financial. Trusts were required to (i) make a 6% return on capital employed equivalent to an interest charge and public dividend (ii) break even after paying interest (not dividends) and (iii) stay within the external financing limit. There is no logic in requiring NHS services to make a return on capital because the value of NHS estate is a function of historical supply and location and in any case there is little logic behind requiring government, as owner of capital, to pay itself for the use of that capital. **However, despite this major change in policy neither the rationale for requiring NHS trusts to make a return on capital, nor the choice of a 6% rate of return on capital employed have ever been challenged or properly evaluated.**[3]

8. Trusts reflect the additional costs of capital charges in the prices they charge to the purchasers. Health authorities receive capital charges on the basis of the services within their area, not on the basis of the contracts they place. Trusts charge purchasers on the basis of their capital costs and not on the basis of the allocations purchasers receive to cover the cost of capital. The capital charge element of the price is an important lever in establishing different prices referred to as Reference Costs across NHS providers thereby enabling competition for services and the forcing down of prices, as the government funds services on the basis of average prices. The main point to note is that pricing is an arbitrary, unscientific and inexact mechanism as it involves different assumptions and there is no standardised methodology for pricing any of the components which make up the service. More importantly it removes the crucial element of cross subsidisation.

9. Capital charges are supposed to be resource neutral. However they are a source of leakage since services formerly supplied by the NHS and provided by the private independent sector also include a charge for capital. It can thus be seen that even at the system level capital charges are not be resource neutral as they were originally intended to be.

10. Moreover at local level capital charges can represent a real cost or a real saving depending on how services have been priced. **There is a lack of transparency in the formula and methods of calculating and allocating capital charges to purchasers and from purchasers to providers of health care. There has never been an evaluation of the capital charging regime, with respect to equity and planning.**[4]

11. Two arguments are commonly made to support the introduction of capital charging. The first, that the introduction of capital charges would increase the efficiency of the NHS's use of assets, has no evidence to support it. On the contrary, the problem stemmed from government failure to inject sufficient capital funds.[2] The second claim is that because capital charges are or have been non-cash allocations they are resource neutral and there is no net

[3] Shaoul JE. Charging for capital in the NHS: to improve efficiency? *Management Accounting Research* 1998;9:95-112.
[4] Pollock AM, Gaffney D. Capital charges - a tax on the NHS. *BMJ* 1998;317:157-8.

effect on local services. That being the case one might ask why the government chose to put in this complex system.

12. In an under-funded NHS the introduction of capital charges has had catastrophic effects. Their introduction in NHS trusts in the 1990s had strongly negative effects on trust assets and finances. Aggregated financial accounts of NHS acute hospital trusts in England for 1992-98 inclusive show that trusts as a whole failed to make the 6% target rate of return in all years except 1992 and 1994 (table 1). Even then, many trusts were unable to break even after paying interest. The cost of capital charges to the NHS as a whole might have been zero; but their average cost to each NHS acute hospital trust in 1998 (the first year when the government collected the full 6%) was £393,000. In fact, the situation was so parlous that the Department of Health decided not to collect the full 6% until 1998.[5]

13. The National Audit Office annual accounts show that in 1999-2000 78 trusts were in serious financial difficulties, failing to meet all their statutory financial duties.[6] The Department of Health's recent departmental report[7] lists as one of the causes of trusts failing in their financial duties "financial problems in Health Authorities leading to Trusts being unable to agree prices sufficient to cover their costs plus the six per cent rate of return" (12.24, p. 92)

14. The second argument - that capital charges have forced NHS trusts to weigh the worth of capital expenditure against the opportunity costs forgone and that that is a good thing - ignores their actual impact. Trusts were reluctant to undertake any new investment because increasing the value of the asset base increases capital charges. In other words at the local level charges acted as a real cost pressure. Capital charges deterred trusts from undertaking what the DoH regarded as a reasonable amount of expenditure for capital goods. In the first three years of their operation, NHS acute hospital trusts in England underspent on their capital budget by an average of £200,000 per year.[8] Between 1993 and 1997 NHS backlog maintenance costs rose from £2.4bn to £3.1bn.[9]

15. These shortfalls were a direct consequence of underfunding and the reluctance to take on the debt servicing costs arising from capital charges. Capital charges encouraged NHS trusts to sell NHS assets. As well as contributing to longer waiting lists, the loss of capacity arising from such sales and consequent reductions in bed numbers has been regretted in the report of the National Beds Inquiry[10] and in the NHS Plan.[5] Capital charges have had a strongly negative impact on the capital base of the NHS (and especially on planned capital expenditure) and in particular accelerated the decline in service capacity. **The volume and scale of land sales and disposals has not properly been recorded or been made subject to parliamentary scrutiny. Nor has the DoH published a proper estimate of the cash released from land sales, nor has it described how land sales and the subsequent use of PFI (see below) affect the capital charging regime.**

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[5] Pollock AM, Shaoul J, Vickers N. Authors' reply to John Appleby. *BMJ* 2001;323:281.

[6] National Audit Office. *NHS (England) Summarised Accounts 1999-2000*. London: National Audit Office 2001.

[7] Department of Health. *The Government's expenditure plans 2000-2001*. London: The Stationery Office, 2000.

[8] Shaoul J. NHS trusts: a capital way of operating. Manchester: Manchester University, 1996. (Working paper.)

[9] Department of Health. *The NHS plan: a plan for investment, a plan for reform*. London: The Stationery Office 2000.

[10] Department of Health. *Shaping the future NHS: long term planning for hospitals and related services. consultation document on the findings of the National Beds Inquiry*. London: The Stationery Office 2000.

How private finance compounds the effect of the capital charging regime in an under-resourced system.

16. Just as the rationale behind the policy which saw a switch from government grant to debt finance has never been questioned, neither has the switch to private finance the system where the government borrows indirectly by raisings funds for capital investment through an intermediary of businesses and banks. In the case of hospitals, a consortium of bankers, builders and service operators known as a special purpose vehicle raise the finance for capital investment, in return for which they design build and operate the buildings and receive an annual fee which covers the cost of capital, interest and services.

17. In the absence of government grant or public finance for new capital expenditure private finance is the only source of funds for new investment. This means that trusts have had not only to consider capital charges on retained estate but also the effect of diverting revenue budgets to service the real debts of the new owners of capital, ie, the PFI consortia.

18. The government and its civil servants persistently challenge the notion that PFI is responsible for the reductions in bed numbers and claim either that the clinicians decide the bed numbers or that reductions in bed numbers were simply a function of previous trends. But as we have repeatedly shown using government data, while reductions in bed numbers have been occurring, the DoH bed statistics indicated a flattening out of efficiency savings from increasing the proportion of day case surgery, reducing length of stay and increasing bed occupancy rates as early as 1995.[11] Moreover reductions in acute beds have plateaued since 1995. It was notable that all PFI schemes involved major reductions in acute bed numbers and services and that rehab and longer stay beds are being closed to fund PFI hospitals.[12,13,14,15]

19. The reductions in bed numbers are also the result in part of the introduction of the capital charging regime which created a pressure locally to decrease the estate (see above). Capital charges were a new claim on scarce revenue budgets and their effect has been compounded by the switch to using private finance which is very expensive. PFI and capital charges, as finance directors acknowledged, created a major affordability gap. This arose between what the purchasers (health authorities and trusts) said they could afford and the requirements of the PFI consortia. The affordability gap arose in part because of the high costs of any new investment. It can be seen (table 2) that the capital value of the new estates is much higher than the asset value of the hospitals they are replacing, even though the new schemes are generally situated on smaller and cheaper land sites and one hospital with a much smaller capacity is replacing up to two or three hospitals. Moreover most if not all of these schemes have seen a rapid escalation in costs from outline business case of more than 200% (table 3).

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[11] URL: http://www.doh.gov.uk/hospitalactivity/statistics/2000-01/beds_open_overnight/y00.htm
[12] Pollock AM, Dunnigan M, Gaffney D, Macfarlane A, Majeed FA. What happens when the private sector plans hospital services for the NHS: three case studies under the private finance initiative. *BMJ* 1997;314:266-71.
[13] Gaffney D, Pollock AM, Price D, Shaoul J. PFI in the NHS - is there an economic case? *BMJ* 319;116-9:1999.
[14] Price D, Gaffney D, Pollock AM. *'The only game in town?' A report on the Cumberland Infirmary Carlisle PFI* London: UNISON 1999.
[15] Pollock AM, Price D, Dunnigan M. *Deficits before patients: a report on the Worcester Royal Infirmary PFI and Worcestershire hospitals reconfiguration*. London: 2000.

20. The higher capital expenditure necessarily incurs higher capital charges in the form of PFI payments and a capital charges on retained estate and equipment.

Private finance and service reduction

21. Regardless of the reasons for the higher cost and the cost escalation, the important point to note is the impact on the revenue budget where the annual cost of capital to PFI hospitals has risen from an average of 9% of annual revenue to 20% (table 4). The escalating costs of using PFI and the increased leakage of money from the revenue budget results in reductions in the budget available for care.

22. All cost increases resulting from capital investment have to be met from the revenue budgets. Our research into the first 14 PFI hospitals has shown that the affordability gap is bridged in four ways: (i) through subsidies and smoothing mechanisms from the Treasury for the first batch (ii) the diversion of regional capital budgets which were originally intended for other parts of the NHS (iii) through diversion of resources from other services and land sale (iv) through cuts in the actual services.

23. Attempts to keep the costs down have seen dramatic average bed losses of 30% in the first 11 PFI hospital schemes and reductions in clinical budgets of up to 20%, the relocation to cheaper land sites in order to offset the higher costs by land sales, and the removal of equipment from the schemes.

24. The source of evidence for the downsizing in bed numbers and staff budgets lies in the planning documentation which underpins the Full Business Cases. Trusts have been given unprecedented control over the planning of new hospitals, employing their own management consultants and advisors. Formerly regions did planning on the basis of population needs. Now health authorities, regions, and clinicians have no active input into determining service capacity. Many of the full business cases do not give detailed caseload and bed planning numbers. There has been a major and unexplained departure from traditional normative and trend based planning. Moreover, much of the planning shows a failure to adhere to standardised DoH definitions of caseload and beds, making interpretation and comparison of previous and current bed numbers and caseload almost impossible. This has led to statistical gerrymandering.[16]

25. The planning documentation available reveals that management consultants were either incompetent or simply doing the task they had been asked to do, namely, using unrealistic performance targets for length of stay, occupancy, and day case surgery to justify major reductions in bed numbers. Many of the plans use selective non-evidence-based reviews of admissions to claim that caseload could be deflected to alternative settings, but the location, nature and costs of alternative settings are not provided.

26. Civil servants have pointed out that bed numbers are now increasing in PFI schemes since the National Beds Inquiry. But three points should be noted. First, there has been no increase in the baseline of total bed numbers, but rather 13,000 NHS beds have closed since 1997. The reported increase in general and acute beds is simply a reclassification of the beds and not an actual increase in the overall total number of NHS beds. Second, it is not entirely clear in which sector the increased bed provision is to be provided ie whether in public, for-

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[16] Dunnigan MG. *The downsized hospital hypothesis: value for money? The results of reducing staffed bed capacity on clinical activity in Lothian Health Board and other Scottish NHS hospitals between 1991 and 2000*. Glasgow: NHSCA 2001.

profit, acute, or nursing home beds. The final and most important point concerns how the increase in beds and services are being funded. Where PFI schemes have increased bed numbers from the original plans this must increase costs. It is important to ascertain how service increases are being funded and whether it is at the expense of the system as a whole.

27. Although more money has been pledged to the NHS under the Comprehensive Spending Review, it is not known whether it will be enough to cover the increased cost of capital, let alone keep pace with service needs. The review allows for average annual real terms increases of 6.1% in NHS UK funding over the four years to 2003-04. But NHS pay and prices increase faster than inflation and many trusts report annual cost pressures of 6% just to maintain current service levels and eliminate deficits. Moreover much of the new money has been earmarked for modernisation and is not being distributed to the local level.

28. Trusts are under a great deal of pressure not to reveal their financial difficulties or the real cuts, which are taking place in services. The new performance framework is tied to performance targets for the NHS which includes a financial requirement to break even. Trust chief executives' and directors' pay and careers are predicated upon gaining a three star rating.[17] The new performance framework which allows three star trusts new earned autonomies includes greater financial decision making and control over the use of resources from land sales and entering PFI deals and setting up private companies. While providers are in an increasingly powerful position regarding the planning of services they are now also responsible for their own investment and their own revenue to break even. The government has introduced new guidelines and powers which will for the first time in 50 years introduce a time limit to NHS care through the creation of an intermediate care sector. Trusts will have the potential to redefine some NHS care as personal care and to introduce charges for it.[18]

29. This has major implications for accountability and transparency. Under these conditions, it will become increasingly difficult for the public to understand what is going on how care is being paid for and how it is being redefined. This has the potential to increase inequalities in access and will invariably lead to increasing fragmentation and loss of coordination in planning and providing care.

Conclusions

30. The system of capital charges (public debt finance) makes new investment unaffordable whether public or private. There is no logic in requiring NHS services to make a return on capital because the value of NHS estate is largely a function of historical supply and location. Private finance diverts scarce resources away from services to paying the new owners of capital, and exacerbates under-funding and decreases the volume of services available to the public.

31. If the government is committed to an affordable universal national health service and to expanding the range and volume of services which have been lost, it would abandon the system of debt financing, reinstate government grant, and properly resource the revenue requirements. It would also abolish the internal market and pricing and restore planning structures thereby reversing the trend which has seen population needs divorced from service planning.

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[17]Department of Health. *NHS performance ratings: acute trusts 2000/01.* London: Department of Health 2001. URL: http://www.doh.gov.uk/performanceratings/index.html

[18] DoH Health Service Circular / Local Authority Circular. HSC 2001/01: LAC(2001)1 Intermediate care.

32. The indications are that the retention of market structures, the establishment of trusts, the capital charging regime, the requirement to use private finance, and the new freedoms of trusts to engage in commercial ventures will return the NHS to a pre-1948 situation where trusts become increasingly reliant on the wealth of the local area.[19] Many PFI hospitals, for instance Carlisle and UCLH, are actively seeking charitable funds to help with revenue funding of new capital schemes.

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[19] Mohan J, Gorsky M. *Don't look back? Voluntary and charitable finance of hospitals in Britain, past and present*. London: OHE & ACCE 2001.

Table 1. Mean required and actual capital charges per NHS trust (£000)

Year	No of trusts	Average total income per trust	Average operating surplus	Surplus as a % of income	Required capital charges	Actual capital charges	Shortfall
1992	42	61,712	4,578	7.4	6,593	6,484	109
1993	92	60,560	3,400	5.6	6,328	5,550	778
1994	169	62,690	3,828	6.1	6,183	5,530	653
1995	235	65,743	3,468	5.3	6,189	5,418	771
1996	241	69,586	2,904	4.2	6,586	5,650	936
1997	239	74,081	2,950	4.0	7,010	6,293	717
1998	238	77,745	3,315	4.3	7,372	6,979	393
All					46,261	41,904	4,357

Figures are for all NHS acute care trusts in England, 1992-98 inclusive
Source: *Fitzhugh directory of NHS trusts*
Required capital charges = 6% on capital value plus depreciation
Actual capital charges = surplus (to pay interest and dividends) plus depreciation

Table 2: Table showing escalation in Asset values of a sample of hospitals- prior to and after PFI.

	Net book value (after depreciation) £m	Cost or valuation £m	PFI construction cost £m
Carlisle (1999)	22	33	87
Bishop Auckland (1998)	18	24	67
University College London Hospital (2000)	295	308	422
University Hospital Birmingham (2000)	145	179	291
Norfolk & Norwich (1998)	18	39	144
Swindon & Marlborough (2000)	21	37	96
South Bucks (2000)	88	99	45
South Derbyshire (2000)	130	151	177
Greenwich (2000)	47	56	93
Bromley (2000)	67	83	118

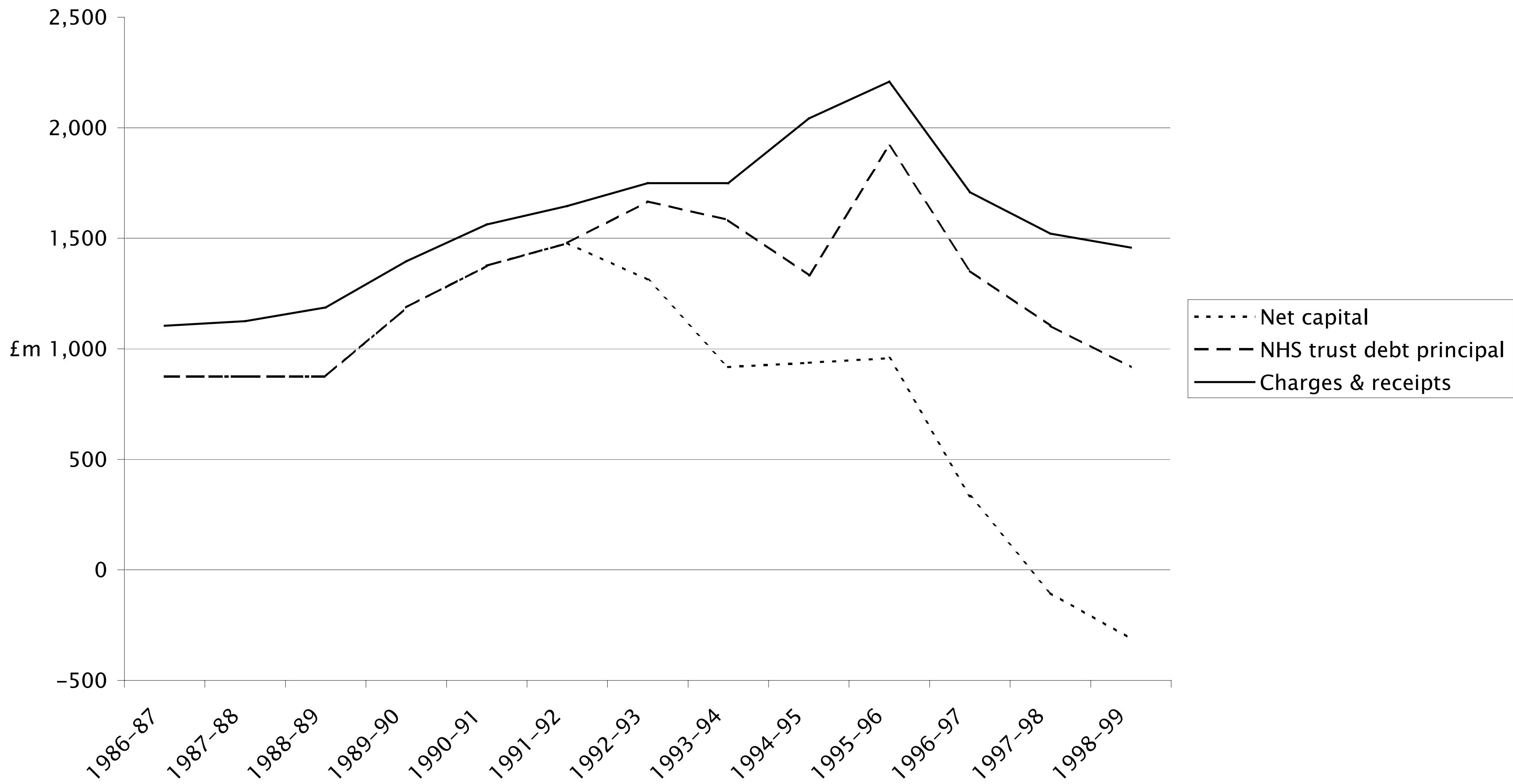
Source: Annual reports and accounts; Department of Health press releases

Table 3 Cost of capital as a percentage of income, pre and post PFI

Trust	Pre PFI	Post PFI
	Capital as % of income	Capital as % of projected income
Norfolk & Norwich	0.7	18.9
South Tees Acute Hospitals	3.9	10.0
Dartford & Gravesham	7.5	27.2
Greenwich Healthcare	3.7	13.3
Swindon & Marlborough	3.3	14.3
Bromley Hospitals	7.0	10.7
Calderdale Healthcare	3.0	11.3
North Durham Healthcare	2.9	9.9

Sources: Fitzhugh Directory 1999; Health Committee, *Public Expenditure on Health and Personal Social Services 2000. Memorandum received from the Department of Health containing replies to a written questionnaire from the Committee*. London: the Stationery Office 2000; NHS Trusts Annual Accounts, 1998-99, 1999-2000.

Figure 1. Financing of hospital and community health services capital expenditure, 1986–87 to 1998–99



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Date: 31 May 2001

INQUIRY INTO PFI AND PUBLIC/PRIVATE PARTNERSHIPS

1. Introduction

This paper reflects the views of APSE's membership across Scotland in response to the invitation to present evidence to the Finance Committee on their inquiry into PFI and Public Private Partnerships.

2. Background

The Association for Public Service Excellence is the representative organisation for over 250 local authorities across the United Kingdom. Its membership reflects a tripartite approach, with equal involvement from elected members, officers and trade unions.

The Association consults, develops, promotes and advises on best practice in the delivery of public services. APSE has been at the forefront of assisting its 32 local authority members across Scotland in the implementation of Best Value and the wider social policy agenda of the Scottish Executive. APSE promotes quality public service provision through networking, sharing of information and best practice and is committed to the concept of continuous improvement.

3. Response to Questions

(a) **What are the advantages and disadvantages to the public sector in funding capital expenditure in this way? What is the basis for the argument that private capital is required to obtain efficiency savings in service delivery?**

Much of the public sector has been starved of capital investment over a period of almost thirty years. Any initiative that begins to address the resultant crisis is therefore welcome to some extent.

The apparent primary advantage of PFI is that it allows expenditure on public infrastructure to take place without such spending being restricted by treasury limits on public debt. Given that this brings with it an inevitable impact on revenue expenditure it begs the question of why private investment should be

considered preferable to public investment. In economic terms, there is no reason why this should be the case. **Productive expenditure is beneficial whatever the source**. Unfortunately, the method used to calculate aggregate public sector debt used in the UK (Public Sector Net Cash Requirement) fails to distinguish between productive expenditure and consumptive expenditure. This rather blunt and increasingly anachronistic approach was introduced at a time of crisis when draconian measures were demanded as a quid pro quo after the IMF stepped in to bolster the UK economy flowing the oil crisis of the 1970s.

APSE would like to take this opportunity to once more **call for a review of the definition of public expenditure with a view to bringing Scotland in line with the rest of Europe**. The adoption of General Government Financial Deficit (GGFD) in place of PSNCR would allow for far greater flexibility in public sector investment decisions allowing them to be driven by a more meaningful assessment of the advantages and disadvantages of wholly public, wholly private or mixed investment.

Modernisation of treasury rules would bring with it a more positive approach to the PFI. The route would no longer be chosen because it is the only way around public spending restrictions and therefore Hobson's choice but because in a given situation its real advantage, transfer of risk to the private sector, would outweigh its disadvantages. The significance of those **disadvantages will vary from project to project** but would include:

- **Increased revenue costs as an inevitable price of risk transfer and the usually higher costs of borrowing in the private sector**
- **Loss of democratic control and accountability**
- **Long lead in times**
- **Complex contractual arrangements leading to high initial costs**
- **Loss of flexibility arising from necessarily long-term arrangements**

The Association **does not accept the argument that private sector involvement in public sector capital projects automatically brings with it greater efficiency and therefore savings**. The appropriateness of this approach will depend on the requirements and nature of each project. In any event there are numerous examples of where Public Private Partnerships have failed to deliver promised savings and some that have proved to be spectacularly expensive.

The Association is particularly concerned that in some schemes **so called efficiency savings are really reductions in overheads resulting from the imposition of longer working hours and cuts in terms and conditions of the staff employed to maintain PFI assets**. Local Authorities considering the PFI route should be **conscious of the potential impact on local economies and levels of social exclusion of adopting private solutions to public need**.

Successful outcomes through this delivery vehicle are by no means guaranteed, and whilst it is still early days in examining the actual eventual cost, there are some early indicators of critical failure in already established projects: -

1. First PFI hospitals suffering from string of design problems
2. Royal College of Nursing confirms that the correlation between outsourcing of hospital cleaning services and the rise of infections in hospitals is 'strong'.
3. Three private firms running prisons have seen their contracts given back to Prison Service.

(b) **What are the best value determinants of PPP?**

As a possible procurement option **PPP should be subject to the same best value determinants as any other option**. Unfortunately restrictions on public borrowing often leave public bodies feeling that their options are actually very limited. Where private finance is the only finance available other considerations including the wishes of stakeholders are inevitably diminished in importance. Decisions about how best to provide supporting services such as building cleaning, grounds maintenance and building maintenance are also affected where capital finance decisions are driven by treasury rules rather than by the wishes of local communities.

The best value framework requires cyclical review and continual improvement. The long-term arrangements that characterise the PFI may be incompatible with these requirements. Twenty-five or thirty year contracts may include clauses guaranteeing performance but will not allow for any fundamental change in the way that a service is delivered

(c) What has been the experience of this form of investment on public sector employees? Is the perceived effectiveness of PFI/PPP projects obtained at the expense of individuals who are providing the service?

Critical questions surrounding TUPE and Pension Rights and their application within such projects remain. For example, efficiency savings leading to re-negotiation of existing terms and conditions. Other considerations include the likelihood that many new employees joining such schemes could be offered lower salary conditions thus **creating a 'two tier' workforce**.

Research into the employment impact of CCT suggested that savings were largely generated through reductions in the terms and conditions of employment of transferring workforces. There was also a significant gender in-balance in that women were disproportionately affected. Despite the TUPE regulations there is a real danger that PFI schemes may seek to make long-term savings in the same way. The Association would therefore **call for a gender impact study to be undertaken as part and parcel of each public sector procurement option appraisal**.

7. Conclusion

In conclusion: -

- **APSE welcomes the Finance Committee's inquiry into PFI and Public Private Partnerships as there is a clear need to clarify the ongoing considerations, which surround the use of PFI and PPPs in Scotland.**

- **The Association believes that the selective use of the private sector can bring real benefits to public service delivery. However procurement decisions must be based on a full appraisal of available options and not be driven disproportionately by an unnecessary and unhelpful preference for private sources of capital.**

APSE welcomes this opportunity to present written evidence to the Finance Committee and stands ready to provide further written or oral evidence if and when required.

For further information, please contact: -

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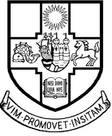
30 May 2001
Association for Public Service Excellence



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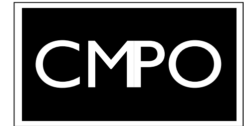

Leverhulme Centre for Market and Public Organisation

Director: Paul A. Grout, Professor of Political Economy

Callum Thomson,
Clerk to the Finance Committee,
Committee Chambers,
The Scottish Parliament,
Edinburgh,
EH99 1SP

4th October 2001

Dear Callum,

We are currently conducting research into PFI projects at the Leverhulme Centre for Market and Public Economics and will forward research papers to you as they arise. In the meantime I have drafted a short letter which highlights some of the simple deficiencies of current public/private comparisons. We conclude, somewhat tentatively, that the net effect of these deficiencies is that private provision may be more cost effective than is currently recognised.

Value for Money Test

At the most generic level, the impact of any project can be viewed as the difference between aggregate benefits and costs. In other words, it is summarised by the present value of the cash flow of benefits, or services, net of costs. The traditional method of assessing whether a project is beneficial, and to compare delivery by the private or public sector, is to conduct a fully blown cost benefit study. That is, a comparison between the streams of costs and benefits under private and public provision.

The approach adopted in the UK to decide between public or private provision does not do this. Instead it calculates a Public Sector Comparator (PSC), which is the best guess of the cost of delivering the project in the public sector, and compares this to the outcome of a private sector competition. This is a very different exercise from the traditional cost benefit analysis that is still conducted in many countries. An example, of a transport project makes this clear.

The public sector model assumes that the public sector procures and owns the road. If public provision is undertaken then the cost to the Treasury is the cost of procuring and running the road. This is an assessment of costs but has no measure of benefits built into the calculation. In contrast, the private sector provision model assumes that a consortium owns the road and the government pay the consortium according to usage by the general public. The figure does indeed represent a cost as viewed by the Treasury but, in terms of a cost-benefit analysis, is technically far closer to a present value of the benefits of the project net the costs. Thus the value for money test neither compares the true cost of public delivery with the true cost of private delivery, nor compares the benefits of public and private provision. Instead it compares the cost of public

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provision with something more akin to the value of benefits of private provision. This has a series of consequences.

Discount rates

Adequate discounting of flows of benefits and costs is an essential preliminary step to any comparison between public and private sector provision. The current practice is to assign a unique discount rate to both public and private sector cash flows. If the private sector figure is smaller then it is chosen. In theory if the public sector number is smaller then public provision is chosen.

It is known that the choice of provision is sensitive to discount rates. For example, in its investigation of the first four DBFO road contracts, the National Audit Office considers the sensitivity of the comparators to the discount rate. In this particular instance, the value for money of the A419/A417 DBFO [i] project became negative following the hypothetical decrease of the real annual discount rate (from eight to six percentage points). [ii] Therefore, it is important to apply the correct discount rate.

It is generally accepted in finance that revenues are more risky than costs and that revenues should be discounted at higher rates than costs. The analogue in this context is that benefits are likely to be more risky than costs and should be discounted at higher rates than costs. This implies that the public sector comparator should use a lower discount rate than that used to discount the private alternative. Failure to recognise this may overstate the cost of private provision relative to public provision. Given the sensitivity of PFI projects to changes in discount rates, the use of a single discount rate for the public/private comparison may mask significant differences in efficiency between private and public sector provision. This may have little impact on some PFI projects, such as defence projects, but far greater impact on the comparison of transport PFI projects.

Benefits

Private finance projects are based upon the delivery of verifiable services within the terms of a contractual agreement but the level and quality of public sector delivery are not defined, since no formal contract is written for public sector provision. There is no reason, therefore, to suppose that identical flows of services, hence benefits, would arise from public and private sector provision.

The failure of the PSC to deal with benefits makes it virtually impossible to make a sensible comparison of public v. private delivery. One suspects that in general this works against private provision. For example, in a private finance project, payment by the service purchaser only occurs upon service delivery. All risks associated with the project benefits are therefore borne by the private sector provider. Such risk transfer reduces the true expected cost of private sector delivery, since the government only makes payments for services when actual delivery has been verified. This is not fully represented in the public/private comparison and hence the public sector looks far cheaper per unit of 'output' than is actually the case.

Competition

Empirical evidence shows clear benefits of contracting out. For example, in refuse collection savings of around 20% are frequently documented as a result of compulsory competitive tendering. Similarly, there have been enormous gains in labour productivity within the privatised utilities. In contrast such levels of cost savings do not appear to be observed in private finance projects. A recent report commissioned by the Treasury [iii] finds 17% cost savings in PFI projects. However, this figure is based on a small sample of 29 PFI cases and, more importantly, the report identifies that 60% of those apparent savings can be attributed to the chosen risk transfer valuation method. That is, it is not present in the raw evidence.

It may be that there is something unusual about private involvement in PFI projects that differs significantly from other forms of ‘privatisation’, but a simple comparison between, on the one hand, the data presented on PFI projects and, on the other, experience of CCT and privatised utilities does indicate that there may be problems in the current assessment of value for money. It is worth adding, however, that the competitive process may itself be masking efficiency gains.

For example, privatised utilities have been successful in reducing costs but significant proportions of this gain have been received by shareholders over the years. Similar gains could be present within PFI projects but not appear in the value for money test because of weak competition. The value for money test compares the cost to the Treasury of different methods of delivery. It is not a direct test of the efficiency of public versus private sector delivery. Where there is limited scope for funding of public projects there is an incentive for those wishing to see a project go ahead to leak information to the private bidders that will increase the likelihood that they will beat the PSC. In certain cases this may drive down the private price but one suspects that more often it provides a focal bidding point that may enable a greater share of any efficiency gains to remain within the consortium.

This raises a general question of the purpose of PFI. If the main driver is to save Treasury expenditure then efficiency gains that fail to impact on Treasury payments bring no benefit. In contrast, if the drive is to improve efficiency in the economy and to release scarce resources, such as labour, for alternative uses then it is less important how the benefits of greater efficiency are allocated. Although, an obvious point, it is worth emphasising that the primary purpose of PFI is often unclear.

This letter is rather brief but I hope that it may be helpful in highlighting some of the problems with the current assessment methods and the conclusions that are drawn from the evidence based on them. I and my co-researcher on the project, Ludivine Jeandupeux, would be happy to discuss the issues in more detail if we can be of any assistance,

Yours sincerely

Paul Grout

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[i] Design, Build, Finance, and Operate.

[ii] Table 14 page 34: National Audit Office, The Private Finance Initiative: The First Four Design, Build, Finance and Operate Roads Contracts, HC 476 Session 1997-1998, 26 January 1998.

[iii] *Value for money drivers in the private finance initiative*, A report by Arthur Andersen and Enterprise LSE, commissioned by The Treasury Taskforce, January 2000.

Is the Private Finance Initiative a Good Deal?[1]

Paul Grout[2] *argues that the rules that dictate when to opt for PFI/PPP instead of public provision are flawed. Despite views to the contrary he contends that it is the benefits of private sector provision not public sector that are most likely to be underestimated by the current process.*

In the last twenty years there has been a two step change in the idea of what the public sector should be expected to provide. The first step, the privatisation programme, although dramatic at the time, now seems relatively tame. Gone are the days when the state was expected to own and operate networks, such as telecoms and electricity, run airlines or operate automobile businesses. Ownership was passed to the private sector and the role of the state rolled back to its natural function as regulator of residual dominant positions.

The second stage, the Private Public Partnership/Private Finance Initiative approach, is proving just as controversial. The state is now stepping back from buying and owning more traditional assets such as roads and hospitals. Here the state remains the core purchaser but is choosing to buy a flow of services from the private sector and leave the building and ownership of the assets to the private sector. This article is concerned with the PPP/PFI choice.

The traditional, and thorough, way to assess whether private provision is better than public is to look at the costs and benefits of each of the provision alternatives and undertake an appraisal. These days, however, few cost benefit studies of this type are undertaken. They are thought to be too complex and imprecise. Instead a value for money test is undertaken. It is this simplified approach that is the source of the problem. This article argues that the rules that dictate when to opt for private instead of public provision are flawed and that it is the benefits of private sector provision not public sector that are most likely to be underestimated by the current process.

Background

A large part of the controversy surrounding PFI projects stems from distrust of the government's case that private provision of infrastructure and public services is really better. The rules dictating when to opt for private instead of public provision have aroused suspicion and there is a view amongst the sceptics that the government is trying to 'fiddle' the books to make private provision appear beneficial.

Some of this is based on old chestnuts such as the notion that, since the government can borrow more cheaply than the private sector, it must be better to have government provision. In reality, regardless of the project, the government can borrow more

[1] Forthcoming in *Market and Public Organisation*, Issue 6, December, 2001
[2] Professor of Political Economy and Director of the Leverhulme Centre for Market and Public Organisation, University of Bristol

cheaply than the private sector simply because they are more likely to repay than anyone else is. In the last resort, no matter how unsuccessful a project, the government is able to increase taxation and hence ensure that it can repay debt. This is why the public sector can borrow more cheaply, not because public ownership makes a project less risky and cheaper than it would be in the private sector.

Indeed, the difference between the required return on private sector debt and public sector debt is greatest where risk is greatest. Hence the false view that the government can provide cheap money would predict that the public sector should really be setting its sights on dot.com and swaptions markets rather than investing in the safer options of hospitals and roads. A rather implausible conclusion.

However, we cannot be dismissive of concerns about the rules that determine the public/private choice. People are right to think that something is 'funny' about the way that the public/private decision is judged. In fact, the current rules are flawed and distort the decision. However, it is almost certainly the case that the failure of the current rules works in exactly the opposite direction than is commonly believed. It is the private not the public sector that is harmed by the current process.

The value for money approach

A value for money test asks the following question. Does the Treasury pay less for private provision than public provision? If the answer is yes then the private provision route is taken. In the case of a road, for example, the test compares two cash flows. On the one hand, it calculates the cost if the public sector procures and owns the road. This is the 'public sector comparator'. The alternative assesses how much the Treasury would have to pay to a private consortium for every vehicle using the consortium's road for the next 40 years. This is the PFI alternative. In the public provision case the government is buying a road whilst in the PFI alternative the government is buying services. In the latter case the private consortium owns the road.

The fact that one is comparing a public sector comparator that measures the cost of buying assets, on the one hand, with a PFI contract that measures the cost of buying services, on the other, is like comparing apples with oranges. Of course, this is not an insurmountable problem if one recognises that one is comparing apples with oranges. The problem with the Government's existing value for money tests is that they fail to distinguish between the apples and oranges, instead they treat everything as a fruit cocktail.

It is helpful to think of the problem in terms of a private sector analogy, say the building and letting of an office block by a private company. If the project just breaks even, i.e., rents just cover costs, then the company could measure the scale of the project either by referring to the cost of buying the block or to the value of all the expected rents. That is, one can calculate the cost of hiring a contractor to build the block or alternatively one can calculate the present value of all the future rents that may be received over the life of the building.

But the latter is a very different animal from the former. The 'build cost' is a front-end cash flow; the majority spread over two years or so and may be a relatively fixed figure, depending on the procurement contract and exposure to cost overruns. In contrast, the present value of rents is spread over forty years or so and will be massively more risky. The demand for space will depend on the state of the economy and so rents will be lower when the economy faces hard times. As common sense suggests, and any finance textbook shows, future rents should be discounted at a higher rate because of this uncertainty. However, there are even bigger differences to worry about. For example, if in a particular year the offices have something wrong with them

then there will be no rents arriving at all in that year. This again suggests that the future rents should attract a higher discount rate. The salient point is that if the company does not take account of these factors in the discount rate then the project will look as if it is very profitable when it is not. That is, present value of expected rents will be grossly over estimated.

The analogy with the value for money test is clear. The public sector comparator is analogous to the cost of hiring the contractor to build the office. The PFI alternative is equivalent to calculating the cost to the Treasury of paying all the future rents but failing to take account of the risk. As we have seen, the present value of future rent is overestimated and suggests to the Treasury that building the office itself is a falsely cheaper alternative. In the PFI context the public sector comparator appears better value than it really is.

Four critical concerns

A simple application of economic theory identifies four areas where the apples need sorting from the oranges – the failure risk, the inherent risk of services, the treatment of quality and the role of profitability.

First, the current rules take no account of the fact that the payment to the contractor may not be made, i.e., failure risk is not recognised. The inability to deal correctly with failure risk is a major problem for PFI projects. The scale of the problem stems from the ferocious nature of the PFI incentive schemes. Most payment on delivery schemes look a bit like the 'movie' problem. If the film takes months longer to shoot than intended then the future returns from the film get pushed further away and have lower value as a result. This creates a strong incentive to finish on time. But most PFI projects have far more powerful incentive schemes built into them. If a project is supposed to deliver services for 25 years and comes on stream five years late then the contract does not push the whole process back five years in time but only pays out for 20 years. Indeed, the consortium loses more than 20% of the value since the years that get no payment are the initial years, those with the highest present value. This is a powerful incentive scheme, good in one respect since it imposes powerful incentives to deliver the services on time, but under current rules creates a massive underestimate of the value of private delivery. In short the existing methodology does not take proper account that the costs are incurred by the public sector under conventional procurement whether or not the desired benefits are received, whereas under the PFI the public sector only pays to the extent that it receives these outputs. That is, the expected cost of most PFI projects is much lower than appears in the value for money test.

Second, the inability to recognise the inherent risk of services leads to overestimates of the cost of private provision. For example, the volume of vehicles on a road will be prey to the state of the economy in the same way as the volume of office take up. As with the office block, this risk needs to be recognised. Of course, the risk will be project specific and what is appropriate in the road context may not be appropriate for MOD contracts. What is certain is that the omission of failure risk and the inherent service risk in the discount rate overestimate the cost of private sector delivery in comparison to the public sector comparator. Because the PFI projects are so long lived small differences in discount rates may have huge impact on the attractiveness of PFI projects and so we may be far away from recognising the true benefits of private provision.

Third, the value for money tests fail to recognise the quality of benefits delivered. A common criticism of the PPP/PFI programme is that they have failed to come up with really innovative approaches. This is not altogether surprising if these do not receive their true value in the assessment. It

is far easier to replicate the public sector project at a lower cost.

Finally, there is a real issue of how to treat profitability. With the current system the ability of the private sector to deliver more cheaply than the public sector is only seen to have value when it reduces the Treasury cost. Whether this makes any sense or not goes to the heart of the reasons for adopting a mixed private and public delivery system in the first place. If the sole driver is cost reduction then the current approach to profitability is correct. But if the PPP/PFI model should be thought of as part of the overall productivity drive, and to my mind it makes sense to see it this way, then better productivity is the true test. How the spoils get split is important but not the sole issue. If productivity is an objective we ought to recognise this more formally in the assessment process.

Where do we go from here?

The empirical significance of the four points raised in the previous section is currently unknown but two points appear to be fairly clear.

- One, the net impact of the failure of the current system to recognise these effects seems to work almost universally against the private sector, although the true answer can only be known when the correct assessment is undertaken. I agree with the view that something is wrong with the current approach but the idea that there is a fiddle to help the private sector is wrong. The bias looks to be strongly in the opposite direction.

- Second, the failure to recognise these effects is unlikely to be small beer. I have argued that the Treasury should use different discount rates for PFI projects and the public sector comparator. Because PFI projects are long lived the consequences of small differences may be huge. For example, if the PFI discount rate is wrong by one per cent, then the costs of private provision may be overestimated by around 14% on a forty-year project.

So where should we go from here? A good first step would be to conduct a study of the sensitivity of existing projects to differences in discount rates between the public sector comparator and the PFI model. As far as I understand this has never been done. I anticipate that the effect is likely to be considerable. Of course, looking at existing projects somewhat misses a lot of the point. It is the very projects that failed to get going, which may well include many high tech projects, where the effects may be biggest. We need a reassessment of the assessment procedures. We cannot engage in a sensible PPP/PFI debate until we have a clear idea of the financial benefits.

The Scottish Parliament

Finance Committee Inquiry into PFI and Public Private Partnerships.

Submission by Geoff Haley, Chairman of International Project Finance Association.

Background

Private Finance Initiative

Since 1979 the UK Government has sought to involve the private sector in even wider areas of the economy in the belief that private sector enterprise and disciplines can bring gains in efficiency and reductions in cost. The objective has been to transform the role of the public sector from being a provider of services to that of an enabler and purchaser of services. From 1979 to 1990 over 50% of the public sector economic activity has been transferred to the private sector, mainly due to the privatisation of the state run industries. Over 650,000 employees transferred to the private sector during this period. The Private Finance Initiative lies somewhere between outright privatisation and the contracting out of services. The Government had already begun to explore the possibility of using private finance to procure public infrastructure with the commencement of the Channel Tunnel in 1985 and the Dartford River Crossing in 1987. The Private Finance Initiative (PFI) was launched by Norman Lamont in 1992 with two principal objectives:

- To introduce private sector efficiency and management skills into the ownership and maintenance of public capital assets

- To encourage the private sector to provide capital for the construction and maintenance of new infrastructure, facilities, buildings and equipment.

The policy got off to a shaky start as developers, civil engineering and building contractors were highly suspicious of a new form of contracting which required them to provide long term finance for new buildings and facilities against a background of unclear rules and regulations and equally suspicious attitude of public officials. However, the PFI gained new momentum in November 1994 when Kenneth Clarke announced:

"we need to take the private finance message to the heart of all decision-making in government [.....]So I am announcing today that in future the Treasury will not approve any capital project unless private finance options have been explored."

The effect of this pronouncement was that every government department, quango and local authority must look at the feasibility of awarding a contract to the private sector to finance, design, build and operate any new buildings, facilities or equipment. Ultimately the public servant must evaluate whether using the private sector will provide better value for money than using public money. The policy covers a very wide range of sectors from transportation (shadow toll roads and tram systems) healthcare e.g. (new general hospitals) provision of new computer networks throughout the NHS and DSS, universities and schools, water and sewerage schemes, new transmitter services for the BBC, new privately run prisons for the Home Office, new accommodation blocks for the Ministry of Defence, as well as urban renewal schemes and social housing to be undertaken throughout the UK.

Public Private Partnership-

Since 1997 the Labour Government has not only continued to use the PFI route but has sought to enhance and improve it in every possible way. To that effect Sir Malcolm Bates was immediately asked to conduct a review of PFI. All his recommendations were accepted and he finalised a second review. The Government has very swiftly stamped its authority on the process. Roads projects and NHS projects have been ruthlessly and objectively streamlined with only those most likely to succeed being allowed to continue. It has enacted new legislation, such as the Local Government (Contract) Act 1998, published standardised terms, conducted and published the results of the two reviews of the PFI by Sir Malcolm Bates addressing the institutional structure, the process itself, guidance and dissemination of know-how as well as attacking the problem of bid costs. Another review was undertaken by Peter Gershon, who was invited to review civil procurement in Central Government in the light of the Government's objectives on efficiency, modernisation and competitiveness in the short and medium term, resulting from this review was the creation of the Office of Government Commerce.

Public Private Partnership developed alongside PFI's; despite initial teething troubles both PFI and PPP's are now a major way of procuring all kinds of projects and services and major contractors have reorganised their businesses to take account of the changes.

Issues

EU Procurement Rules

There is currently a disagreement between the UK Government and the European Commission as to the choice of procedure for procurement of PFI and PPPs. The disagreement relates to the UK Government's use of the negotiated procedure, which should only be used in "exceptional circumstances", when putting PPP projects out to tender. The Government advises use of this procedure for most PPP projects since it allows the procuring authority to negotiate the terms and conditions of the final contract with the preferred bidder with the aim of securing best value for money.

The dispute involves the Pimlico Schools PPP project which was advertised under the negotiated procedure. The European Commission issued Written Opinion to the Government claiming that it was infringing the procurement rules by using the negotiated procedure for PFI projects as a general rule, rather than exceptionally. The UK Government has since sent a written response to the Commission's Written Opinion defending it's use of the negotiated procedure. The exact nature of the discussion between the Government and the Commission is not known since neither of the documents is publicly available. The Commission has commenced infringement proceedings against the UK Government and the case is pending before the European Court of Justice. Should the Commission win the case it would have a profound effect on the way PFI projects are currently tendered in the UK.

Bidding costs are presently high – often £2 to £3 million expenditure to bid a £30 million capital project. If the choice of negotiating with one preferred bidder is removed, each bidder would be required to submit detailed bids and incur equivalent expenses to that of a preferred bidder. The private sector do not have the human or financial resources to undertake this course of action.

The European Directives do not adequately cover procedures applicable to PFI's and PPP's and a new Directive from the European Parliament should be enabled to clarify and resolve these issues.

Are PFI's and PPP's True Partnerships

The concept of the Private Finance Initiative was introduced to inject private finance and private sector management skills into what previously would have been a public sector project.

The concept eventually became to be perceived as a private sector instrument as opposed to a method of linking public/private interests.

The concept of the Public Private Partnership was introduced to counter act such adverse reaction.

Are PPP's now creating true partnerships between the public and private sector? Probably not according to recent feedback from some in the public sector.

Both PFI and PPP's are regulated through a series of complex legal and contractual structures. Each parties rights and obligations are clearly set out in a set of contract documents. To understand those rights requires a regular review and scrutiny of the documents.

Some Chief Executives in the NHS Trusts who have experience of operating the new arrangements are calling for an increased involvement by the trust in the decision making process at the SPV level. Some would like a seat on the SPV Board, others would like to invest Trust equity into the SPV and have a return on that equity equal to the private sector.

Some Government Departments, local authorities and Trusts would like to see partnering arrangements introduced to improve the working relationship between the private and public sectors during the operations phase.

Once possibility is to create an informal partnership or alliancing structure above the contractual structure – such structures have proved to be successful in the North Sea between the oil companies and their contractors.

Public Sector Employees

Public Sector Employees - Background

The Transfer of Undertakings (Protection of Employment) Regulations 1981 SI 1981/1794 ("the Transfer Regulations") apply to a situation where the provision of a service changes hands. The Transfer Regulations originate from a European Union Council Directive, the ultimate arbiter of which is the European Court of Justice.

The Transfer Regulations generally apply to outsourcing and PFI/PPP projects; they apply to those projects which involve the transfer of services with an existing workforce e.g. hospitals but would have no application to new projects, e.g. toll roads.

The purpose of the Regulations is to protect employees who are affected by a transfer of an undertaking (or part) in which they are employed. Protection is afforded by transferring employees on their existing terms and with continuity of service; financial penalties imposed on the transferor or transferee for dismissal of employees for a reason connected with the transfer; employee representatives to be informed in advance about the transfer and effect on the workforce.

In effect, all employees employed in the undertaking must be taken on by the new operator of the undertaking ("the transferee"). The transferee must honour all existing terms and conditions of employment. The transferee is substituted for the transferor in the employees' contracts. In addition, employees transfer with any accrued rights and liabilities. The intention is to prevent the transferee from replacing the transferor's employees with its own new staff.

Any dismissal for a reason connected with the transfer will be automatically "unfair" whether it occurs before or after the transfer.

Government Proposals

On 11th September 2001, the government issued a consultation paper identifying proposals for changing TUPE. The background to the consultation paper is the revised Acquired Rights Directive Council Directive 2001/23/EC) promulgated in March 2001, which principally consolidated the 1977 and 1998 Directives.

The positive principle underlying TUPE is identified by the government as "the coupling of flexibility for business with fairness for employees". Its stated objective in amending the Transfer Regulations is to ensure the effective operation of the Regulations for employers, contractors and employees.

There are in all twelve areas in which the government considers proposals for change. Although no draft regulations have been prepared at this stage, a number of themes can be seen to run through these proposals.

- Striving for clarity and certainty;
- Addressing distinctions between the position of public sector and private sector employees;
- Promoting "the rescue culture" so that jobs are maintained and redundancies reduced;
- Increasing transparency between the parties to a transfer;
- Advancing the government policy of increasing pension provisions whilst reducing dependence upon the state pension;

Part of the exercise undertaken by government has been to estimate the likely impact of changes to TUPE. Using a survey to provide a statistical model and relying on a number of other sources, the government estimates that TUPE affects about 1% of undertakings per annum. It concludes that a total of 2,000 to 8,000 businesses with between 150,000 and 180,000 employees will be effected.

Scope of New Proposals

The first proposal is to introduce to the Regulations a new definition of a transfer of undertaking. The definition essentially codifies a number of decisions of the European Court of Justice.

A separate proposal deals with transfers within the public sector – these do not constitute transfers of undertakings under the Directive.

Occupational Pensions

Accrued rights in an occupational pension scheme are presently covered, but future rights are not.

- Two proposals are made for consideration. The first would put protection for the public sector on a statutory footing, whilst the second would amend TUPE to afford a degree of protection for occupational pension rights on transfer for public and private sector employees alike.

Dismissal by Reason of a Transfer of Undertaking

Such a dismissal is automatically unfair under Regulation 8 of TUPE, but an exception is made where economic, technical or organisational reasons ("ETO") entailing changes in the workforce are the reason or principal reason for the dismissal. Courts have grappled with the question of whether dismissal for a reason connected with the transfer and dismissal for an ETO reason are mutually exclusive.

The government considers that this is an issue which can and should be resolved by improved drafting, making it clear that ETO reasons are a subset of reasons connected with the transfer.

Changes to Terms & Conditions of Employment

The domestic controversy as to whether a valid variation could be made to an employee's terms and conditions after a transfer of undertaking had taken place was carried all the way to the House of Lords in the two cases of Meade & Baxendale v British Fuels Ltd and Wilson v St. Helen Borough Council. The employees won in the former case and lost in the latter because of differences in the reasons underlying the changes.

The government proposes to make the position clearer. It intends to introduce amendments to TUPE to the effect that it is permissible to introduce transfer-related changes that are made for an ETO reason. The lawfulness of the changes will then depend upon considerations that would apply irrespective of a transfer – such as the consideration that unilateral changes imposed by an employer would constitute a breach of contract.

Information & Consultation

The revised Directive introduces three major changes to the original directive, and the government intends to amend TUPE to ensure that it accords with the revised Directive. The three changes to the revised Directive are

- The proposed date of the transfer must be supplied to employee representatives;
- Employers will no longer be able to side-step their obligations in this regard by asserting that the decision resulting in the transfer was taken, not by the undertaking in question, but by a parent company or other controlling undertaking;
- Employers must provide information to individual employees where, through no fault of their own, there are no employee representatives. The government considers that this last item is already met by existing provisions.

In addition, there is an interesting suggestion canvassed in the consultation paper. The government is considering whether to require employers to supply to employ representatives a copy of any information relating to its employee liabilities which it has supplied to the

prospective transferor. The government's reticence is based on its perception that such an obligation might involve disclosure to employees of commercially sensitive information.

Current Position

The position of employees within PFI and PPP is becoming somewhere confused. The Government Consultation paper clearly sets out its proposals on TUPE.

In addition the boundaries relating to skills transfer have been clearly identified in PPPs for both education and health i.e teachers, doctors and nurses remain in the public sector. However, progress was being made in transferring more public sector employees to the private sector e.g. a project let under a year agreement to design, build, finance and provide nursing staff for a renal unit in the south west.

The Minister for health has now confused matters by making an exception for NHS employees. Porters, cooks, cleaners, laundry and security staff will be seconded to the private sector in three pilot schemes.

Will similar decisions be made for other sectors?

Clarification of government policy as a whole is required. The control and management of staff is fundamental to the operation of PPPs.

PFI/PPPs – Advantages

- Value for money: under these contracts, the private sector partner is incentivised to provide high quality public services and the public sector only pays for the level of services actually delivered.

- Higher standard services: the incentives on both sides of the contract are aligned towards delivering cost-effective public services consistently to the required standard.

- Risk transfer: a key feature of both PFI and PPP contracts and a main economic driver which makes this form of contract better value for money than conventional procurement is risk transfer. The principle behind the optimum risk transfer is that risk should be borne by the party best able to manage it. In practice, risk transfer is achieved through the provisions of the contract and the payment mechanism which forms part of it.

- Construction risks remain with the private sector.

UK GAAP for PFI

- In the UK the way PFI schemes are accounted for reflects the key principles of PFI namely that:

  - PFI schemes should embody the integrated provision of services, rather than being solely an alternatively means for the public sector to lease assets

  - Requires the contractor to accept sufficient risk transfer to be seen as the owner of the underlying assets necessary to provide these services.

- Where a scheme meets these requirements it is said to be 'off-balance sheet' to the public sector, as the private contractor from an accounting perspective is seen as owning the assets, and all the public sector has entered into is a long term service contract.

- Under UK GAAP, the accounting principles by which the assessment of who owns assets in the context of a PFI scheme, is undertaken in accordance with FRS 5-Accounting for the Substance of Transactions, and in particular Application Note F to the Standard – Private Finance Initiative and Similar Contracts.

- Though UK GAAP is not typically designed for government accounting, the UK Government has adopted an accounting assessment which, though subtly different in some respects, substantially mirrors that of FRS 5 (known as Treasury Technical Note 1 – Revised, or TTN1).

- The key features of the accounting assessment, whether under FRS 5 or TTN1 are:

  - assessing whether the contract is separable: in effect this means ensuring the contract is properly for the fully integrated provision of services and assets and then the provision of asset in themselves can not be split away from the associated services.

  - assessing the extent to which risk transfer to the commercial operator is achieved: this is done by reference to seven key criteria of risk identified by the guidance, which are:

- **demand risk: the extent to which the contractor is exposed to changes in income as a consequence of changes in the intensity with which the underlying assets are used.**
- **third party revenues: whether the contractor is exposed to income other than from the public sector.**
- **design risk: the extent to which the contractor can determine the nature of the property, subject to meeting the public sector's output specifications.**
- **changes in relevant costs: whether the contractor is exposed to potentially significant changes in the cost of providing the specified services over the duration of the contract.**
- **penalties for underperformance/unavailability: the likelihood and potential scope of the penalties suffered by the contractors if they do not deliver to the specified level of performance.**
- **obsolescence: the extent to which the contractor will be exposed to changes in technology (though is typically only relevant to IT based contracts).**
- **residual value: whether the contractor takes the risk the actual residual value of the property at the end of the contract will be different from that expected.**

- These accounting assessments are made in respect of the proposed contact, with a particular emphasis on the payment mechanism. The key risks typically relate to demand, or where that is not significant, residual value. And over time, the increasing sophistication of the UK PFI market has enabled the contractual expression of the transfer of overall ownership risk in a way which is neither punitive to the contractor, nor too costly to the public sector.

The practical approach

- From the perspective of the Government's own accounting, it is important (under UK Government rules) that a PFI scheme is off-balance sheet. This is because if so, then the Government has only entered into a service agreement and it does not need to recognise the assets, or their associated borrowing.

- Under UK Government accounting (which has recently changed from a cash based to an accruals based approach, known as resource accounting) finance leases, which an 'on-balance sheet' PFI scheme would be counts against, increase the UK's Public Sector Borrowing Requirements (an equivalent national debt).

- Therefore, in broad terms, central government would account for different schemes as follows:

  - **'off-balance sheet PFI': no assets or associated debt funding recognised by the government. Annual charge made to revenue in respect of the 'service' payments made under the scheme: No substantive difference between the approach under either cash or resource accounting.**

  - **'on-balance sheet PFI': in effect treated as entering into a finance lease for the provision of assets. Therefore the government has borrowed to finance assets and this is reflected in its accounts as follows:**

  - **under the cash accounting regime: the fair value (NPV) of the scheme counted as a first call against the sponsoring department's cash limit for the year thereby reducing its available resources by that amount. That amount would also score as government borrowing in the year the scheme was entered into. All subsequent charges under the scheme would be offset against the department's debt charges from the treasury (to avoid the department paying twice). As there is no balance sheet, there is no recognition of the underlying assets.**

  - **under the resource accounting regime: fair value (NAV) of the scheme reduces the sponsoring department's overall resource limit and therefore has less to spend going forward. The assets and associated finance lease liability now recognized on the balance sheet; and the annual payment to the contractor is offset against the capital charge calculated on the assets now recognized as belonging to the government.**

- In summary, under UK Government accounting rules, if a PFI (or any other) scheme is not off-balance sheet it counts as borrowing, and the full fair value of the assets is required to be funded in the year scheme is entered into.

- PFI schemes are also entered into by local government and the NHS. Though minor (if complex) differences apply to the accounting regimes under which they operate, the general accounting requirements are the same as for the local government.

PFI/PPP Disadvantages

- Some loss of control by public sector.
- Higher cost of capital provided.
- In assessing whether a privately financed scheme provides value for money the public sector client must take into account that private money costs more than public money since the government is always able to borrow money more cheaply than the private sector. Where it is proposed that the public sector should contribute some value to the project whether as cash or in kind (for example, land and buildings) it will usually be necessary to compare and cost the two alternatives of using public as opposed to private money. The marginal costs of using private finance must not exceed the marginal value to the public sector of carrying out the project.

Risk Transfer/ Value For Money

- The Government requires that PFI projects should satisfy two principal criteria:

  the private sector must genuinely assume risks
  the public sector must receive value for money in return for its contribution to the project.

Risk Transfer

- The theory of PFI is that certain risks connected with capital assets are better managed by private sector companies whose core business it is to deal with these matters on a day-to-day basis. The risks include maintenance risks (for example, the risk that a heating and ventilation system has not been correctly designed and planned) and operational risk (for examples, the risk that the boiler breaks down after three year's service).
- Since the private sector's core business is managing the risks associated with the above services, it can achieve significant economies of scale. At the same time it is worthwhile for the Government to pay a premium in order to remove these risks and perhaps free-up some contingency funds for other uses

Value For Money

- Value for money is measured not only in terms of price but also in terms of the quality or reliability of the service or facility. For example, when London Underground closed a £400 million deal with GEC Alsthom to supply, operate and maintain new trains for the Northern Line; the Treasury estimates that this deal transferred to GEC Alsthorm twice the performance risk available through conventional finance. The reliability standard below which GEC receives a financial penalty was nearly four times higher than the best fleet in service on the Underground at the time.

Our Ref: MD\RL\PFI
Your Ref:

31 May 2001

Callum Thomson
The Clerk to the Finance Committee
Scottish Parliament
EDINBURGH
EH99 1SP

Dear Mr Thomson

ASC RESPONSE TO THE FINANCE COMMITTEE INQUIRY TO PFI AND PUBLIC PRIVATE PARTNERSHIP

The Association of Scottish Colleges (ASC) welcomes this opportunity to submit its views to the Scottish Parliament's Finance Committee on the subject of Public Private Partnership (PPP).

The ASC is the policy and representative voice of Scotland's colleges. Further education is the lynchpin of lifelong learning and of improving the employability of the workforce and access to education and training for disadvantaged people.

Further education in Scotland is a fully devolved public service. The FE sector consists of 43 incorporated colleges and 4 others. It employs over 19,000 people and enrols over 410,000 students on its wide range of courses.

ASC is not affiliated to larger organisations or political parties in the UK. It seeks to advance better understanding, appreciation and investment in further education for the benefit of Scotland and its people.

FE in Scotland has benefited from PPP. The Stirling Centre was the first education PPP project in the UK. The Kilwinning Centre is another example of an efficient procurement. Both centres have been successful in helping colleges deliver FE to new communities who hitherto had no such provision. The same positive results are expected in Livingston when the new college's campus opens later this year.

More detailed responses to the questions set out in the consultation are attached at Annex A.

We hope these observations are helpful and would be happy to provide further information if required.

Yours sincerely

AMANDA R DRUMMOND
European & International Manager

FINANCE COMMITTEE INQUIRY TO PFI & PUBLIC PRIVATE PARTNERSHIPS

Q1. What are the advantages and disadvantages to the public sector in funding capital expenditure in this way? What is the basis for the argument that private capital is required to obtain efficiency savings in service delivery?
<u>Advantages</u> **1. PPP can deliver new infrastructure more efficiently than traditional procurement models e.g. Stirling FE Centre, West Lothian College, Livingstone and James Watt College, Kilwinning Centre. In all three the PPP approach represented better value for money than traditional procurement.** **2. Finite capital budget for FE. Need to look at ways of getting private capital budget to improve estate. Some use of borrowing e.g. Lauder College, but PPP also useful as costs can be met out of revenue.** **3. PPP also helpful in that it leads to more care in design to minimise maintenance costs, this has led to high standards of finish in, for example, Kilwinning Campus.** **4. Provides an option for capital funding not available from public funds.** **5. Forces a long term financial assessment which identifies the long term costs and assesses the sustainability of the project. It defers payment over the contract life (usually 25 years) but the main advantage is that it focuses the procurement process on the outputs required.** <u>Disadvantages</u> **1. Care needs to be taken that costs are affordable and do not place too high a burden on revenue stream. Contracts are long terms - 25/30 years.** **2. Not always best approach where smaller scale maintenance work is needed (which is an FE priority) because of costs of procurement and lack of interest in smaller projects by developers.** **3. Cost and complexity of the legal structure, PFI and PPP are bureaucratic and applicable only to very large projects. It can't address large-scale maintenance / refurbishment issues.**
Q2. What are the best value determinants of PPP?
Cost - Revenue savings in operating with realistic revenue streams for the private sector. **True risk transfer.** **Whole life cycle costings for the project.**

Q3. How relevant are the assumptions used in assessing projects (e.g. discount rate, repayment period, risk transfer)?
Most are speculative and because of the extended life span are not robust reflections of true costs. Risk analysis and transfer can, however, significantly impact on whether PFI is assessed to be better value than the PSC.
Q4. What are the costs of the capital programme? Is it possible to separate out capital charges from efficiency savings?
First part cannot be answered! **Yes, it is possible to separate charges and savings but the latter over time are increasingly irrelevant. Direct comparison may not always be possible. A proper PFI payment stream should encompass service delivery and capital costs.**
Q5. What implication does the introduction of Resource Accounting and Budgeting have for tracking this form of public sector capital investment, particularly what are the implications in this connection of a transfer from capital charges to revenue funding?
Difficulties in providing a "Budget Balance Sheet" to track capital charges etc.
Q6. What are the long-term implications of PFI/PPP projects on revenue funding in the Scottish budget?
Increased funding. Significant proportions of capital budgets will be used to service PFI projects.
Q7. To what extent is open consultation possible, given "commercial" confidentiality" requirements?
Limited, as all agreements are "commercial in confidence".
Q8. What has been the experience of this form of investment on public sector employees? Is the perceived effectiveness of PFI/PPP projects obtained at the expense of individuals who are providing the service?
PFI/PPP is perceived as transferring aspects of the public service to the private sector. Cynicism abounds.

SUBMISSION BY THE ASSOCIATION OF SCOTTISH COLLEGES TO THE FINANCE COMMITTEE OF THE SCOTTISH PARLIAMENT

Submission by the Association of Scottish Colleges to the Finance Committee of the Scottish Parliament

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1. **Private Finance Initiative and Public Private Partnerships (PFI/PPP)**

1.1 This submission adds to earlier summary evidence submitted by ASC on the views of the Further Education colleges on the use of Private Finance Initiative (PFI) or Public Private Partnership (PPP) for major estates projects.

2. **Background**

2.1 In all but a few cases, FE Colleges in Scotland own and manage their own estates and facilities. A few colleges have buildings which are leased from or shared with other users. Although Stirling Centre of Falkirk College was the first education PFI project in the UK, PFI has not been taken up on a large scale so far by the FE sector in Scotland. To date, there have been 3 completed projects with a combined value of £30 million.

2.2 Two of the PFI projects are new-build additions to the college estate providing another centre at a distance from the main campus. The third - and largest - so far project has been the complete relocation and rebuild of a colleges' main campus in a new location. Projects of a similar nature, however, have been undertaken or are planned by the FE sector by means other than PFI (see Annex 1).

3. **FE's Need for Investment**

3.1 The FE estate is in need of major investment. A condition survey undertaken by Scottish Further Education Funding Council (SFEFC) indicated that about £220 million was needed over 10 years simply to bring the estate up to current health and safety standards. Modernisation of the estate to current standards of flexibility and reasonable student expectation may require another £400 million over 10 years. It must be stressed, however, that there is no "master plan" for the FE estate or its modernisation. Colleges must prepare their own plans and seek the means of financing these in isolation and on an opportunistic basis.

4. **Sources of Finance**

4.1 FE colleges offer high quality teaching and training throughout Scotland but suffer from a legacy of poor quality buildings inherited from regional and islands councils and historic under-funding of revenue needs. Unlike the universities, colleges do not have significant capital reserves or endowments. Nor do colleges have access to preferential loans or public sector borrowing. Substantial financial support has been won from the Millennium Commission (particularly for the UHI Project in the Highlands & Islands), and from the European Regional Development Fund (ERDF) as capital grants towards individual projects which contribute to the aims of EU Structural Funds.

4.2 For most projects colleges have to put together their own cocktail of funding. Efforts to raise funds from alumni, charitable bodies or businesses are increasing. In some instances, part-funding is by commercial loan facilities. But the majority of projects must rely on public sector sources whether as initial capital outlay, or revenue finance to service debt or pay for leases and PFI project charges.

5. Advantages of PFI

5.1 The experience so far suggests that FE colleges can gain significant advantages from involvement in a PFI project to:

- Acquire a new campus or centre sooner, and to a higher standard, than traditional financing resources would permit;
- Obtain additional and/more flexible capacity for teaching;
- Locate key facilities closer to student and employer demand; and
- (Where facilities management is contracted out) focus more on key functions of teaching and support for students rather than managing the estate.

5.2 As against these advantages there are important issues with which PFI will confront the college. These include:

- Time, effort, cost of professional support in preparation stages;
- Lack of expertise to plan, appraise and negotiate a PFI deal;
- Ownership of site and assets to be provided;
- Transfer of risk leading to reduced control of building and facilities;
- Securing the underwriting of revenue commitments for a long period; and
- Flexibility if circumstances affecting the projects or the finances of the college should change.

6. Project Appraisal

6.1 Colleges need approval to proceed with a PFI project or substantial commercial borrowing from the Scottish Further Education Funding Council (SFEFC). The benefits of the preferred option have to be demonstrated by formal, option appraisal. Scottish Executive's PFI Unit may assist colleges in seeking potential partners and in the process of appraisal of proposals. But the initiative and responsibility for any PFI project rests with the college itself. *ASC is seeking ways to enable colleges to share experience and obtain access to expert advice at an early stage when considering large estate projects.*

7. Value for Money

7.1 Better quality of estates has a cost. PFI brings the issue of maintenance and renewal to the fore over the intended life of the project (usually 25 years). Main grant funding for FE Colleges is allocated on an annual basis with only limited assurance as to what will be available further ahead. Calculations of

net benefit therefore tend to be theoretical for a specified but not guaranteed volume of funded activity. Different forms of undertaking have been given for the extra volume for teaching which each PFI project is expected to generate. *There is no provision for overall increase in volume of teaching activity in the Scottish Executive's spending plans for the next 2 financial year's i.e. 2002-04*.

8. **Transfer of Risk**

8.1 For projects so far, the issue of transfer of risk relates to both construction of the building and, management of the facilities once available for use. It is often said that effectiveness cost control of capital projects is directly proportional to the amount of time and effort for project preparation before work starts. PFI projects are more difficult to bring to commencement because of the legal intricacies and of the need to negotiate with a "consortium" of funders and contractors. For construction of a building, the key issue is the level and terms of charge which the client will be expected to pay. The evidence so far is that contractors and the funder seek to maximise the client's commitment and minimise their own risk.

8.2 For management of facilities the transfer of control is the main issue for the college as client. The early examples of facilities management agreements are very detailed and tend to be inflexible. Best use of any new building has to be learned in the light of experience. PFI terms can inhibit this flexibility for the client.

9. **Issues for Capital Investment in FE**

9.1 It seems likely that the FE sector will continue to use a variety of approaches to funding, ownership, and control suited to the varying needs of particular estates projects. PFI will not be the preferred option for many smaller projects or even for some of the largest projects. Where PFI is a realistic possibility, however, the FE colleges will need:

- Earlier and more accessible support in planning and appraising projects;
- Back-up for negotiation of second and third generation PFI contracts; and
- Training in the "client" responsibility for facilities management agreements.

9.2 Other important development needs for FE include:

- Consideration of a "consortium" (or bundling) approach to obtain loan finance or PFI on better terms for a range of projects rather than to have to negotiate each loan or contract individually;
- A clearer indication of priorities for the sector in terms of new buildings and likely revenue support for additional teaching capacity;
- Improving FE's capacity to raise funds from private sources (such as alumni, charities and business); and
- Consideration of how the loss of access to substantial amounts of ERDF will impact on building projects in the second half of this decade.

9.3 All FE Colleges are stretched to afford modernisation, relocation, or new build for their estates. Future opportunities may conclude collaboration ventures:

- Between partner colleges;
- With commercial partners; and
- With other public agencies

9.4 Significant projects in modernising the estate over the next decade will require:

- Start-up grants for initial design and appraisal costs from SFEFC;
- Underwriting of capital costs by either capital grant or guaranteed venture funding (from SFEFC); and
- An extensive training and development programme to equip college management with the skills needed to plan, appraise, negotiate, and oversee major capital projects

ASC Executive
12 December 2001

Major Buildings Projects of Scottish FE Colleges **Annex 1**

1. PFI Projects

The 3 estates projects undertaken by FE Colleges under PFI are as follows:

1.1 Stirling Further Education Centre

Sponsor:	Falkirk College of Further & Higher Education
Winning Consortium:	Stirling Centre Ltd
Capital Value:	£3.6m
Contract Length:	25 years
Advisers to the College:	
Financial:	Anderson Lyall
Legal:	Maclay, Murray & Spens
Technical:	Knight Frank
Senior Lender:	Bank of Scotland
Status:	Operational

Funds came from a combination of ERDF, Scottish Office and Forth Valley Enterprise.

1.2 North Ayrshire College Campus, Kilwinning

Sponsor:	James Watt College of Further & Higher Education
Winning Consortium:	KE Project Ltd
Capital Value:	£8.6m
Contract Length:	25 years
Advisers to the College:	
Financial:	Pricewaterhouse Coopers
Legal:	Dundas & Wilson
Technical:	Doig & Smith
Senior Lender:	Bank of Scotland
Status:	Operational

Funds came from ERDF, North Ayrshire Council, Enterprise Ayrshire and the Scottish Office.

1.3 West Lothian College Livingston Campus

Sponsor:	West Lothian College
Winning Consortium:	HBG Construction Ltd
Capital Value:	£17.8m
Contract Length:	
Advisers to the College:	
Financial:	Pricewaterhouse Coopers
Legal:	Morton Fraser Commercial
Technical:	GTMS, GTFM, Keppies
Senior Lender:	Bank of Scotland
Status:	Contract signed December 1999 Campus opened July 2001

Funds came from a combination of SFEFC, ERDF, Lothian and Edinburgh Enterprises Limited (LEEL).

2. Other Projects - Non PFI

2.1 UHI Millennium Institute (UHI)

UHI is a designated Higher Education Institution created by the University of the Highlands & Islands project and operates through its 13 Academic Partners and 2 Associated Institutions, linked by a high-speed telecommunications network.

The Academic Partners are: Perth, Moray, Inverness, North Highland, Lews Castle, Orkney, Shetland & Argyll Colleges, Scottish Association for Marine Science, Sabhal Mor Ostaig, North Atlantic Fisheries College, Highland Theological College and Seafish Aquaculture - the 2 Associated Institutions are Lochaber College & Highland Psychiatric Research Foundation.

The total investment in the development of the project currently stands at £93.5m with £33.4m from Millennium Commission Funding, £14.8 from ERDF, £15.9m from the Scottish Executive and the remainder from a combination of public and private sources.

The bulk of the funding, £55m, was invested the development of operational education facilities; £23m in ICT infrastructure and £15m on Project Management and Academic Development.

2.2 Glasgow College of Nautical College

Aldephi Centre, Glasgow Gorbals - opened 12/1/98

This is a new education, training and community facility at the heart of the area's regeneration strategy.

The funding package for the refurbishment totalled £3.9m and comprised support from Glasgow City Council, GDA and ERDF (£1.8M)

2.3 New John Wheatley College Campus in Easterhouse

The new campus replaces a building which had come to the end of its working life. It will accommodate up to 700 students in the Greater Easterhouse area and covers approx. 4,500 square metres.

It provides state-of-the-art digital learning opportunities, comprehensive pre school crèche facilities and a wide range of features to enable full learning access for those with disabilities.

The Body Shop Foundation has also made a substantial contribution to the cost of fitting out parts of the building.

The total project cost was £6.1m of which £3.6m came from SFEFC, £2.3m from ERDF, £0.1m from GDA and £60,000 from the Scottish Executive.

2.4 **Edinburgh's Telford College**

The college is planning a major new build of a single main campus on a new site in the Waterfront development in North East Edinburgh.

This project is to relocate and consolidate all the main teaching facilities on a single site. The initial build will reduce volume of space compared to present. The college plans to ensure better space utilisation with the new building and will retain of campus learning centres and expand its e-learning capacity.

The estimated cost of the capital project is £55m. The target is to open the new building in August 2005 which will mean acquisition of the preferred site and site entry by mid 2002 followed by site preparation.

An offer of capital grant of £14.8m has been made by SFEFC. The balance will come from either the disposal of existing sites and/or PFI etc. But the college will have to be creative in bridging the funding gap in the cost of the project.

SFEFC is also assisting the college with initial professional fees (estimated to be £0.5m).

Callum Thomson
Clerk to the Finance Committee
The Scottish Parliament
Edinburgh
EH99 1SP

Also emailed, excluding attachments, to:
finance.committee@scottish.parliament

31 May 2001

Dear Mr Thomson,

FINANCE COMMITTEE INQUIRY INTO PFI/PPP

In response to Mike Watson's letter to me of 23 May, we are pleased to set out below our responses to the eight questions raised in his letter. Our responses are deliberately concise. We would be pleased to expand upon them at the Committee's request, either in writing or through oral presentation.

1. *What are the advantages and disadvantages to the public sector in funding capital expenditure in this way? What is the basis for the argument that private capital is required to obtain efficiency savings in service delivery?*

Private finance is usually more expensive than the funding available directly to Government. However, that additional cost is sometimes overstated and it is often compared misleadingly with the cost of public funding without adjusting public funding for the risk which private funders include in their costs. Moreover, the availability of private finance for good projects is in effect infinite. In contrast, Government funding is usually subject to artificial limits, even though a failure to spend in any one year can in the long term result in poorer Value for Money (eg failure to maintain existing assets or invest in "spend to save" projects). A degree of private sector investment in projects transfers project risk and so encourages commitment and can be used as a basis for performance-related remuneration. However, it is possible on occasion to strike a balance between the advantages and disadvantages of private finance by including substantial public sector funding; Canmore's projects at Inverness airport (the new terminal) and for Falkirk College at Stirling both include substantial EU grant funding.

It is widely assumed that an inability or unwillingness to invest in public services was the main driver for the creation of PFI. That is for the Government of the day to answer. However, whatever the original intention, the result has been a fundamental review of how public use infrastructure is procured and delivered. We believe that a willingness to enter into such a debate can be only a good thing. The private sector increasingly "out sources" support functions. The public sector should at least consider this option.

2. *What are the best value determinants of PPP?*

The only way to determine whether a PPP approach offers Best Value is to compare it against the alternative of "traditional" direct procurement and operation (and any other applicable service delivery models). We generally concur with existing Treasury guidance on the calculation of Public Sector Comparators, although our experience indicates that such Comparators sometimes underestimate the value of the risks transferred to the private sector and frequently underestimate the costs of direct provision. In particular ongoing maintenance and life cycle costs are often understated by the public sector; we believe that this is possibly the result of inadequate historic data for the public sector estate and/or a history of insufficient maintenance.

Moreover, we believe that PPP contracts should routinely be structured over longer periods than is currently normally the case so as to match contracts more closely to the design life of buildings and to transfer to the private sector the whole life costs of the public infrastructure which it provides.

The PPP process can also encourage radically different design solutions, as is demonstrated by our projects at Dumfries & Galloway Royal Infirmary and Inverness Airport in particular. Unfortunately, in our view good design is still not sufficiently encouraged. Too often value is confused with cost and no premium is available for design excellence.

3. *How relevant are the assumptions used in assessing projects (eg discount rate, repayment method, risk transfer)?*

Clearly such assessments are highly dependent upon their underpinning assumptions. We understand that the public sector generally uses Treasury generated assumptions for discount rates; we do not disagree with the assumptions which we have seen. As a consequence of the Private Finance Initiative – and this is not often acknowledged – project promoters are now able to borrow for much longer periods than was previously the case (commonly up to thirty years for even relatively modest projects). So PPP pricing is no longer artificially inflated by lenders' requirements to repay loans too quickly. Loans are also markedly cheaper than in the early years of PFI. That being said, pricing of PPP projects is still probably more influenced by the requirements of lenders' financial ratios than any other single factor. As referenced in responses above, risk transfer assumptions are also very important and are often, in our experience, understated.

4. *What are the costs of the capital programme? Is it possible to separate out capital charges from efficiency savings?*

This question implies an underlying desire to separate the initial cost of a building from its ongoing operation. We suggest that is in itself not the correct approach. Rather the public sector should seek to ascertain the whole life costs of accommodating given functions: it should concentrate upon the cost inclusive of maintenance and life cycle costs; ongoing energy efficiency should also be considered; the procurement system should encourage users and providers to focus on optimising the functional efficiency of buildings. A PPP approach should (and in our experience generally does) take all these factors into account.

That being said, yes it is possible to strip out the separate costs within an overall PPP price, but why do so?

With regard to efficiency, we suggest that a proper comparison between a PPP solution and the Public Sector Comparator (see our response to 2 above) is the best measure of the relative efficiency of a PPP solution. Implicit or explicit in the PPP price may be assumptions of achievable operating efficiencies over the life of the contract. These are normally probed during negotiations prior to contract signature. These efficiency savings are assumed by the PPP provider and so represent an element of risk transfer. As such they are presumably to be encouraged providing that this does not include unfair or inappropriate treatment of the employees involved.

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

Canmore has been supportive of Government moves to open the PFI/PPP procurement process to public scrutiny. We recognise that the public sector must be accountable for its procurement actions. We believe that much research to date on the relative advantages of PPP procurement has been inaccurate. On occasion this is the result of bias by the authors and/or those who have funded the research, but insufficient provision of data post signature of contracts must surely have made sound research more difficult to carry out. For example, we fully support the publication after contract signature of the relevant Final Business Case. We believe that this should contain a full comparison with the Public Sector Comparator of the resulting price agreed.

Some providers appear reluctant to see their pricing open to public scrutiny; we have no such reluctance. Providers will however understandably wish to see their underlying cost data protected by commercial confidentiality. We accept that the public sector and its advisers will wish to probe our costs in price negotiations; we co-operate fully in this process. The sharing in confidence of underlying cost data is arguably required to ensure that Best Value is achieved during negotiations, but it is not then required for the public to be able to compare the resulting price with the alternative of direct public provision.

There is also substantial scope to involve users and affected staff in negotiations with short-listed bidders. If those involved in such consultation are willing and able to be bound by commercial confidentiality, then bidders should be willing to discuss their proposals in considerable detail. In addition, it is possible to solicit public views of proposed short-listed design solutions prior to selection of a preferred private sector partner. However, such open consultation requires confidence on both sides; if it is abused (as we consider it has been to our detriment in a project outside Scotland) then bidders will be reluctant to participate.

8. *What has been the experience of this form of investment on public sector employees? Is the perceived effectiveness of PFI/PPP projects obtained at the expense of individuals who are providing the service?*

Canmore has discussed the implications of PFI/PPP for existing public sector employees with Unison officials. To work, PPP/PFI provision of buildings must at a minimum include their ongoing maintenance ("hard" FM). This usually involves few, if any, existing public sector employees. We have always questioned the inclusion of "soft" FM services (eg cleaning and catering etc.) in PPP/PFI contracts. It was initially argued that the inclusion of "soft" FM would help to ensure "off balance sheet" treatment of such projects; we have never believed this to be the case and we have been proved correct by current accounting guidance. We continue to argue that optimum procurement is best served by maximising Value for Money and avoiding artificial structures. It is certainly not Value for Money to create diseconomies of scale by thoughtlessly breaking up existing arrangements which are working well. We generally recommend that the public sector should decide how best "soft" FM services can be provided mindful of arrangements for similar provision in other sites. If we are asked to provide a full package of services then we are pleased to respond accordingly, but we have never encountered a project where the inclusion of "soft" FM made a project work which could not have worked otherwise.

Canmore has three PPP/PFI projects in Scotland and a further three in England. Our projects each illustrate different structural models:

- Inverness Airport – Inverness Airport Terminal Limited built and now operate all "non airside" activities (ie it provides a fully serviced terminal environment and manages all concessions) for Highland & Islands Airports Limited under a twenty-five year contract based upon receiving charges per passenger from HIAL for its core terminal provision. No public sector employees transferred.
- Stirling Centre – Stirling Centre Limited provide a maintained campus inclusive of cleaning, portering and associated services. "Green field" development - no existing staff transferred.
- Dumfries & Galloway Royal Infirmary - reprovided maternity and new day case wing. Provided of new building inclusive of maintenance. No staff transfers; existing Trust staff to remain in Trust employment elsewhere on its sites.
- St George's Hospital, south London – reprovision of tertiary care wing for neuroscience and cardiothoracic services by Blackshaw Healthcare Services. FM includes maintenance, cleaning and other domestic provision, laundry and pest control. Canmore led discussions with site TU representatives. It is likely that all existing Trust staff will be offered alternative positions with the Trust. Existing private sector service provider employees will transfer under TUPE.

Generally we recognise that change is potentially alarming for the staff involved. However, it is often not recognised that PPP/PFI contracts are no more of a threat to existing employees than traditional Best Value exercises. Indeed, PFI contracts have often offered more future stability to employees than existing market testing provisions.

In order to address the fear of change, routinely we unilaterally offer not to change the terms and conditions of transferred employees for at least five years without their prior consent. In any case, our experience is that public sector employees do not enjoy terms and conditions which in the round are materially better than those of equivalent private sector employees.

A copy of Canmore's policy statement for Trades Union and Employee Representation is attached together with policy statements on Health & Safety and the Environment.

PPP/PFI is not the answer to all the Government's procurement problems, but it deserves the measured and informed consideration which we trust will be accorded it by the Committee. Correctly structured, PPP/PFI can lift the procurement burden and free the public sector to concentrate on its core mission. Please let me know if we can assist the Committee in its deliberations.

Yours sincerely

Andrew J Gordon
Chief Executive

cc: John Henderson, Head of Private Finance Unit, The Scottish Executive

THE SCOTTISH PARLIAMENT FINANCE COMMITTEE

INQUIRY INTO PUBLIC PRIVATE PARTNERSHIPS

1. INTRODUCTION

1.1 Glasgow welcomes the opportunity of contributing towards the Finance Committee's Inquiry into Public Private Partnerships having entered into a major arrangement in July 2000.

1.2 The Council's contribution is solely an officer view on the issues you have a identified and is based on the practical experience of one major project – the Glasgow Secondary Schools Project.

1.3 It is noted that submissions are required to be lodged by 31 May 2001.

2. GLASGOW SECONDARY SCHOOLS PROJECT

2.1 The Council had recognised the need to improve accommodation in secondary schools, much of which was in a poor state of repair. The Council was also committed to ensuring a best value approach was taken in the project delivery and this included the reduction of surplus capacity by rationalising the number of schools.

2.2 The main objectives of the project were

a) To raise standards (Glasgow schools are well below national standards for educational attainment although there are improvements year on year).

b) Improve pupil attendance

c) Prepare pupils for the information age through Information Communication Technology (ICT) skills

d) Raise morale, commitment, dedication of teachers

e) Make a contribution to the regeneration of Glasgow

2.3 The Council had already made a start, before the PPP process commenced, in implementing its strategy by reducing the number of schools from 38 to 29 and investing all the savings, which were mainly property costs, back into Education. A PPP approach ensured that the capital investment required to modernise the 29 Schools will take place over a relatively short period of time.

2.4 Clearly a massive investment was required to improve the schools accommodation and this was to be achieved by a mixture of new build, extension and refurbishment of existing schools. In addition investment was required to expand the ICT provision in every secondary school. This improved standard of service provision also needed to be maintained over the lifetime of the assets to ensure the continued high standards were met.

2.5 The initial capital investment by the winning consortium over the 3 year construction period is over £200 million with almost the same investment again in life cycle maintenance costs.

3. VIEWS ON THE ISSUES IDENTIFIED BY THE INQUIRY

Question 1: What are the advantages and disadvantages to the public sector in funding capital expenditure in this way? What is the basis for the argument that private capital is required to obtain efficiency savings in service delivery?

Response: The Scottish Executive limits the level of capital expenditure Local Authorities can finance through borrowing. The Single Allocation limits the level for all Non-Housing Capital Expenditure. Local Authorities may also finance capital expenditure through the generation of capital receipts, together with Capital Funded From Revenue (CFCR).

This arrangement leaves Councils with the difficult task of prioritising scarce resources across a wide range of services against a background of significant need for sustainable capital investment in core facilities.

A clear advantage in the PPP approach is that large and immediate capital investment can be made in Council facilities which would not otherwise be possible under traditional procurement routes.

The Glasgow Secondary Schools Project is injecting over £200 million of capital investment over a 3 year period. Because the Consortium are also providing property related services over a 30 year period, it is clearly in their interests (and in the Council's) to ensure the investment considers the long-term use of the buildings. More effective investment decisions are possible because the long-term view can be properly considered, allowing greater efficiencies and cost savings in the future service provision of the buildings.

The nature of the PPP projects ensures that risk is transferred to the party best able to manage that risk. In the case of the Glasgow Secondary Schools Project most of the risks (such as construction cost, latent defects, and operational risks) passed to the successful bidder. This also gives the Council increased certainty in budgetary control as the unitary charge is fixed, apart from inflation, over a 30 year period.

The Service Provider has the incentive to ensure the smooth and efficient running of the property services provision because of the financial penalties which would be applied by the Council for poor performance.

There can be little doubt that a new or refurbished school, which remains well maintained, can have a positive impact on the morale of both teachers and pupils, to the ultimate benefit of the standard of educational achievement.

Question 2: What are the best value determinants of PPP?

Response: In the Glasgow Secondary Schools Project Best Value was initially considered through the preparation of an Outline Business Case which considered various options including

- A "do nothing" option which carried on with the then current provision
- A public sector comparator (PSC) in which the Council funded the project by traditional procurement
- A full PPP project

At the Invitation to Negotiate stage there were 4 shortlisted bidders competing for the contract and this number of bidders ensured that the competition would be keen and offered the Council a wide choice of submissions to consider. The Council also requested the bidders to submit mandatory variant bids and encouraged the bidders to submit their own variant bids where value for money to the Council could be demonstrated.

The Council at this stage was able to focus on the best solutions submitted and challenge the bidders on design, quality and cost as part of the negotiation process.

Separate Council officer evaluation teams were set up to consider the financial, legal, technical, facility management, ICT and educational issues involved in the bids. This in-depth and focussed approach to project evaluation allowed careful scrutiny of the details of each bid and ensured a comprehensive comparison was achieved which clearly highlighted the strengths and weaknesses of each of the bids.

This evaluation process produced 2 bidders to take part in the Best and Final Offer stage which used the same evaluation procedures detailed above at the ITN stage. The bids from both consortia had been refined from the ITN stage as a result of the in-depth clarification and negotiation which had been undertaken by both sides. This was clearly evident in the quality, innovation and value for money aspects of the bids.

The PPP approach clearly met the Council objectives and offered best value for money in the total cost of the project, the affordability to the Council and the much shorter time scale of the project investment all to the benefit of education provision. The Council also benefited from the innovative approach to design and operation of the schools that the service provider brought to the process.

Question 3: How relevant are the assumptions used in assessing projects (e.g. discount rate, repayment period, risk transfer).

Response: As stated in the response to Question 2, various criteria were used in evaluating the project, and Treasury Taskforce guidance was also taken into account in the approach taken to the evaluation process.

The total Net Present Value of the project was one of the criteria and this calculation is dependent on the discount rate, repayment period and risk transfer. The assessment of risk transfer was particularly important in the evaluation of the project, and detailed and careful consideration was given to the composition and calculation of this factor.

Question 4: What are the costs of the capital programme? Is it possible to separate out capital charges from efficiency savings?

Response: In the Glasgow Secondary Schools Project the capital investment over the 3 year construction period is just over £200 million, with approximately the same amount of investment in life-cycle maintenance planned over the 30 year contract period.

The unitary payment does not separately identify capital charges or efficiency savings. However, the PSC model does quantify these factors for comparison purposes.

Question 5: What implication does the introduction of Resource Accounting and Budgeting have for tracking this form of public sector investment, particularly what are the implications in this connection of a transfer from capital charges to revenue funding?

Response: There are no firm proposals detailed as yet for the introduction of Resource Accounting and Budgeting in Scottish Local Authorities. Although the mainstream financial accounts of Local Authorities are prepared on an accruals basis, matching income and expenditure over the relevant accounting period, a separate memorandum account is maintained to record all capital expenditure/receipts on a cash basis.

Question 6: What are the long-term implications of PFI/PPP projects on revenue funding in the Scottish budget?

Response: In the case of the Glasgow Secondary Schools Project the long term implications for the Scottish budget are a commitment to grant fund the Council's contractual obligations through payment of Level Playing Field Support (LPFS).

LPFS is intended to provide grant funding to Councils as if the capital investment had been financed by the traditional procurement method. In other words, revenue grant support is broadly the same, no matter the method of procurement.

In the same way that the Council has been reassured that the project represents best value for money for Glasgow Council Taxpayers, the national taxpayer will wish to be reassured that the grant support itself represents best value for money.

Question 7: To what extent is open consultation possible, given "commercial confidentiality" requirements.

Response: In the Glasgow Secondary Schools Project great care was taken to try to ensure that the correct balance was achieved between the Council undertaking genuine consultation while keeping commercial confidentiality with the bidders.

The major stakeholders, including head teachers and school boards chairpersons, were kept fully informed at each stage of the PPP process but were made fully aware of their responsibilities with regard to confidentiality. Indeed, major stakeholders had input into the evaluation of the bids.

Ultimately, all information was released as soon as possible to all interested parties when confidentiality was no longer an issue.

Question 8: What has been the experience of this form of investment on public sector employees? Is the perceived effectiveness of PFI/PPP projects obtained at the expense of individuals who are providing the service?

Response: In the Glasgow Secondary Schools Project Council employees involved in janitorial and cleaning services were transferred over to the new employer when the successful service provider moved into the schools.

There was full consultation with the employees involved, and their trade unions, by both the Council and the service provider. Full TUPE rights and protected pension conditions applied to the transfer.

The indications in these early days of the new service are that employees are satisfied with the new career structure, together with the training and development opportunities being offered. To put this in context, to date, only 1 employee out of 600 employees transferred has since left the employment of the Private Sector Consortium.

4. CONCLUSIONS

4.1 In conclusion, officers' experience of the Glasgow Secondary Schools Project has been a positive one. Best Value was secured through the transfer of financial resources from 38 schools, may of which were in a poor state of repair, to 29 Schools of high quality. The PPP approach enabled high quality service provision to be guaranteed over a 30 year period.

4.2 This is not to suggest that all PFI/PPP Projects must by definition represent best value. PFI/PPPs are only one method of procurement and, as with all methods of procurement, best value will require to be judged on an individual case-by-case basis.

GB/BD
30 May 2001

THE SCOTTISH PARLIAMENT
FINANCE COMMITTEE: PPP INQUIRY

Introduction

Thank you for your letter of 4th May 2001 inviting us to present our views on PPPs in Scotland as part of the Scottish Parliament's inquiry into PPP projects. You have asked us to comment on questions, particularly those numbered 1, 2, 3, 4, 7 and 8.

Question 1: ***What are the advantages and disadvantages to the public sector and funding capital expenditure in this way? What is the basis for the argument that private capital is required to obtain efficiency savings in service delivery?***

This is a two part question recognising the distinction between the provision of private capital and private sector provision of services. We will answer each question separately and then comment upon the linking between the questions.

Part 1

There are probably three main advantages to the use of private capital for the procurement of public sector assets. First, it promotes that the procurement of an asset is based on its whole life cost and not simply on its initial construction cost. Whilst we do not advise directly on this issue as part of our business, we are aware of projects where we believe the initial construction costs have been increased in order to minimise lifecycle costs – and that this has resulted in a lower whole life cost than might have been the case if the project had been procured on the basis of the lowest construction cost.

Second, the use of private capital transfers the risk of performance of the asset to the private sector. This is because the private sector only realises its investment if it is able to ensure that the asset performs according to its contractual obligations.

Third, there is a fuller examination of all the risks affecting a project at the outset (by both the government and lenders) meaning that cost estimates are more robust. This is driven by the necessity for fixed price construction and service contracts. As a consequence, investment decisions are based upon better information.

We have not included price certainty as an advantage because this could be achieved by other contractual means. For example, a design and build contract (where the procurement decision is based upon initial construction cost) and the design build operate contract (where the decision is based on the whole life cost). However, we would argue that a DBO contract gives less fixed price whole life costing certainty than a project utilising private capital because it is not necessary to ensure performance of the asset in order to realise the investment in the project. Thus, it is more likely in a DBO project that an under-performing asset would result in a loss to the public sector rather than the private sector.

The disadvantages of using private capital are threefold. First, most of these projects are financed by way of project finance and an essential aspect of project finance is a fixed price turnkey construction contract. In order to be able to ensure delivery of a project on cost and on time a contractor is unlikely to use a new or untested design philosophy. Equally, they are unlikely to utilise audacious designs, where the design

development cost may be inherently less certain. This does not mean that private capital does not promote good designs simply that the designs are likely to utilise tried and tested techniques. There is nearly always a strong design competition element to the procurement of any PPP project.

Second, project finance is a complex financing technique relying on the cashflows generated by a project. There are many factors affecting project cashflows and all of these needed to be catered for in the project documentation. An inevitable consequence of this is that the procurement process will take some time.

Third, it should not be forgotten that the use of private capital requires the award of a long term service contract, often 25 or 30 years. This locks the public sector to a single service provider for a period in excess of 25 years. The jury is still out – and will be out for some time – on how this will impact on the quality of service delivery.

Part 2

The principal argument that private capital is required to obtain efficiency savings in service delivery is that investors in a project do not realise their investment if the asset does not perform. This provides a strong incentive to ensure the expected asset performance. A similar contract could be constructed which did not rely upon private capital but which contained the same type of payment mechanism. However, given that investor's investment in the project would be realised on completion of the construction, there is only the service provider's profit margin at stake. It is more likely therefore that the public sector will suffer loss using the DBO contract model when an asset performs below expectation than it would using the DBFO contract model.

The Committee is right to recognise the distinction between the advantages/disadvantages of private sector *service* provision and the advantages/disadvantages of private *capital*. Often in public debate people include among the advantages of private capital, advantages which are, in fact, generated by private sector service provision. It is correct to compare the potential impacts of D&B (design & build) procurement, DBO (design build operate) procurement and DBFO (design build finance operate) procurement.

Question 2: *What are the best value determinants of PPP?*

Our first question addressed the advantages of utilising private capital. Our answer to this question addresses the advantages inherent in private sector service provision. These, potentially, are: technical expertise (including training), management expertise, flexible resource management, different employment contracting strategies from the public sector and, finally, the fixed cost discipline. Only the last of these is dependent upon the contractual framework and this benefit may be more illusory than real.

The balance of advantage/disadvantage in relation to the first three items depends upon the activity in question. For example, if maintenance and facilities management are being considered there is a considerable body of private sector expertise and a well developed market. In these cases, the private sector is able to offer increased technical expertise, management expertise and resource management.

The fourth benefit, namely differing employment contracting strategies, would appear to offer some advantages. (We will deal with the impact on employees in our answer

to Question 8). Most private sector providers are keen to switch employees onto their style of employment contract, presumably because they are of the view that they can better manage services when their staff are employed on their style of contract. Of course, TUPE means that employees will transfer across on their existing terms and conditions and any switch to new contracts will be only with each employee's consent. However, it certainly appears the case that private sector providers believe there to be an inherent disadvantage in the form of contract used by the public sector.

Question 3: ***How relevant are the assumptions used in assessing projects (e.g discount rate, repayment period, risk transfer)?***

We assume (given the examples used in the question) that the question is referring to assessing value for money on projects. All the identified assumptions are key to assessing value for money. The net cost of an asset needs to be assessed over a given period of time. There are always risks associated with any asset, the materialisation of which will affect overall costs. If you elect to assess the project cost by means of a net present value (as opposed to the total overall project spend during the assessment period) then a discount rate must be used. The answer to the question of whether projects should be assessed by overall project cost or net present value (or, more correctly, the net present cost) is less clear but we shall leave this one to the accountants. It is clearly important to use net present value if you are assessing the returns on a range of possible investments where the investments may be realised over different periods of time. However, as a means of comparing the costs of various solutions to the same project over the same assessment period (and where there is not likely to be variance between inflation affecting the project and inflation generally), the requirement to use the net present value seems less clear.

The assumptions used are often critical to assessing value for money, and the use of different assumptions may lead to different conclusions when comparisons (both private to private and private to public) are made. It is essential that assumptions are made but equally it is essential that the assumptions are neutral and reflect the best available evidence.

Question 4: ***What are the costs of the capital programme? Is it possible to separate out capital charges from efficiency savings?***

Given the amount of information required to be provided by bidders it is possible to analyse the project company's costs in terms of debt repayments, current service provision and any capital investments required during the life of the project. Further, it is possible to work out the capital expended in creating the asset in the first place.

It is possible therefore to ascertain the level of capital investment in public sector assets generated by PPP contracts. It would also be theoretically possible to work out the cost of procuring this investment by taking the net present value of debt repayments and projected equity dividends. However, we would caution that in relation to individual projects much of the information required to do this would be confidential.

We do not think however that it follows that you can assess value for money on infrastructure and services separately. You may be able in some circumstances to separate out a service which is not integral to the infrastructure or linked in terms of

service delivery to the other services but this is likely to be the exception rather than the rule.

Question 7: ***To what extent is open consultation possible, given "commercial confidentiality" requirements?***

Commercial confidentiality is a significant constraint on open consultation because much of what the public and politicians would like to discuss would be pricing and inventive service proposals, both of which the successful bidder's competitors would very much like to know.

Question 8: ***What has been the experience of this form of investment on public sector employees? Is the perceived effectiveness of PFI/PPP projects obtained at the expense of individuals who are providing the service?***

This is a difficult question to answer given that empirical evidence differs substantially from project to project. Our response should be caveated on the basis that we are not directly involved in this area of projects and the views expressed here are based on anecdotal evidence. However, there does appear to be one principal at work.

A large number of employees working in the public sector have the benefit of membership of UNISON. This gives them a collective bargaining power that is lost if their activity is transferred to the private sector. At the same time, an employee working in the public sector tends to work at a particular site. If that person transfers their employment to an organisation which provides similar services across a range of sites they have the opportunity to progress their careers further than they would have in the public sector. In national facilities management organisations, employees have the potential to advance further up the career ladder by taking responsibility for a broader range of activities at a broader range of sites.

Thus, the experience of employees transferring to the private sector appears to be related to their prospects of being able to progress within the new career structure of the private sector organisation. If these are good (usually because of the skill set of the individual) there appears to be increased benefits to the employee concerned. If the prospects of progression are low, the loss of the collective bargaining power of UNISON would potentially act to the detriment of the employees affected.

MacRoberts
31 May 2001

INQUIRY INTO PFI / PPP BY THE FINANCE COMMITTEE OF THE SCOTTISH PARLIAMENT

Response to Issues Raised

June 2001

1.1 What are the advantages and disadvantages to the Public sector in funding capital expenditure in this way?

One of the main advantages for the Public sector from the introduction of PFI / PPP is the provision, at value and on time, of facilities that traditional public procurement methods have failed to deliver. The risks associated with the delivery of PFI / PPP projects on time reside with the Private sector, and the imposition of liquidated damages primarily in the form of foregone payment for services for late delivery of facilities ensures that project timescales are met.

The transfer of risk that takes place in PFI / PPP ensures that the Public sector achieves "value for money" in terms of the provision of public services for the capital employed. The introduction of PFI / PPP has seen higher levels of performance and greater quality of public services provided by the Private sector than that traditionally offered by the Public sector. In addition, maintenance costs can be identified and spread over the duration of a PFI / PPP contract, ensuring regular and appropriate maintenance of the capital asset.

Further, competition to provide infrastructure projects for the Public sector has encouraged the Private sector to bring forward innovative solutions to issues of public service provision.

By balancing the cost of finance, the cost of risk transfer, and the increased level of service provision and maintenance it can be clearly demonstrated that PFI / PPP provides "Value for Money" for the Public sector.

1.2 What is the basis for the argument that private capital is required to obtain efficiency savings in service delivery?

As noted above, greater competition for the provision of PPP contracts has led, and will continue to lead to, greater innovation in the supply of public services. The certainty and consistency of service delivery over the lifetime of a PPP project lead to further efficiency savings over the project term.

The concept of "Spend to Save" is well known and accepted, and forms the basis of many Public sector and PFI / PPP projects.

By allowing the Private sector to provide innovative service infrastructure, PPP enables improvement in the performance and availability of service provision by the Public sector.

PPP enables an integrated approach to service provision, with capital investment, reactive maintenance and lifecycle planning being carefully blended together to provide cost effective and efficient solution for the Public sector. Any attempt to separate out these individual components and in particular a lack of synergy between asset procurement and asset maintenance/service delivery will lead to a disjointed service delivery.

2. What are the best value determinants of PPP?

The ability to take a life cycle replacement view in the provision of public services over a 25 to 30 year concession period enables the Private sector to provide a cost effective package in terms of the total costs to the Public sector over this time period.

Further, the transfer of capital risk from Public to Private sector not only enhances "value for money" in the provision of services, but also allows Public sector capital to be employed in other areas.

As indicated above, by taking a long term view the Private sector can introduce innovation in the proposals that it puts forward to the Public sector so that the final solution arrived at delivers best value to that sector.

A typical example of this is Supply Chain Management, which is incorporated increasingly into PFI / PPP projects, with the life value of individual construction elements being guaranteed by manufacturers over the period of the concession.

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

All assumptions in the financial model and related commercial agreements are key in determining the affordability and viability of any project.

The discount rate used in assessing projects is well established and understood by project funders and Private sector consortia.

Similarly the repayment period of a project is fixed at a length of time which is calculated against the concession period duration, as approved in the Outline Business Case of the project.

Where there is the need for considerable work in the assessment of projects is in the area of risk transfer, or more accurately the costing of the benefit of transferring individual risks from the Public to the Private sector. Risk should lie with the party best able to control that risk, to provide value for money to the public sector.

A risk matrix requires to be agreed between the Public and Private sectors to allow an accurate assessment of the magnitude of the cost benefit to be achieved by the sharing of risks. This demonstration of risk sharing will underpin the affordability of the Private sector solution as compared to the Public sector comparitor.

4. What are the costs of the capital programme? Is it possible to separate out capital charges from efficiency savings?

This question would be more appropriately and comprehensively answered by an organisation engaged in funding PFI / PPP projects.

5. What implication does the introduction of Resource Accounting and Budgeting have for tracking this form of Public sector capital investment, particularly what are the implications in this connection of a transfer from capital charges to revenue funding?

This question would be more appropriately and comprehensively answered by a Public Sector Organisation with PFI / PPP experience.

6. What are the long-term implications of PFI / PPP projects on revenue funding in the Scottish budget?

This question would be more appropriately and comprehensively answered by an academic organisation, or by the Scottish Executive.

7. To what extent is open consultation possible, given "commercial confidentiality" requirements?

The increase in competition from private sector participants in PFI / PPP projects has seen greater diversity in the options put to the Public sector at the bidding stage. Given the cost to the Private sector companies of bidding for these projects they are understandably concerned that their innovation on a particular project is kept confidential.

Many Public sector companies would be reluctant to engage in a selection process that was too open, as they would run the risk of their experience and innovation being transferred to their competitors.

When a Private sector company becomes a Preferred Partner then the opportunity for open consultation is far higher.

8. What has been the experience of this form of investment on Public sector employees? Is the perceived effectiveness of PFI / PPP projects obtained at the expense of individuals who are providing the service?

We have not encountered any serious problems in this regard. From our experience we believe that this is largely down to the care and attention given to ensuring a smooth transition of employees from the Public to Private sector. The initial transition may be helped in some instances by job specific training, mentoring and coaching.

The Rt Hon Sir David Steel KBE MSP
The Presiding Officer

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11 December 2001

In our recent written evidence to the Committee, the Corporate Body indicated that we were anticipating receipt of a report from the Holyrood Progress Group which would assess the issues facing the project in its final key stages. We have now had an opportunity to consider that information and, as anticipated, we are able to report further to you. The information in this letter will of course be updated and presented again to the Committee in the context of our next regular quarterly report early in 2002.

As we said in the November report, there have been a number of delays to individual construction packages, largely due to the fact that some design issues have taken longer to resolve than had been anticipated. The work involved in dealing with the insolvency of Flour City UK has also had a knock-on impact on programme. The Bovis programming team, in discussion with the architects and engineers, have responded to these issues by undertaking a comprehensive examination of the strategic programme. The outcome of this was reported to us by the HPG on 27th November.

It is clear that there now has to be some re-sequencing of works to take account of the impact of delays. In practical terms, this has a number of likely consequences: some contractors will have to be on site either at different times or else for longer than originally envisaged; some off-site storage of materials may be required; additional cranes may be required on certain parts of the site at the same time; scaffolding may have to be erected and dismantled to a revised programme etc. It is also possible that measures such as extended shift working might have to be adopted in late 2002/early 2003 in order to meet the May 2003 occupation date, but decisions about additional means of acceleration such as these do not require to be taken at this point.

The impact on individual contractors will vary from package to package and it is not feasible at this stage to put a definitive cost against all possible scenarios. However you should be aware that the figure in the risk register against the risk of potential costs associated with design programme overruns has now been revised upwards from £2.5m to £21.03m, (taking the total design and construction risk figure in the register to £40.58m[1]). This is an increase of £18.5m, of which £5m relates to those specific acceleration measures which may arise later.

I appreciate that the focus of your Committee's report at this stage in the budget process will be on the financial year 2002/3. It is in fact likely that the majority of these costs, *were they to be incurred*, would fall in financial year 2003/4. However, we thought that it was important that Members should be aware at this stage of the potential order of future costs.

As the Committee is aware, all these so-called 'risk' figures are the product of calculations based on a number of sensitive assumptions and represent *potential* rather than *certain* costs. The SPCB will require at a later date – probably around September of next year – to decide whether it would be appropriate to undertake the type of acceleration measures mentioned earlier and to incur the costs associated with these. We shall keep the Finance Committee and Parliament informed on this issue.

Clearly we are deeply concerned at the fact that delays to the programme have the potential to have cost implications of this magnitude. The Holyrood Progress Group have been energetic in working to address the areas where they perceive weaknesses contributing to delays; in particular, the design team have clarified and strengthened their internal lines of responsibility for decision making in the completion stage of the project to guard against further delays to the release of detailed design information. In the past week, the Project Team have reported that interim contracts have now been agreed with the key specialist contractors on the foyer and specialist glazing packages. This is a significant step forward in getting more cost and programme certainty about these two critical packages.

It is clearly essential that no more slippage against programme occurs if the target date is to be protected and the costs associated with any delays are not to increase. We have been assured that the detailed and regular programme monitoring we would expect is indeed in place and that this is enabling any problems to be identified and addressed at an early stage.

The SPCB has ensured that, as would be the case with any project of this size and type, a detailed analysis of delays and associated costs is being undertaken by the Project Team to ensure that the client's interests are properly protected in the final reckoning.

[1] This figure also takes into account a number of other small adjustments made in the most recent risk review.

We will of course report in more detail on both the full risk register and inflation projections in the usual format in the New Year. Given that the information in this letter is likely to be of general interest, we would welcome it if you were to copy it to all MSPs.

David Steel