HM TREASURY

A new approach to public private partnerships

December 2012

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Foreword

The United Kingdom has been a leader in modernising the way in which public infrastructure and services are delivered and finding new ways to work in partnerships with the private sector over the last twenty years.

The realities of the private sector market place exert a powerful discipline on businesses to maximise efficiency and take full advantage of business opportunities. Successful Public Private Partnerships (PPP) enable the public sector to access the discipline, skills and expertise of the private sector.

Not all PPPs have, however, been successful. The Private Finance Initiative (PFI), the form of PPP used most frequently in the United Kingdom, has become tarnished by its waste, inflexibility and lack of transparency.

Last year, the Government initiated a fundamental reassessment of PFI. To ensure that we fully understood the breadth and the depth of the problems with PFI, we undertook a call for evidence to gather views from interested parties. We are grateful for the time, effort and thoughtful consideration that respondents put in to their written responses; and to stakeholders who engaged in discussion and debate at bilateral and roundtable events.

We have listened to the concerns raised about PFI and carefully reviewed the evidence submitted in the review. A compelling case for reform was presented. This document announces the conclusions of our review of PFI and sets out the Government's new approach, PF2, for involving private finance in the delivery of public infrastructure and services.

We have sought to provide access to wider sources of equity and debt finance to improve the value for money of financing projects; to increase the transparency of the liabilities created by long term projects and the equity returns achieved by investors; to speed up and reduce the cost of the procurement process; and to provide greater flexibility in the provision of services. The taxpayer will become a shareholder in projects and share in the ongoing investor returns.

PF2 addresses the fundamental concerns that have been expressed by Parliament, the public sector and taxpayers. By commanding greater confidence among both taxpayers and providers we hope that PF2 will become an enduring part of public sector service and infrastructure provision for many years to come.

Chief Secretary to the Treasury

Commercial Secretary to the Treasury

Executive summary

The Government believes that private sector investment, innovation and skills should continue to play a significant role in the delivery of public infrastructure and services. The Open Public Services White Paper sets out the Government's plans for modernising public services. Increasingly, services will not be delivered by the public sector itself but from outside, whether by employee-led mutuals, joint ventures, social or charitable enterprises or commercial providers.

There are a number of ways in which the private sector delivers public infrastructure and services. These arrangements can range from, at one end of the spectrum, privatisation where both ownership and risks are transferred to the private sector, to conventional procurement models where the Government contracts with the private sector for specific packages of works or services. Under conventional procurement the public sector generally retains the risks associated with ownership, operational performance and services integration.

There are also a number of Public Private Partnership (PPP) models, characterised by joint working and risk sharing between the public and private sectors. These can include relatively simple outsourcing-type partnerships – where services are provided on short or medium-term contracts – or longer-run private finance partnerships such as the Private Finance Initiative (PFI). Well-formed partnerships with the private sector have delivered clear benefits: in driving forward efficiencies; getting projects built to time and to budget; and in creating the correct disciplines and incentives on the private sector to manage risk effectively.

While the Government remains committed to private sector involvement in delivering infrastructure, it recognises the concerns with PFI and the need for reform. There has been widespread concern that the public sector has not been getting value for money and taxpayers have not been getting a fair deal now and over the longer-term. There has been a lack of transparency of the financial performance of projects and the returns made by investors and insufficient transparency of the future liabilities to the taxpayer created by PFI projects. This has led to an increasing tension in the relationship between PFI providers, the public sector and the wider public. There have also been recent economic developments to which PFI has needed to respond, particularly changes that have occurred in the global financial markets.

This document sets out the Government's new approach to involving private finance in the delivery of public infrastructure and services through a long-term contractual arrangement, Private Finance 2 (PF2). This continues to draw on private finance and expertise in the delivery of public infrastructure and services whilst addressing past concerns with PFI and responding to the recent changes in the economic context.

A review of PFI

PFI was introduced in order to engage the private sector in the design, build, finance and operation of public infrastructure, with the aim of delivering good quality and well maintained assets that provided value for money for the taxpayer. It has been used across a broad range of sectors. Over 700 projects have reached financial close, securing private sector investment of around £55 billion. Since its introduction, PFI has remained a small but important part of the Government's overall investment in public infrastructure and services.

Weaknesses of PFI

Experience in past projects has demonstrated significant aspects of the model are not satisfactory:

- the PFI procurement process has often been slow and expensive for both the public and the private sector. This has lead to increasing costs and has reduced value for money for the taxpayer;
- PFI contracts have been insufficiently flexible during the operational period, so making alterations to reflect the public sector's service requirements has been difficult;
- there has been insufficient transparency on the future liabilities created by PFI projects to the taxpayer and on the returns made by investors;
- inappropriate risks have been transferred to the private sector resulting in a higher risk premium being charged to the public sector; and
- equity investors in PFI projects are perceived to have made windfall gains, and this has led to concerns about the value for money of projects.

It is also evident that, too often, PFI has been used on projects where its application has been unsuitable and has, therefore, failed to deliver value for money. The previous Government's PFI credit regime provided a budgetary incentive to pursue PFI and, thereby, undermined a genuine appraisal of the optimal delivery route. Weaknesses in the budgetary and value for money framework meant that procurement decisions of government departments were sometimes skewed. This lead to PFI being used in sectors and projects where there was insufficient long term certainty on the future requirements of services; or where fast-paced technological changes made it difficult to establish requirements for the long term.

Strengths of PFI

A Treasury assessment of PFI has indicated that elements of PFI have, however, offered benefits. These include the private sector's project management skills, innovation and risk management expertise, such as, ensuring buildings are delivered to a high quality, on time and budget and that assets are maintained to a high standard throughout their lives.

Reforms already introduced

The Government has already taken a number of steps to address the concerns with PFI and to respond to the recent changes in the economic landscape. These include:

- publishing the Whole of Government Accounts, in order to improve the transparency of PFI liabilities;
- launching the Operational PFI Savings Programme in order to improve the cost effectiveness, value for money and transparency of operational PFI projects. The Government has already met its target making over £1.5billion of efficiencies and savings from operational PFI contracts in England and is currently progressing almost another £1billion;
- abolishing PFI credits at the Spending Review 2010 in order to create a level playing field for all forms of public procurement; and
- introducing new arrangements for the assurance and approval of major projects to strengthen scrutiny and control.

In response to constrained debt markets, the Government has also announced a number of initiatives to support and accelerate infrastructure delivery. These include UK Guarantees, co-lending for PFI projects, housing guarantees, increased capital contributions, setting up the Green Investment Bank and signing a number of memoranda of understanding with institutional investors, pension funds and export credit providers.

The Government does, however, recognise the need to go further to address value for money concerns. It has, therefore, undertaken a call for evidence on the reform of PFI in order to develop a new approach that draws on industry skill and expertise in a way that offers better value for government's investment in public infrastructure and services.

Equity finance

Public sector equity

In order to strengthen significantly the partnership between the public and private sectors, the Government will look to act as a minority equity co-investor in future projects. This will enable:

- greater alignment of interests between the public and private sectors, and a more collaborative approach to improving project performance and managing risk;
- better partnership working, with the public sector having greater visibility of project information and more involvement in strategic decision making;
- more transparency, including in relation to the financial performance of the project company, through its project company board membership; and
- value for money to be improved as, subject to the appropriate management of project risk, the public sector will share in the ongoing investment returns, reducing the overall cost of projects to the public sector.

To ensure an effective role is played by the public sector as an equity investor and to minimise the potential for conflicts of interest between the public sector acting as both investor and procurer, the equity investment will be managed by a commercially-focused central unit located in the Treasury, separate from the procuring authority. The unit will be managed by individuals with the appropriate professional skills to oversee the investment and make commercial decisions. Investment will be made on the same terms as those agreed by the private sector for a particular project.

Private sector equity

There are concerns that the equity returns achieved in PFI projects have been too high and that some investors have made windfall gains. This has undermined public confidence in the value for money of these projects. The Government is keen to see more investors with long-term investment horizons, such as pension funds, investing in projects at an earlier stage. These concerns and objectives have been addressed in the following ways:

- the introduction of funding competitions for a portion of the private sector equity, to enable long-term equity providers to invest in projects before financial close. This will widen access to different types of investor and is expected increase competitive tension, with downward pressure on equity pricing in the longer term.
- the structure of PF2 curbs the ability of primary investors to generate excessive profits and, consequently, the potential for windfall gains on secondary market sales through measures including a mechanism to share unutilised funds in the

lifecycle reserve, the removal of soft services where contractors have typically included a risk premium in the pricing and the introduction of public sector equity.

Greater transparency

The Government is introducing a number of measures that address the concerns of a wide-ranging number of stakeholders, including Parliament, who have called for greater transparency and accountability of PFI arrangements:

- in response to requests for greater transparency over the level of equity returns earned on PFI projects, the Government will require the private sector to provide actual and forecast equity return information for publication;
- public sector equity will also enable greater project transparency and accountability for project delivery and operation as the public sector will receive performance information about the project through membership of the project board;
- building on the steps the Government already has already taken to provide greater transparency, through the publication of an assessment of PFI liabilities in the Whole of Government Accounts, the Government will introduce a control total for all commitments arising from off balance sheet PF2 contracts signed. This will form part of a wider set of reforms to the framework for managing off-balance sheet liabilities which will see the UK at the forefront of international best practice; and
- in response to strong calls from the private sector for greater transparency of the Government's approval process a business case approval tracker will be published on the Treasury website from Spring 2013 which will provide a status update of PF2 and PFI projects in procurement progress through the approval process.

More efficient delivery

A significant proportion of the responses to the call for evidence on PFI reform considered that there was a need to improve public sector procurement skills. Concerns regarding procurement timescales and public sector procurement skills are not, however, limited to PFI. The Cabinet Office has already introduced a number of reforms to address these issues more broadly across Government.

Strengthened Infrastructure UK

Investing in infrastructure is a key element of the Government's growth strategy. The Government will strengthen the mandate of Infrastructure UK (IUK) and increase its commercial expertise to boost the delivery of growth enhancing infrastructure projects across Government. As part of this new role, IUK, together with an enhanced Major Projects Authority, will undertake a detailed assessment of Whitehall's ability to deliver infrastructure, building on their existing work. This assessment will be completed by Budget 2013. To ensure the assessment is as thorough as possible, it will be led by Paul Deighton as his first duty as Commercial Secretary to the Treasury working closely with the Minister for the Cabinet Office and the Chief Secretary to the Treasury.

The Cabinet Office is also introducing a number of reforms to address shortcomings in broader commercial skills across Government, this includes:

- a five year capabilities plan for the whole of Civil Service is planned to indentify which skills and capabilities are in deficit and how these gaps will be filled; and

- the Major Projects Leadership Academy has recently been established to train senior leaders in the delivery of major projects. In future only project leaders who have successfully completed this programme will be able to lead a major government project.

Centralised procurement

One the most frequent suggestions raised in the call for evidence, to address a perceived public sector skills deficit, was a proposal for the greater centralisation and improved professionalism of public sector procurement. International examples of centralised procurement units in countries such as Canada were held up as examples that the UK should follow.

PFI projects are not generally procured by central units but by local authorities, NHS Trusts, Foundation Trusts or central government departments. The first PF2 programme, the Priority Schools Building Programme will, however, be procured by a central unit in the Department for Education, the Education Funding Agency. Other departments with PF2 pipelines will also be encouraged to establish a central procurement unit when they embark on a new programme.

The Government recognises that departmental centralisation of procurement, while representing a significant step forward, does not go as far as establishing a single, centralised procurement unit. The business case for such a unit will be kept under review during the IUK and MPA assessments and when future pipelines are confirmed.

Streamlining PF2 procurement

The Government is also putting in place specific measures to improve PF2 procurement to ensure it is faster and cheaper going forward, without sacrificing quality and competitiveness:

- the Government will require departmental ministers to commit to an ambitious procurement timetable when PF2 business cases are submitted to the Treasury for approval. The competitive tendering phase of PF2 projects, measured from the issuance of project tender to the appointment of a preferred bidder, will not be allowed to take longer than 18 months. After this point, funding will not be approved by Treasury unless an exemption to the commitment had been granted by the Chief Secretary;
- to streamline further the procurement process, a comprehensive suite of new standard documentation will be launched. This will include new procurement and contract guidance, a standard shareholders' agreement, a standard facilities management service output specification and a pro-forma payment mechanism for accommodation projects. The Government will also introduce a new standardised and efficient approach to running PF2 procurement following the Government's Lean Sourcing principles; and
- to ensure that projects do not go to market before they are fully prepared, additional Treasury checks will be introduced as part of the Treasury business case approval point to scrutinise project preparation prior to issuing project tenders.

Flexible service provision

PF2 will continue to combine asset design and construction with responsibility for maintenance and renewal in a single contact. This will ensure that the contractor continues to be incentivised to consider future operational costs as decisions are made during the project's design and reconstruction.

Flexibility has been a significant problem for PFI projects in the past, this will be addressed through:

- reducing the number of services included in PF2 projects. Services, such as cleaning and catering, will be excluded from the contract and provided separately through shorter term contracts in order to provide the public sector with the flexibility to alter service specifications over time;
- providing procuring authorities with the discretion on the inclusion of certain minor maintenance activities at the project outset; and
- providing additional flexibility on the provision of services once a contract is in operation and at the contract's end.

Appropriate risk allocation

Effective risk management is important in all forms of procurement but is particularly so for PF2 contracts. However, in the past, under PFI, the risk allocation has not always offered value for money. Under PF2, changes to the risk allocation will be made to improve value for money through:

- the greater retention and management of certain risks by the public sector, such as the risk of additional capital expenditure arising from an unforeseeable general change in law; and
- amendments to the current provisions that set out the arrangements for risk sharing of core required insurances in the operational phase of projects, so as to allow the public sector to take a more appropriate share of risk and reduce the contractor's need to build up reserves against increases in insurance premiums.

Future debt finance

Role of the lender

Stakeholders, including project sponsors and government, take comfort in the due diligence and project monitoring undertaken by project finance lenders. However, while these disciplines provided by the debt providers have been, and remain, valuable, the highly geared capital structures in past PFI projects have tended to restrict operational project flexibility. Uncertain debt markets have also accelerated the need to consider different financing structures from wider sources of debt finance, so that such that projects can continue to secure long-term debt on value for money terms.

Shortage of competitively priced debt finance

Prior to 2008, there was an active bond market for UK and international PPP projects. These bonds benefitted from a guarantee, or 'wrap', provided by monoline credit insurers. However, exposures and losses relating to certain defaulting loan products resulted in the downgrade of monolines active in the European project finance markets. Following these downgrades, investors ceased investing in monoline wrapped project bonds.

Since then, PFI projects have been largely dependent on the bank loan market as the provider of long-term debt finance. However, the Eurozone sovereign debt crisis, combined with a downturn in the global economy and new bank regulatory requirements, has had a major impact on debt markets. It has become increasingly challenging to raise debt finance for projects. The cost of long-term borrowing for infrastructure projects has increased sharply and the availability of long-term bank debt has significantly decreased. Where long-term bank finance is still available, margins demanded by the banks are often at levels which threaten the value for money of projects.

While banks continue to offer short-term loan structures, government does not believe that the refinancing risk represents value for money. Banks can, though, still play an important role in the financing of PF2 projects, whether through long-term loans or products to support institutional investment, including construction guarantees or mezzanine facilities providing credit enhancement.

PF2

Government has engaged directly with institutional investors, banks, credit rating agencies and the European Investment Bank (EIB) to assess the range of alternative financing options available to support infrastructure delivery and the credit requirements and project characteristics required to meet investor requirements.

PF2 will be structured in such a way that it:

- facilitates access to the capital markets, capitalising on the appetite of institutional investors and of other sources of long-term debt finance. Capital markets, whether public or private, have a deep pool of investors who are attracted to the relatively low risk infrastructure asset class;
- provides deleveraged capital structures, facilitated by public sector co-investment, combined with better risk allocation and the removal of certain operational risks which are expected to facilitate access to institutional investor capital; and
- continues to encourage alternative financing sources including loan, guarantee and credit support products provided by commercial banks, the EIB and other financial institutions.

To achieve this, the tender process will require bidders to develop a long-term financing solution where bank debt does not provide the majority of the financing requirement. Institutional investment will, therefore, become an important source of finance for PF2.

Efficiency and value for money

PF2 will offer improved value for money for the public sector and the taxpayer. The measures taken to achieve this include:

- public equity co-investment in future projects to ensure better alignment of objectives, greater transparency and improved value for money;
- accelerated delivery ensuring procurement is faster and cheaper than in the past, with improved public sector procurement capability;
- more flexible service provision, together with a gain share mechanism for any surplus lifecycle funds;
- significantly increasing the level of capital grant that authorities can make to projects, without disrupting the transfer of risk to the private sector; and
- encouraging the assessment and use of a greater range of debt financing sources to secure affordable, value for money long-term debt finance.

These improvements, taken together, will deliver substantially improved value for money. In addition, real progress has been achieved with the Operational PFI Savings Programme, where contracting authorities have reported over £1.5 billion of committed efficiencies and savings with a further £1 billion in discussion.

Recognising the wide range of contracting options which are now available to procuring authorities, and to ensure that all reasonable, viable contracting options are considered as part of the appraisal process, the Government will update the existing Value for Money Assessment to reflect these alternatives. The updated and extended guidance will be published for consultation in spring 2013.

Future application

The first confirmed programme to which PF2 will be applied is the £1.75 billion privately financed element of the Priority Schools Building Programme (PSBP). The Treasury and the Department for Education have been working together closely in the development of PF2.

In addition, the Treasury is working with the Ministry of Defence as they finalise their basing strategy and infrastructure investment plans for a more cost effective estate that meets 'Future Force 2020' requirements, to explore how much of this investment – including construction and maintenance activity – can be delivered through PF2.

In the health sector the Sandwell and West Birmingham Hospitals NHS Trust project is working with the Department of Health to assess the suitability of PF2 to deliver significant new investment, enabling consolidation of services from multiple sites and reorganisation of activity between hospital and community settings

While the immediate PF2 pipeline is focused on accommodation projects, an asset class which has been a particular focus of the PFI reforms, the Government wants to ensure that all suitable projects take advantage of the benefits of PF2. Looking forward the Treasury will work with departments to assess which future projects are eligible for PF2.

Standardisation of PF2 Contracts

Accompanying this policy document is detailed draft guidance for PF2 titled "Standardisation of PF2 Contracts". This sets out the approach to be taken to structuring PF2 contracts, allocating risks between the public and private sector parties and promoting a common understanding of the new model in the market.

Drafts of the new standard form services output template, pro forma payment mechanism, and shareholder arrangements will be published shortly for consultation. Following this they will be incorporated into "Standardisation of PF2 Contracts" which will then be republished in final form.

Summary of reform measures in PF2

Equity: To strengthen significantly the partnership between the public and private sector the Government will:

- look to act as a minority public equity co-investor in PF2 projects; and
- introduce funding competitions for a proportion of equity to attract long-term investors into projects prior to financial close.

Accelerating delivery: To ensure that procurement is much faster and cheaper than in the past the Government is:

- improve public sector procurement capability by strengthening the mandate of Infrastructure UK and supporting departmental centralised procurement units;
- committing that the tendering phase of PF2 projects, measured from project tender to the appointment of a preferred bidder, will not be allowed to take longer than 18 months unless an exemption from the Chief Secretary is agreed;
- introducing a standardised and efficient approach to PF2 procurement and launching a comprehensive suite of standard documentation; and
- strengthening the scrutiny of project preparation by introducing additional Treasury checks at the pre-procurement stage.

Flexible service provision: To improve the flexibility, transparency and efficiency of services:

- soft services such as cleaning and catering will be removed from projects;
- procuring authorities will have discretion on the inclusion of certain minor maintenance activities at the project outset. There will be additional flexibility to add or remove certain elective services once a contract is in operation;
- an open book approach and a gain share mechanism for the lifecycle fund will be introduced to facilitate the sharing of any surplus lifecycle funding; and
- periodic reviews of service provision will be introduced.

Greater transparency: To transform the approach taken to transparency the Government will:

- introduce a control total for all commitments arising from off-balance sheet PF2 contracts signed;
- require the private sector to provide equity return information for publication;
- publish an annual report detailing project and financial information on all projects where Government holds a public sector equity stake;
- introduce a business case approval tracker on the Treasury website; and
- improve the information provisions within the standard contractual guidance.

Appropriate risk allocation: To improve value for money there will be greater management of risks by the public sector, including the risk of additional capital expenditure arising from an unforeseeable general change in law, utilities costs, site contamination and insurance.

Future debt finance: The financing structure for PF2 will be designed to enable access to long-term debt finance, and in particular, the capital markets.

Delivering value for money: Government will develop and consult on guidance which will replace the existing Value for Money Assessment Guidance.

1 Review of the Private Finance Initiative

The Private Finance Initiative (PFI) was introduced in 1992 as a means of harnessing the private sector's management skills and commercial expertise, to bring discipline to the delivery of public infrastructure. The overall aim of the policy was to achieve better value for money for the taxpayer by ensuring that infrastructure projects were delivered to time and to cost, and that assets were well maintained.

Over the last 20 years PFI has become the form of Public Private Partnership (PPP) used most frequently in the United Kingdom and has been used across a broad range of sectors.

The Government's overall objective for the delivery of public infrastructure and services is to secure value for money. There is a range of contracting approaches available to achieve this. As currently, however, it is expected that conventional procurement will continue to be used to deliver a large proportion of the future investment in public infrastructure.

Experience of past projects has shown that a number of aspects of PFI are not working effectively and this has led to sub-optimal value for money in some projects. This has included a slow and expensive procurement process, insufficiently flexible contracts, a lack of transparency of the future liabilities created by PFI projects and the perception that some equity investors have made windfall gains. Some features of PFI have, however, operated as intended, delivering projects to time and to budget, creating incentives on the private sector to manage risk effectively and ensuring that assets are maintained properly during the contract term.

The Government has already taken a number of steps to address the concerns with PFI and to reflect the recent changes in the economic landscape. These include:

- publishing the Whole of Government Accounts in order to improve the transparency of PFI liabilities. This shows that the present value of future PFI obligations, including service charges, is £144.6 billion (2010/11);
- launching the Operational PFI Savings Programme to improve the cost effectiveness, value for money and transparency of operational PFI projects;
- abolishing PFI credits at the Spending Review 2010 in order to create a level playing field for all forms of public procurement;
- introducing new arrangements for the assurance and approval of major projects to strengthen scrutiny and control; and
- announcing a number of measures to respond to changing economic conditions, including a new temporary lending programme for PPP projects, increasing capital contributions during a project's construction period to improve affordability and the UK Guarantees programme.

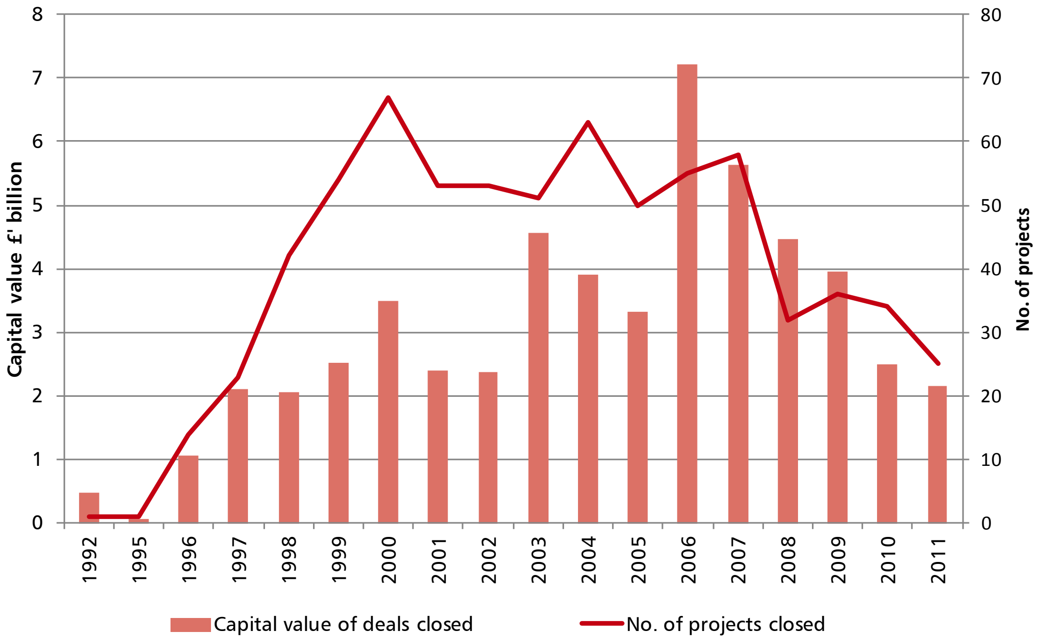
The Government does, however, recognise the need to go further and has, therefore, launched a new approach, PF2, to facilitate genuine partnerships between the public and private sector. Capital spending on public infrastructure is a devolved matter and so PF2 will apply in England only.

1.1 The Government introduced PFI in 1992 as a means of harnessing the private sector's efficiency, management and commercial expertise and to bring greater discipline to the procurement of public infrastructure. Under this policy, the private sector was engaged to design, build, finance and operate infrastructure facilities through a long-term contractual arrangement. PFI was introduced to deliver high quality assets and services and better value for money for the public sector. It aimed to do this through the transfer of appropriate risks to the private sector, a clear focus on the whole of life costs of projects and an innovative approach to service delivery. The payment for PFI projects was structured to ensure that the public sector only paid for the services that were delivered.

1.2 The delivery of projects using conventional procurement normally involves the public sector contracting with the private sector to construct an asset, with the public sector providing the design and the financing itself. The public sector is then responsible for operating the asset once it is built and can outsource these operational services to the private sector under separate contracts. In many cases, however, due to the nature of short-term budgetary decisions public sector authorities do not make provisions for asset maintenance. The delivery of projects under PFI is often more complex than those delivered using a conventional route. This is due, in part, to the lengthy contract periods involved, the greater sharing of risks between the public and private sector and the integration of different aspects of the investment.

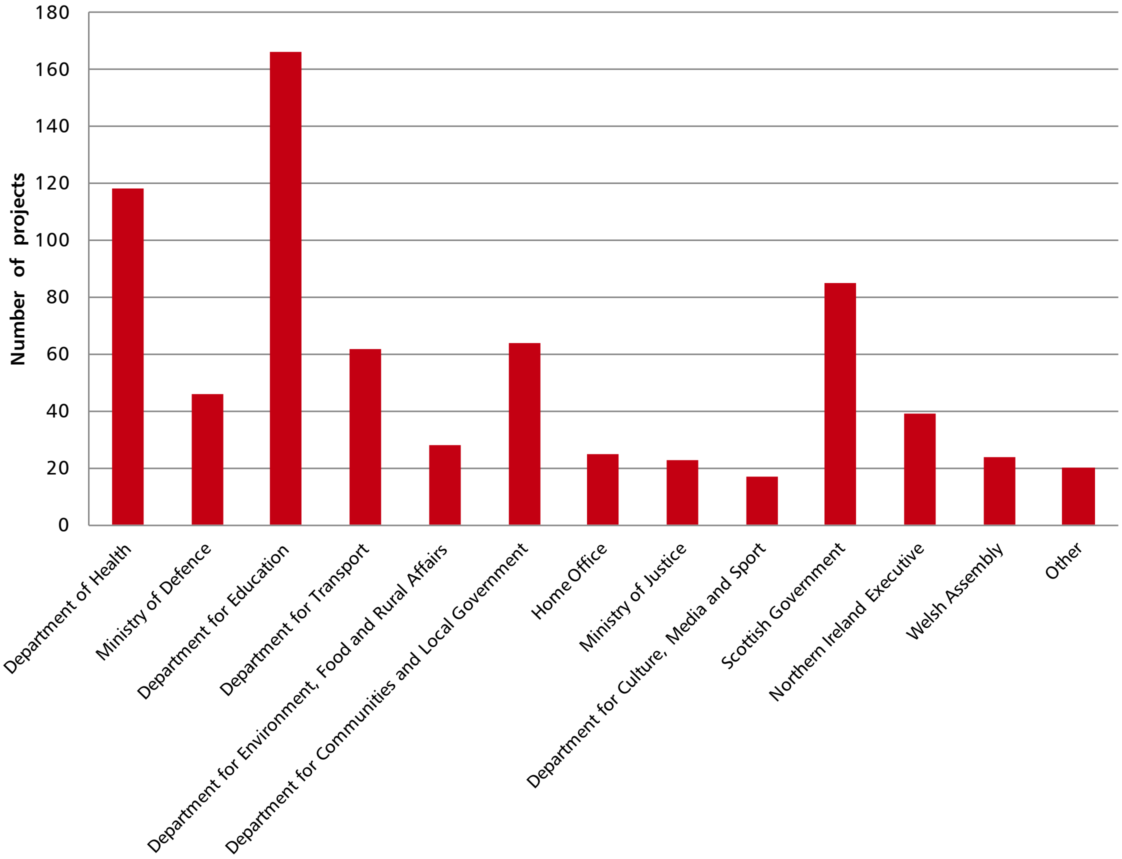
1.3 PFI has been used in the past where there has been a significant investment need for an asset followed by a requirement for ongoing services. PFI has become the form of public private partnership (PPP) most often used in the United Kingdom, with over 700 PFI projects, with total capital costs of £54.7 billion, having reached financial close. Projects have been delivered across a broad range of sectors including schools, hospitals, roads, prisons, housing, defence and waste facilities. Chart 1.A shows the spread of the delivery of these projects over time by number and capital costs and Chart 1.B shows the number of projects that have been undertaken by each Government Department.

Chart 1.A: Number of projects reaching financial close and total capital costs incurred by calendar year



Figures based on departmental and Devolved Administration returns. Current projects only - does not include projects that have expired or terminated.
Source: HM Treasury. Data correct at 31 March 2012.

Chart 1.B: Number of PFI projects by Government Department as at 31 March 2012



Other includes the Department for Work and Pensions, HM Revenue and Customs, GCHQ, HM Treasury, Foreign and Commonwealth Office, Department for Business, Innovation and Skills, Crown Prosecution Service, Cabinet Office and the Department for Energy and Climate Change
Source: HM Treasury. Data as at 31 March 2012.

1.4 Since PFI was introduced, it has remained a small but important part of the Government's overall investment in public infrastructure. In the financial year 2011/12, Public Sector Net Investment (PSNI), the gross spending on investment less depreciation, totalled £26.7 billion. The capital cost of those PFI projects that reached financial close in 2011/12 was £2.1 billion. There are, however, a number of alternative approaches that can be used to deliver capital investment and this decision is based on a value for money assessment (see Chapter 7, *Efficiency and value for money*).

1.5 Conventional procurement will continue to be used to deliver a large proportion of future investment in public infrastructure. There are a number of key differences between conventional procurement and PFI which are outlined in Table 1.A below.

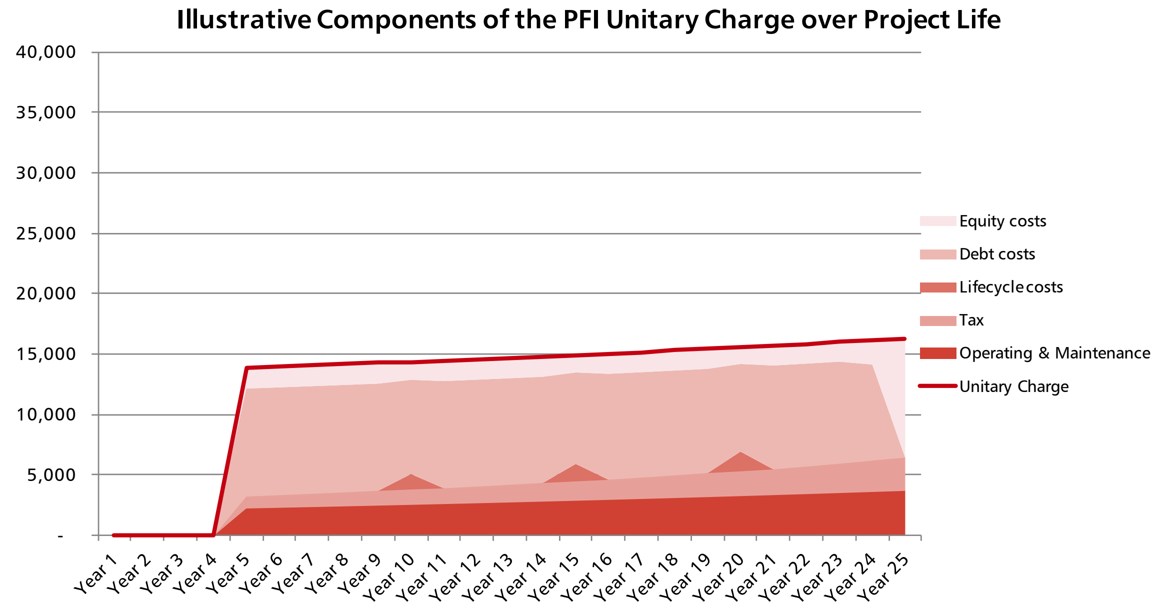
Table 1.A: Comparison of PFI and conventional procurement

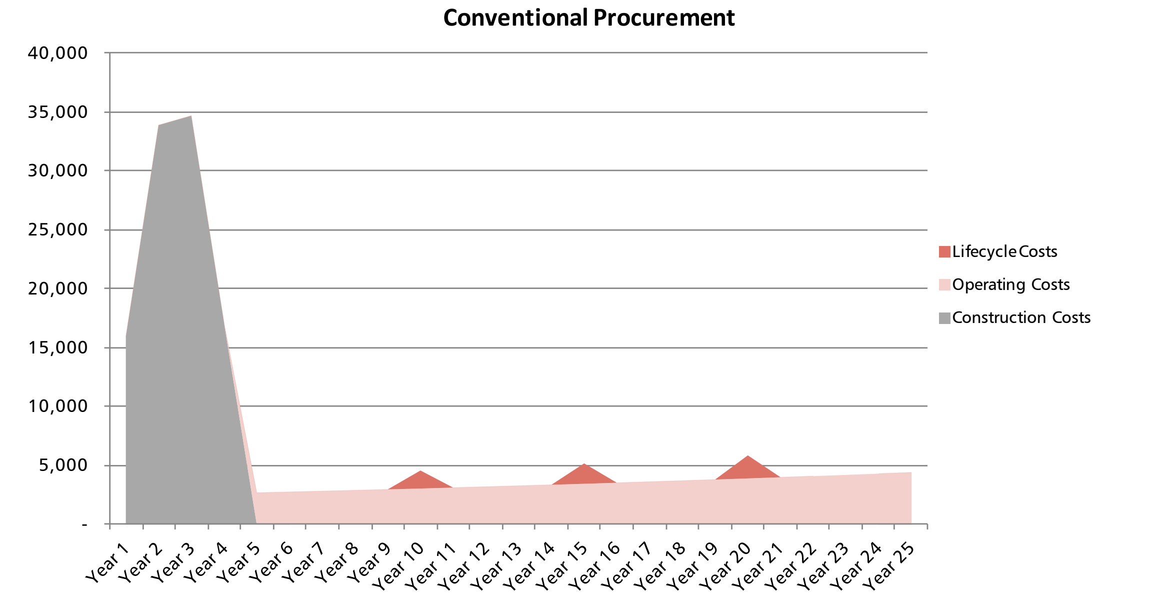
Conventional procurement	PFI
Usually short-term design and construction contracts.	A long-term contract (c.20-30 years) integrating design, build, finance, and , sometimes, maintenance of the facility.
Requirements tend to be specified on an input basis.	Requirements are specified as outputs to maximise private sector innovation.
The procuring authority usually holds the risk on construction delays and cost overruns.	The private sector party holds the risk of construction delays and cost overruns to provide incentives for delivery to time and to cost.
The procuring authority pays for the costs of construction, maintenance and services as they arise.	All costs are included in a "unitary" payment which is fixed over the life of the contract and is not payable until construction is complete and services have commenced to an agreed standard.
The procuring authority pays for the capital costs at the beginning of the project through capital budget.	The capital costs of construction are financed by the private sector borrower, and the costs are amortised over the life of the project.
Borrowing is financed through issuance of government gilts, managed on a Government portfolio basis.	Borrowing is financed by the private sector on a project by project basis.
Payment for maintenance and services are not generally linked to performance.	The unitary charge payments are linked to a performance regime. Deductions may be made if services are not delivered to contractual requirements.
There is no long-term contractual commitment for the provision of maintenance. Authorities can flex their requirements and the costs of maintenance. Only a small number of authorities put in place planned maintenance regimes.	The public sector pays for ongoing maintenance and lifecycle replacement costs as part of the annual unitary charge, and the costs are therefore smoothed across the contract term. This means that the asset is appropriately maintained over the project's life, but the costs of maintenance are effectively locked in over this period.

1.6 One key difference between conventionally procured projects and those procured using PFI is the timing of payments from the public sector to the private sector. Under conventional procurement, the public sector pays the capital cost of the project upfront, followed by an ongoing amount for maintenance services over the life of the asset.

1.7 Under PFI and PF2, the public sector does not pay for the project's capital costs over the construction period. Once the project is operational and is performing to the required standard, the public sector pays a unitary charge which includes payments for ongoing maintenance of the asset, as well as repayment of, and interest on, debt used to finance the capital costs. The unitary charge, therefore, represents the whole life cost associated with the asset. Chart 1.C provides an illustrative payment profile for a conventionally procured project and a PFI project. Chart 1.C also provides an illustration of how the annual unitary charge payment breaks down, for a typical accommodation PFI project, into the components of debt, equity, lifecycle, operating and maintenance costs and tax. Under conventional procurement, the costs include construction, operation and lifecycle.

Chart 1.C: Illustrative payment profile for a conventionally procured project and a PFI project





Source: HM Treasury

Accounting for PFI projects

1.8 The accounting treatment of PFI projects in the UK National Accounts is determined by the European System of Accounts 1995 (ESA95) framework. The ESA95 framework is followed by all members of the European Union and is set and enforced by Eurostat.

1.9 The Manual on Government Deficit and Debt (MGDD), which aids the application of the ESA95 framework specifically for Government, considers the relative balance of construction, demand and availability risk of a project in order to determine the balance sheet treatment. Departments are responsible for determining the classification of projects for both departmental accounts and budgets which since 2011-12 have both been independently verified through the annual audit or department financial statements. Contracts are also made available to the independent Office for National Statistics as required to check that they are classified in accordance with the MGDD.

1.10 If the public sector carries construction risk, the asset is viewed as being on the public sector balance sheet for the purposes of the National Accounts. Where the private sector holds construction risk and one of either demand or availability risk, the asset is not considered to be on the public sector balance sheet for the purpose of the National Accounts.

Box 1.A: Departmental accounting for PFI projects

Departmental accounts are based on International Financial Reporting Standards (IFRS), which determine the treatment of projects by assessing which party has control of the asset. The classification of a lease as finance (on balance sheet) or operation (off balance sheet) is based on the control of project ownership. Around 90 per cent of PFI projects are classified as on balance sheet under IFRS.

In certain cases, the ESA95 and IFRS accounting standards are not aligned for the public sector and this is the case for PFI.

The Government has published the Whole of Government Accounts (WGA) which transparently presents PFI liabilities under IFRS. WGA shows that the present value of future PFI obligations, including service charges, is £144.6 billion (2010-11).

Budgeting for PFI projects

1.11 Departments have separate budgets for resource and capital spending. Resource spending (RDEL) includes current expenditure such as pay or procurement. Capital spending (CDEL) includes new investment. The scoring of the project in departmental budgets depends on whether the project is classified as on or off balance sheet under ESA95.

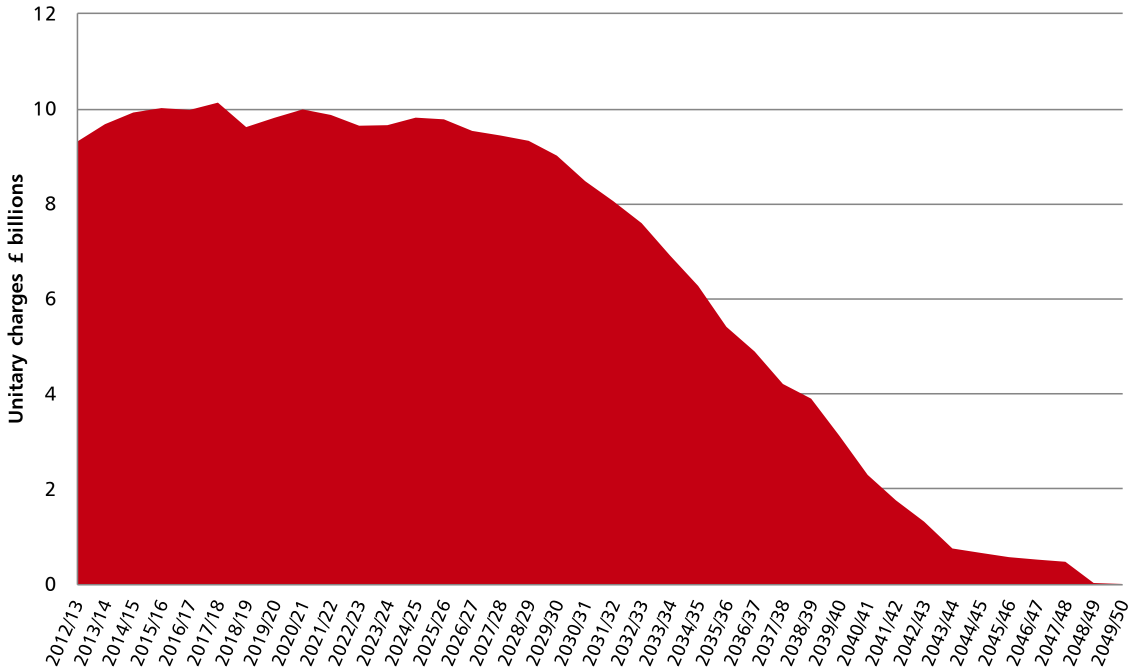
1.12 If a central government project is deemed to be on balance sheet under ESA95, then the capital value of the project (i.e. the debt required to undertake the project) is recorded as CDEL in the first year of operation; and the interest, service and depreciation are recorded as RDEL each year unitary charges are paid.

1.13 If a central government project is deemed to be off balance sheet under ESA95, then there is no impact on the department’s CDEL in the first year of operation. The full unitary charge (including interest, service and debt repayment) does, however, score in RDEL each year. Around 85 per cent of past PFI projects have been considered off-balance sheet under ESA95.

1.14 Departmental budgets are set as part of the Spending Review process. The Government has always been clear that value for money and not the accounting treatment is the key determinant of whether a PFI scheme should go ahead.

1.15 In order to ensure transparency, the Treasury has regularly published estimated future unitary charge payments for all signed PFI projects. An updated profile of these unitary charge payments is shown in Chart 1.D. The unitary charges are presented as nominal figures, i.e. they include an assumption for future inflation and have not been discounted.

Chart 1.D: Estimated future unitary charge payments (in nominal terms, undiscounted) under signed PFI projects



Source: HM Treasury. Figures are based on departmental and Devolved Administration returns. These figures represent the estimated payments that the public sector expects to make to the private sector for services delivered under PFI. The payment mechanisms of PFI contracts contain provision for performance deduction – which reduce payment if the service is unavailable or to a poor standard to incentivise contractor performance – and may therefore be lower than these figures.

Assessing PFI

1.16 Since its inception, PFI has been used across a broad spectrum of projects. It has become evident over time that significant aspects of PFI need to be reformed. There have also been cases where PFI has been used inappropriately and these projects have failed to deliver value for money to the taxpayer. Some features of PFI have, however, worked well in the past in providing incentives on the private sector to manage risks effectively and to maintain assets throughout their life.

1.17 Government policy has been to use PFI only where it is appropriate and where it is expected to deliver value for money. The cost of financing a project by traditional procurement will inevitably be less than the cost of private finance since the Government can borrow at a lower rate than private sector entities. The economic case for private finance projects has, therefore, rested on achieving better value for money than conventional procurement, through cost savings in the construction and operation of the project; or through the delivery of a qualitatively superior project.

1.18 Experience in past projects has demonstrated that significant aspects of PFI have been unsatisfactory for the following reasons:

- the private sector has made windfall gains on projects, through the refinancing of debt and the sale of equity investment to third parties. This has led to concerns about the value for money of projects;
- there has been a lack of transparency on the financial performance of projects and the returns made by investors. It has also been considered that there has been

insufficient transparency on the future liabilities to the taxpayer created by PFI projects;

- there have been poor relationships between the public and private sectors which have hindered effective contract management;
- the PFI procurement process has often been lengthy and costly for both the public and private sectors, on average taking just under three years to tender and close a deal. This has adversely affected value for money for the taxpayer;
- there has been insufficient flexibility during the operational period of projects and, therefore, the ability to make alterations in response to changing public sector service requirements has been inadequate. In 2008, the National audit Office (NAO) concluded that changes to operational PFI projects are often poor value for money[1] (see Box 1.B); and
- inappropriate risks have been transferred to the private sector resulting in a higher risk premium being charged to the public sector or an inefficient capital structure, and/or capital reserves being maintained.

Box 1.B: Making changes to the Avon and Somerset courts project

In a 2008 report on *Making changes in operational PFI projects*[1], the NAO highlighted that under the Avon and Somerset courts project an extra 15 per cent was charged by the project company for a major change request. When the procuring authority challenged the project company on where the contract stated that a fee could be charged for a major change, the project company responded by arguing that the contract did not specify that it could not be charged.

1.19 It is also evident that, too often, PFI has been used on projects on which its application has been unsuitable and has, therefore, failed to deliver value for money. PFI has proven to be unsuitable where:

- the transaction costs of pursuing the PFI route are disproportionate compared to the value of the project;
- fast paced technological changes make it difficult to establish requirements in the long term;
- the nature of the services being delivered do not allow the public sector to clearly define its needs over the long term;
- insufficient attention has been paid to forecasting demand for the asset over the long term. Due to the long term nature of the contractual commitments under PFI it is more costly for the public sector to unwind a PFI project than a conventionally procured project if it is not required in the future; and
- the delivery route has been pursued to secure the budgetary incentives presented by the previous Government's PFI credit regime rather than due to a genuine appraisal of the optimal delivery model.

1.20 However, the evidence has confirmed that elements of PFI can, however, be appropriate for the delivery of major and complex capital projects with significant ongoing maintenance

[1] National Audit Office, Making changes in operational PFI projects, January 2008

requirements. Here, the private sector can offer project management skills, innovation and risk management expertise that can bring benefits. Features of PFI that can be successful, where appropriately implemented, include the following:

- PFI ensures that buildings are constructed to a high quality;
- assets are maintained to a high standard throughout their life due to the long term nature of the PFI contractual commitments. The public sector has benefitted directly from the private sector's consideration of costs over the entire length of the contract, rather than just the during design and construction phase;
- facilities are completed on time and within budget (see Box 1.C);
- the private sector is incentivised to manage risks effectively. In 2009, the NAO reported that the use of private finance can deliver real risk transfer with a good contract[2]. Risk transfer has proved successful as the public sector has been protected when projects have gone wrong (see Box 1.D);
- the structure of the PFI payment stream from the public to the private sector allows deductions to be made if the project does not meet the contractual requirements. This means that the public sector can be confident that it only pays for services it receives; and
- output-based specifications have allowed bidders to develop innovative approaches which deliver value for money for the public sector.

Box 1.C: Delivery to time and to price

The NAO's 2009 report, *Private Finance Projects*[2], highlighted that PFI contracts are fixed price and that they impose heavy financial costs on the project company if they do not deliver on time and this can incentivise the timely delivery of projects. In response to a survey undertaken by the NAO on projects between 2003 and 2008, it was found that 69 per cent of projects reported delivery to the contracted timetable and 65 per cent to contracted price.

Box 1.D: Jarvis

In its 2012 report *Equity investment in privately financed projects*[3] the NAO highlighted a number of projects where equity losses have occurred in projects. In 2004, the construction costs of several projects involving Jarvis companies exceeded those anticipated during the bidding process. Jarvis plc and other PFI investors bore the costs of filling the £120million funding gap in projects including Whittington Hospital, Tyne and Wear fire stations, Lancaster University and Wirral Schools.

1.21 Recent economic developments have also led to a need to respond to increasingly challenging conditions to raise private finance for projects. The Eurozone sovereign debt crisis, combined with a downturn in the global economy and new bank regulatory requirements, has had a major impact on debt markets. The cost of long-term borrowing for infrastructure projects has increased and the availability of long-term bank debt has materially diminished. In some

[2] National Audit Office, *Private Finance Projects,* November 2009

[3] National Audit Office, *Equity investment in privately financed projects,* February 2012

cases, traditional project finance banks have withdrawn from the market altogether. This is threatening the value for money of projects.

Existing Government interventions

1.22 The Government has also already taken a number of steps to address the historical concerns with PFI projects and changes in economic conditions. The steps taken to address concerns with PFI include the abolition of PFI credits, the introduction of new integrated assurance and approval arrangements, the publication of the WGA and the commitment to deliver £1.5 billion savings from operational PFI projects. In response to the changes in economic conditions, initiatives taken include co-lending to support PFI projects, increased capital contributions phased-in during the construction period to improve affordability and the UK Guarantees programme.

Whole of Government Accounts

1.23 To address concerns regarding the transparency of PFI liabilities, in July 2011 the Government published for the first time an assessment of the PFI liabilities in the WGA. This represented a fundamental step towards providing complete transparency over the level of PFI liabilities. The liabilities represent the three elements of the annual unitary charge of a PFI project. This includes the service element to run the project, which typically includes the cost of cleaning, catering, maintenance and security, repayment of the capital asset built and interest on the capital.

1.24 WGA are full accruals based accounts covering the whole public sector and audited by the NAO. WGA consolidates the accounts of about 1500 bodies, from central government, devolved administrations, the health service, local government and public corporations. WGA treats PPP commitments according to IFRS and includes a table summarising the long-term contractual commitments held by all bodies which are, or are similar to, PFI projects. WGA are published on an annual basis.

Operational PFI Savings Programme

1.25 In order to improve the cost effectiveness, value for money and transparency of operational PFI projects, in July 2011 the Government committed to delivering £1.5 billion in savings from projects in England. This followed positive pilot reviews at the Queen's Hospital Romford and three Ministry of Defence projects.

1.26 To date, over £1.5 billion of efficiencies and savings have been achieved from operational PFI contracts in England and close to another £1billion are in discussion.

1.27 Savings have been achieved through more efficient and flexible use of assets, validation of the scope of services, reviewing financing and management costs and adopting invest to save opportunities. All savings are retained by the procuring authority.

1.28 For further detail on the Operational PFI Savings Programme see Chapter 7, *Efficiency and Value for Money.*

Abolition of PFI credits

1.29 The Government abolished PFI credits in autumn 2010 to create a level playing field for all forms of public procurement and remove the budgetary incentive the credits regime presented. Since the abolition of PFI credits, departments wishing to support PFI projects have been required to prioritise funding from their own budgets. This change has meant that departments have had to consider the economic case of a PFI project and compare this on a like-for-like basis with other calls on their budget. The removal of PFI credits has helped to ensure procuring authorities select the delivery route which provides the best value for money. A description of PFI credits is provided in Box 1.E.

Box 1.E: What were PFI credits?

Under the PFI credit regime, departments wishing to support a programme of local government PFI projects were given a provisional allocation of PFI credits at a Spending Review. PFI credits represented a notional capital sum and were intended to support the capital costs of a project.

Departments awarded this funding to individual projects subject to approval from the Projects Review Group. The funding was then paid to the local authority through a series of grants; these were usually calculated on an annuity basis. These grant payments were top-sliced from Revenue Support Grant within the overall local government Resource Departmental Expenditure Limit allocation.

This ring-fenced funding gave additional spending power to central departments wishing to deliver PFI projects through local authorities. The Government cancelled PFI credits at the Spending Review 2010 to remove this budgetary incentive to use PFI.

Major projects assurance and approval

1.30 To ensure that the PFI procurement route is only pursued when it is most suitable and to strengthen arrangements for scrutiny and control of spending more broadly, the Government introduced a new integrated assurance and approval arrangements in April 2011.

1.31 The revised procedure ensures that the assurance provided by the Major Projects Authority (MPA) is fully integrated with the strengthened Treasury Approval Processes. HM Treasury approval is required for major projects at three business case stages; Strategic Outline Case (SOC), Outline Business Case (OBC) and Full Business Case (FBC).

1.32 Infrastructure UK, a unit within the Treasury, supports Treasury approvals processes and the MPA, particularly in relation to projects in the infrastructure and PPP sectors.

Temporary lending programme for PPP projects, capital contributions and UK Guarantees

1.33 The Government has already responded positively to the economic conditions with a number of interventions to ensure that projects are not delayed as a result of an inability to raise finance at affordable pricing.

1.34 In July 2012, the Government announced a new temporary lending programme for PPP projects to ease capacity constraints in the market.

1.35 The Government has increased capital contributions to PFI projects and phased them in during the construction period to improve affordability and ease debt capacity constraints. This has been approved on several projects in procurement.

1.36 The Government also launched the UK Guarantees programme in July 2012 in response to the changing economic context and to dramatically accelerate nationally significant infrastructure projects. Up to £40 billion in guarantees could be provided to ensure that priority projects in the infrastructure pipeline can raise the finance they need despite challenging credit market conditions. Those projects which are eligible for UK Guarantees could come from a range of sectors, including transport, utilities, energy and communications. The scheme has received 75 enquiries from project sponsors to date, of which 14 projects with a capital value of around £10 billion have been prequalified as eligible for consideration of a guarantee.

1.37 Many of these measures have a finite lifetime and so the review of PFI has needed to respond to the current financing climate, which is likely to remain challenging for an extended period, in order to develop a sustainable funding model for the medium term.

Call for evidence on the reform of PFI

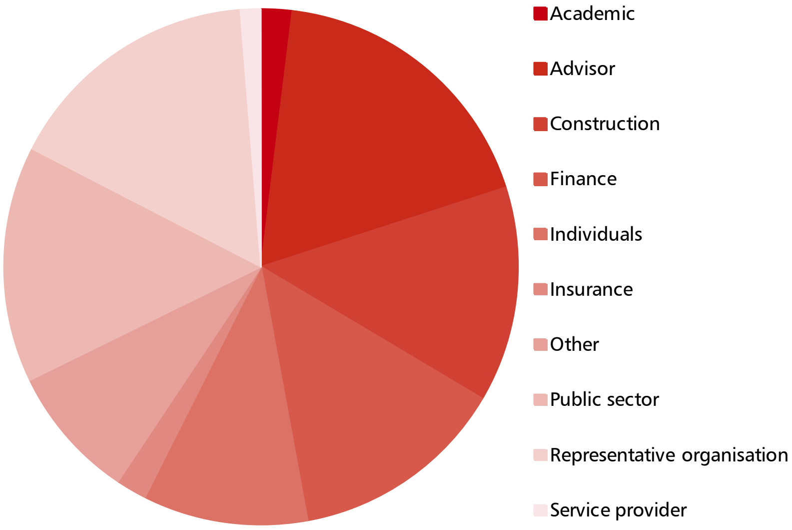
1.38 While the Government had already introduced a number of reforms to PFI it considered that a fundamental reassessment of the model was still required. The Government's aim was to develop a new approach to draw on industry skill, innovation and expertise, in a way that offers better value for the Government's investment in public infrastructure and services. The Government set out its objectives to develop a new approach to the delivery of public infrastructure that:

- is less expensive and uses private sector innovation to deliver services more cost effectively;
- can access a wider range of financing sources, including encouraging a stronger role to be played by institutional investment;
- strikes a better balance between risk and reward to the private sector;
- has greater flexibility to accommodate changing public service needs over time;
- maintains the incentive on the private sector to deliver capital projects to time and to budget and to take performance risk on the delivery of services;
- delivers an accelerated and cheaper procurement process; and
- gives greater financial transparency at all levels of the project so that the public sector is confident that it is getting what it paid for and that the taxpayer is sure it is getting a fair deal now and over the longer term.

1.39 To meet these objectives and to give an opportunity for all interested parties to bring forward proposals on how best to reform the PFI model, the Government launched a call for evidence in December 2011. All parties with an interest in the delivery and financing of future assets were invited to share their views on the reforms that should be implemented for future projects.

1.40 In response to the call for evidence, 136 submissions were received from a range of organisations, including advisors, investors, contractors, service providers, academics and the public sector. 3 responses were received from MPs. In addition, 16 responses were received from individuals. The responses to the call for evidence have been published alongside this document and a summary of the responses received is provided in Annex A. Annex B contains a full list of organisations that responded.

Chart 1.E: The mix of respondents to the call for evidence on the reform of PFI



Source: HM Treasury

1.41 As part of the call for evidence process, a range of views were expressed on how best to reform the PFI model. There were, however, relatively consistent views on the issues that need to be addressed in the new model. It was considered that there is a need for:

- better value for money of the financing of projects;
- the model to be able to access wider sources of equity finance to increase competition and drive down equity returns;
- alternative approaches to debt finance to address capacity constraints in the market;
- greater transparency of the liabilities created by PFI projects and over returns made by investors;
- an increase in speed and reduction in costs of the procurement process;
- greater flexibility in the provision of services due to the long-term nature of the contracts;
- greater transparency over the build up and management of the lifecycle fund; and
- better allocation of risk between the public and private sector, to ensure that risks are placed with the party best able to manage them.

PF2

1.42 PF2 has been developed to address the problems of past PFI projects and to respond to the recent changes in the economic environment, while retaining the benefit of private sector investment. Under the new approach the private sector will continue to be responsible for designing, building, financing and maintaining an infrastructure asset over a defined period, typically between 20-30 years.

1.43 In light of the call for evidence, the Government decided that further major reform of PFI was needed if the use of private finance is going to deliver value for money in future projects. The rest of this document sets out the new approach for involving private finance in the delivery of public infrastructure and services, PF2.

2 Equity finance

In order to strengthen significantly the partnership between the public and private sector, the Government will look to act as a minority equity co-investor in future projects. In particular, an approach of public sector co-investment will mean that:

- objectives will be more closely aligned, ensuring a collaborative approach by both the private and public sector to improving project performance and managing risk;
- a more genuine partnership environment will be created, allowing for a better understanding of perspectives between the public and private sectors;
- there will be improved project transparency, including in relation to the financial performance of the project company, as the public sector will have access to more information through its board membership; and
- value for money will be improved as the public sector will share in the ongoing investment returns, reducing the overall cost of projects to the public sector.

To ensure an effective role is played by the public sector as an equity investor and one that minimises the potential for conflicts of interest between the public sector acting as an investor and a procurer, the equity investment:

- will be managed by a commercially focused central unit in the Treasury, separate from the procuring authority;
- will be managed by individuals with the appropriate professional skills to oversee the investment and make commercial decisions; and
- will be made on a same-terms basis with the private sector.

In addition, the Government will introduce an equity funding competition after the preferred bidder stage for a portion of the private sector equity to widen the sources of equity finance and, in particular, to attract long-term investors into projects at an earlier stage.

Equity finance

2.1 As shareholders, equity investors in projects are the owners of the project company that is responsible for delivering the obligations under the contract and for bearing the risks associated with the design, build, financing and management of public infrastructure and services. Equity investors earn a return on their investment over the project's life and are, therefore, incentivised to meet performance requirements and deliver efficiencies to maximise their returns. Equity investors take on the greatest risk since they only earn a return after payments of operational costs and debt loan obligations. Debt finance, ranking senior to equity in the priority order of payments, is serviced by way of fixed interest and principal repayments. Consequently equity investors, while taking more risk, also take the benefit of any upside in project performance as any profits after the repayment of debt obligations can be distributed to equity investors.

2.2 There are different types of equity investors and they can take different roles in relation to the project (Box 2.A).

Box 2.A: Equity investors

By stage of investment:

- Primary investors – take a lead role in the development of a project and will often have an interest in the sub-contracting entities. They may choose to hold their investment throughout the life of the project or may sell their equity stake post project completion in order to recycle invested capital into new projects.
- Secondary investors – buy an equity stake in an existing project, typically once the construction of the asset is complete.

By investor type:

- Industry sponsors – usually a primary investor, they will often provide management services to the project company and provide some or all of the construction and/or facilities management and maintenance services.
- Financial investors – usually do not have an interest in sub-contracting arrangements. The primary reason for their investment is to maximise returns for their shareholders or fund investors[1] over a medium to long-term basis. They may play a role in initial structuring of the project and day-to-day operations or, alternatively, may be a more passive investor. They also may choose to invest in projects from the outset or purchase equity in the secondary market depending on their target return requirements.
- Institutional investors (equity) – for example pension funds. These investors are not primarily interested in maximising returns. They typically invest on a long-term basis to earn long-term stable returns to match their maturing liabilities e.g. payments to pension holders. Typically, these types of investors have invested in projects during the operational phase of a project so as not to be exposed to bidding and construction risks.

Public Sector Equity

2.3 In order to strengthen significantly the partnership between the public and private sector, the Government will look to act as a minority equity co-investor in future projects. This will ensure a new collaborative approach, which improves value for money for the taxpayer, better aligns interests and fosters a better understanding between the public and private sectors. Through public equity investment, the public and private sector can together harness the operational benefits of the partnership in order to drive project efficiencies and secure the right outcomes.

Better partnership working and a more collaborative approach

Greater project transparency

2.4 Public sector co-investment provides greater project transparency and accountability for project delivery and operation. Through project company board membership at Director level, the public sector will now be able to participate in project governance with the project company's other Directors who will be appointed by the equity providers. This is expected to result in better partnership working between the public and private sector as the public sector

[1] Pension funds and other institutional investors often invest in managed funds to access returns generated from investment in infrastructure assets where they are unable to invest directly due to lack of resourcing or expertise.

will have greater visibility of project information and will be involved in strategic decision making.

2.5 This approach will also help to address concerns around a lack of transparency of financial information related to project performance as the public sector will receive this information in order to make necessary decisions as a Director on the project company board.

2.6 In addition, observer status at board meetings of the project company will be given to the procuring authority or other local representative as appropriate: for example, a school where it is not also the procuring authority. The intention is to support better collaboration, sharing of information and perspectives; and to improve transparency. The observer will help to ensure the project company board understands local issues and concerns, which will support the effective management of the project through better partnering. The governance arrangements for the project vehicle set up to implement the project will be set out in a standard Shareholders' Agreement, a draft of which will be published for consultation shortly. For further details please see Chapter 5 of Standardisation of PF2 Contracts.

Box 2.B: The Shareholders' Agreement

The Shareholders' Agreement sets out the governance arrangements for the vehicle set up to deliver the project. For each project in which the public sector is participating as an equity investor, the Shareholders' Agreement is expected to be standardised, based on a draft to be published for consultation shortly. In summary, the proposed Shareholders' Agreement will set out:

- the parties who are shareholders in the project vehicle created to implement the PF2 project;
- how equity return distributions will be determined; and
- the right of the public sector equity provider to appoint a local level observer to the Board.

2.7 Project and financial information, including that on equity holdings and investor returns in relation to individual projects, will be disclosed through an annual report published by the Treasury.

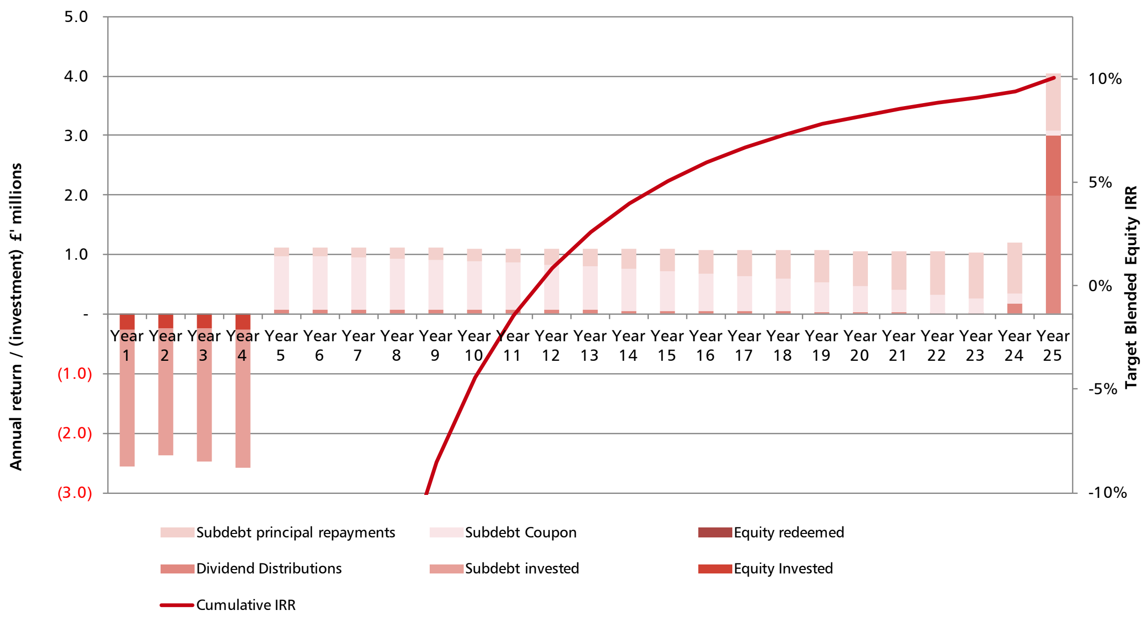
Improved value for money

2.8 A key objective of the review of PFI has been to create a new approach to public private partnerships that is sustainable for the longer-term. Given the diminished availability of long-term bank debt, future projects are likely to need to be structured in such a way that they facilitate access to the capital markets or other sources of long-term debt finance. A greater proportion of equity (i.e. a lower gearing) in the capital structure provides a credit enhancement to the underlying debt rating of the project, which will make the debt more attractive to a wider diversity of long term-debt providers, including institutional investors such as life insurance providers.

2.9 Equity finance comes at a higher cost than debt finance. Including a larger proportion of equity in the structure may, at a project company level, make the project more expensive if the price of debt does not decrease proportionately. However, as the public sector co-investor will earn a return on its investment, assuming appropriate management of project risk, the overall cost to the public sector will be lower under PF2 than would otherwise be the case if the public sector did not invest.

2.10 The target equity return of the public sector will be matched to a market rate (see Box 2.C). Chart 2.A gives an illustrative presentation of the expected equity return profile on a £10 million public sector equity stake over a 25 year contract period that achieves an Internal Rate of Return (IRR) of 10 per cent.

Chart 2.A: Illustration of an equity return profile for a 25 year contract at a return of 10 per cent



Source: HM Treasury

2.11 The funding for the public sector equity investment will come from the procuring authority or sponsoring department. The returns made from investment, in the form of dividends, interest payments on shareholder loans or gains in the eventuality of any sale of the public sector equity stake, will be recycled to the same authority net of the Treasury's costs for managing the investment. Therefore, the risks and rewards from the equity investment will fall to the authority's budget.

A commercially focused investor

2.12 The Government believes that it is important to minimise the potential for conflicts of interest that may arise from the public sector acting both as an investor and a procurer of projects. Responses to the call for evidence also highlighted this as an important issue to resolve to enable an effective role for the public sector as an equity partner.

2.13 The Government will, therefore, establish a central unit, separate from the procuring authority, to carry out equity investment in future projects under PF2. The central unit will be located in the Treasury to ensure a clear separation of public sector interests as a procurer and an investor.

2.14 The commercial basis on which the Treasury will operate and manage the investment will be set out in a clear mandate and governance structure. While the Treasury will be governed by the principles setting out how to manage public funds in Managing Public Money[3], the director which it appoints to the project company's board will have a fiduciary duty to that project

[3] http://www.hm-treasury.gov.uk/d/mpm_whole.pdf

company like all other directors. In order to minimise conflicts of interest, the central unit will not get involved in the bid development, procurement or project approval process.

2.15 The central unit will be staffed by individuals with the relevant professional skills to ensure effective representation on the project company board and an ability to make informed commercial decisions about the management of both individual projects and the portfolio of investment.

Terms of public sector equity investment

2.16 Under PF2, the public sector will act as a co-investor alongside one or more private sector equity providers. The public sector is expected to take a minority shareholding in a project and it will appoint a director to the board of the project company set up to implement the project. The minority stake will ensure that transfer of risk to the private sector is maintained and the necessary incentives on the private sector to achieve efficiencies in the project remain in place.

2.17 Public sector equity investment will be made on the same terms as private sector equity investment (i.e. shareholder rights) to ensure that the partnership is appropriately balanced. Further details on the terms for the investment are set out in Box 2.C.

Box 2.C: Terms of public sector equity investment

- It is expected that the public sector will take a minority shareholding in a project to ensure sufficient risk transfer to the private sector is maintained.
- Investment will be performed on a same terms basis (i.e. shareholder rights) as the private sector equity providers in order to ensure an appropriately weighted partnership.
- Investment will be managed centrally by a unit within the Treasury on a commercial basis.
- Funding competitions for a portion of the private sector equity will provide a transparent market price for the project equity and will set the price for public sector equity. For projects where an equity funding competition is not held the price will be matched to that of the successful bidder.
- The proportion of equity that the public sector intends to invest will be set out in project's tender documents.

Minimising public sector exposure to risk

2.18 The Government recognises that investing equity in projects means sharing in the risks of related to the performance of the project, as well as the returns. There are several ways in which project risk will be managed in each project in order to minimise public sector exposure.

2.19 During the procurement process, as is the case now, projects will go through the integrated assurance and approval arrangements set out in April 2011 and a business case approval process. Projects will be assessed for affordability, value for money and deliverability at three key stages[4]. Detailed due diligence will be performed by both the public and private sector equity investors in addition to due diligence undertaken by debt providers, to assess project risks as so inform the basis of their investment decision.

2.20 The director appointed by the Treasury central unit will have board representation with associated voting rights, including on certain matters that will be reserved to a decision by all or

[4] Major project approval and assurance guidance (April 2011). http://www.hm-treasury.gov.uk/d/major_projects_approvals_assurance_guidance.PDF

a majority of shareholders. However, the Government recognises that there may be circumstances in which it is not appropriate for the public sector to invest in projects. While the assumption is that the public sector will act as a co-investor in all projects, this may not always be the case.

2.21 Establishing a central unit to undertake and manage all the public equity holdings will allow the Government to take a portfolio approach to investment, thereby spreading its risk across a number of projects. For example, if one project suffers impaired performance, another might perform better than anticipated and generate equity returns above those which were forecast. A portfolio approach to investment, therefore, helps to reduce the overall risk to the Exchequer.

Private sector equity

Attracting long term equity investors

2.22 Primary investors play an important role in project development as they lead the structuring of projects. Industry sponsors are a major source of primary equity. They typically have a strong appetite at the bid stage of projects, as their business is the ownership and management of infrastructure assets and the services derived from them. Equity investment by industry sponsors is valuable in supporting the development of projects, giving access to sponsors' experience of delivering infrastructure projects.

2.23 However, the Government is keen to see more investors with longer-term investment horizons, such as pension funds, investing in projects at an earlier stage. These longer-term investors have tended, historically, not to invest directly in projects. In part, this is because they have not developed the in-house skills and resources to manage these investments, but also because they have been averse to the time, risk and cost of bidding for projects.

2.24 The Government will, therefore, implement a mechanism to provide an investment opportunity for these investors. Where appropriate, it will require an equity funding competition after the preferred bidder stage for a proportion of the equity requirement. The timing of such a competition, when project documentation and commercial and financial arrangements are substantially complete, will keep the costs of participation in the competition down and so meet concerns expressed by long-term equity providers. It is also expected that widening access to different types of investor could be expected increase competitive tension, with downward pressure on equity pricing in the longer-term.

Box 2.D: Equity funding competitions

A decision on whether to have an equity funding competition will be made on a project-by-project basis. The parameters for the equity funding competition will be set out in the tender documents for each project on a case-by-case basis. The principles on which the competitions will be based include:

- the equity funding competition will commence after the preferred bidder stage and be executed in advance of financial close;
- it will be run by the private sector with input by and approvals from the public sector;
- bidders will compete based on finalised project documentation as agreed at the preferred bidder stage between the preferred bidder and procuring authority. The competition will not allow for re-negotiation of the these documents; and
- equity funding competitions may result in a tranche of equity with lower equity return. Savings generated through a lower equity return requirement of the winner of the competition will be passed on in full through the unitary charge.

Secondary market equity sales

2.25 Primary investors play a key role in structuring and bidding for projects and are vital to a competitive procurement process. Most primary investors in PF2 projects will need to have the ability to sell their equity post project construction due to balance sheet constraints and a requirement to recycle invested capital into new projects.

2.26 Secondary market investors are often willing to pay a premium for projects when a project is in operation because some major risks, including construction and commissioning, have passed. This can give rise to higher than forecast profits for the primary investor, often referred to as 'windfall gains' or 'excessive profits', which has led to criticism that, in some projects, the private sector investors have made an unreasonable level of profits relative to the level of risk they have borne.

2.27 PF2 contains a number of measures which curb the ability of the primary investors to generate excessive profits and consequently the potential for windfall gains on secondary market sales, including:

- a mechanism to share any unutilised funds in the lifecycle reserve (Chapter 4);
- the public sector receives a share of any gains achieved if project borrowing is refinanced during the contract term. The improved refinancing gain-sharing mechanism, introduced in April 2012, is retained in PF2;
- removal of soft services (Chapter 4). In the past contractors have typically included a risk premium in the pricing of soft service provision. However, the actual costs may have been lower than forecast, thereby reducing the scope and the degree of risk-pricing in the sub-contracts;
- de-leveraging of the capital structure (Chapter 8), which has the impact of sharing efficiency savings across an increased equity investment and, therefore, the return on the equity investment will be lower; and
- equity funding competitions to encourage long-term investment into projects. By encouraging long-term investors at pre-financial close stage, this will reduce the instances and/or quantity of equity traded in the secondary market.

3 More efficient delivery

The Government is committed to ensuring PF2 procurement is faster and cheaper than PFI procurement has been in the past, without sacrificing quality and competitiveness. To achieve this the Government is introducing a number of reforms to:

- improve public sector procurement capability by strengthening the mandate of Infrastructure UK and supporting departmental centralised procurement units, where appropriate;
- streamline the procurement process by introducing a standardised and efficient approach to running PF2 procurement following the Government's Lean Sourcing principles and launching a comprehensive suite of standard documentation;
- establish firm commitments to procurement timescales by requiring departmental ministers to state their commitment to an ambitious procurement timetable when they submit business cases to the Treasury for approval. The competitive tendering phase of PF2 projects will not be allowed to take longer than 18 months unless an exemption is agreed by the Chief Secretary. This will be measured from the issuance of project tender to the appointment of a preferred bidder; and
- strengthen the scrutiny of PF2 project preparation by introducing additional Treasury checks in the business case approval process to ensure that projects have undertaken a sufficient level of project preparation prior to issuing a procurement tender.

PPP Procurement

3.1 Procurements of PF2 projects have a number of features that make them more complex than many other types of procurement. PF2 projects will be a long-term agreement for the design, construction, financing, maintenance, and sometimes operation, of a new asset; and their procurement needs, therefore, to address all these issues during the tendering process. Addressing these issues appropriately takes time. For instance, it will take many months to complete the detailed design development and obtain planning approval for the new asset. Additionally, agreeing how the PF2 project is going to be financed by a private sector partners will add further cost, complexity and time in procurement as financiers require time to conduct their own due diligence and to complete their separate financial negotiations.

3.2 Some of the additional procurement time required for PF2 projects is, therefore, not only necessary but highly beneficial to the overall project. In the past the central benefit of the PFI procurement process, which followed a similar process to that planned for PF2 projects, has been its track record at delivering infrastructure on time and to budget[1]. However, while longer procurement timelines are expected for PF2 projects than for less complex models, the

[1] *NAO (2007) Improving the PFI Tendering Process*

Government believes that procurement timescales for PFI were excessive and is committed to reducing the time and cost of procurement of PF2 projects going forward.

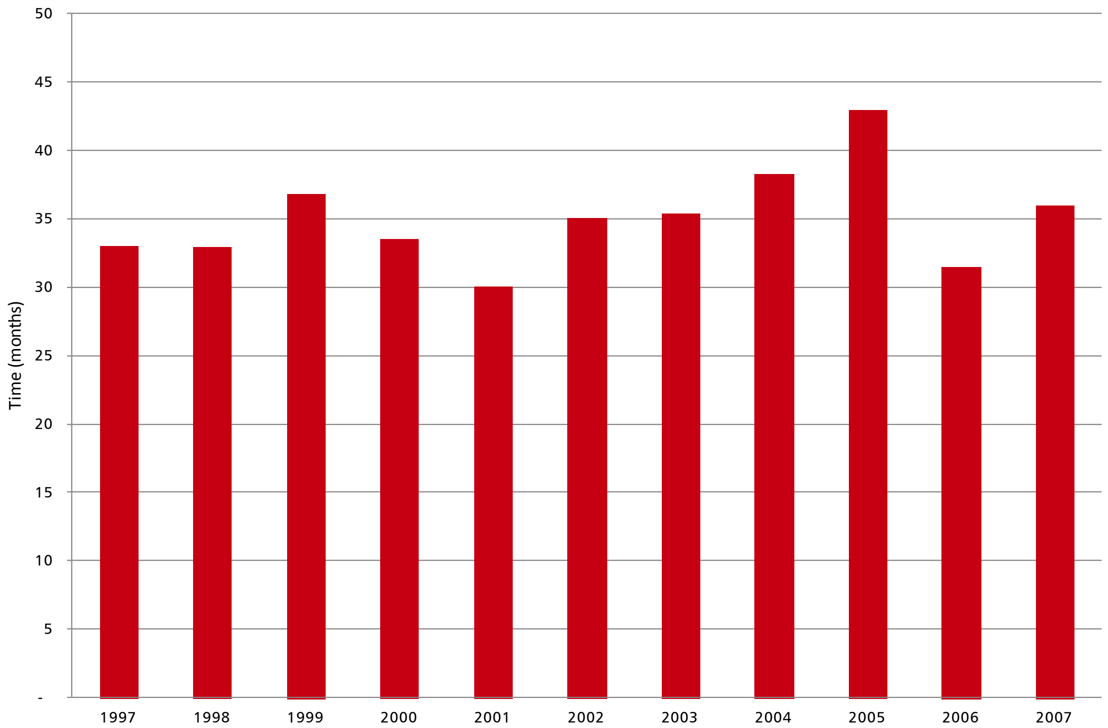
PPP Timelines

3.3 Average PFI procurement times, from initial project tender to financial close, have stubbornly remained at around 35 months. This average has, however, varied by sector; the average procurement time for schools was 22 months in 2008 whilst in sectors such as housing and waste procurement times have consistently been significantly longer.

3.4 The period from the initial project tender to that appointment of the preferred bidder is the most expensive phase of procurement, as this is when multiple bid teams are in competition. In the past, significant bid costs have been incurred by the private sector over this period which ultimately are borne by the public sector in the form of higher contract costs. On average this period took just under 2 years for past PFIs and in the worst PFI cases took over 60 months[2].

3.5 International comparisons on procurement timelines are imperfect as they are affected by differing legal systems, cultural behaviours, interpretation of EU regulations and pre- and post-procurement processes. Nevertheless, the UK procurement timelines do appear to be slower than European comparators and are significantly slower than those achieved in Canada.

Chart 3.A: Average procurement times (OJEU to Financial close) in England



Source: HM Treasury

Improving public sector procurement capability

3.6 The Government recognises the need to ensure that the public sector has the necessary skills and experience to develop and manage future PF2 procurements. Strong commercial and negotiating skills are essential to secure a PF2 procurement outcome which is value for money.

[2] HM Treasury *Data on PFI projects* http://www.hm-treasury.gov.uk/infrastructure_data_pfi.htm

3.7 In the past there have been difficulties in attracting the right level of procurement expertise to public sector roles and ensuring that this expertise is retained within the public sector once it has been developed. The fragmentation of PFI procurement across many procuring authorities has meant that often there has been little opportunity for procurement specialists to move to subsequent projects of a similar size and complexity and apply their skills and lessons learnt to these new projects. Procurement expertise has also been insufficiently valued within the public sector and as a result, public servants have often been reluctant to pursue this as a career path.

Strengthened Infrastructure UK

3.8 The Government will strengthen the mandate of Infrastructure UK (IUK) and increase its commercial expertise to boost the delivery of growth enhancing infrastructure projects across Government. As part of this new role, IUK, together with an enhanced Major Projects Authority, will undertake a detailed assessment of Whitehall's ability to deliver infrastructure, building on their existing work. This assessment will be completed by Budget 2013. To ensure the assessment is as thorough as possible, it will be led by Paul Deighton as his first duty as Commercial Secretary to the Treasury working closely with the Minister for the Cabinet Office and the Chief Secretary to the Treasury.

3.9 The Cabinet Office is also introducing a number of reforms to address shortcomings in broader commercial skills across Government. A five year capabilities plan for the whole of Civil Service[3] will identify which skills and capabilities are in deficit and how these gaps will be filled. The Government's Infrastructure Procurement Routemap, due to be published early next year, will also provide guidance to help ensure the right procurement route is adopted and any public sector capability gaps are identified and addressed.

3.10 The Major Projects Leadership Academy (MPLA) has also recently been established to train senior leaders, developing their leadership ability, technical delivery skills, commercial capability and overall ability to deliver major projects. In future only project leaders who have successfully completed the MPLA intensive development programme will be able to lead a major government project.

Centralised PFI procurement units

3.11 PFI projects are not currently procured by central units but by local authorities, NHS Trusts, Foundation Trusts or one off teams within the responsible central government department.

3.12 There was, however, strong support in the responses to the Government's call for evidence on PFI reform for a centralised approach to procurement across government. International examples of centralised procurement units were held up by many industry stakeholders as a model the UK should follow. In countries such as Canada central procurement bodies, staffed by commercial experts that have a clear focus on delivery, were recognised by many as being a key factor in the countries relatively low PPP procurement times. They have also been credited with reducing the duplication and dilution of procurement capability across the public sector, allowing the benefits of repetition to be realised and enabling economies of scale and efficiencies to be achieved across a procurement programme.

[3] The Cabinet Office (2012) *Civil Service Reform Plan*

Box 3.A: Infrastructure Ontario

Infrastructure Ontario (IO) is a crown agency of the Ontario government and reports directly to the Minister of Infrastructure. IO delivers many of the province's larger and more complex infrastructure renewal projects. It also manages one of the largest real estate portfolios in Canada, provides real estate services, and provides the public sector and not-for-profit organisations with long-term financing to renew public infrastructure. These four major business lines are supported by more than 400 staff.

The Ministry of Infrastructure, in consultation with other government ministries, identifies which projects will be assigned to IO or to a provincial ministry. Once projects are approved for assignment to IO by Cabinet, IO receives a Letter of Direction from the Minister of Infrastructure confirming the projects, including their year of construction start and total project budget.

IO uses a form of PPP called the Alternative Financing and Procurement (AFP) model which transfers the risks of cost overruns and delays to the private-sector, where they are best managed. IO is recognized as an international leader in leveraging private-sector expertise to deliver projects on time and on budget, while maintaining proper public ownership and control of core public infrastructure assets.

Collectively, IO's professionals have significant construction and project management expertise across various sectors, including, hospitals, courthouses, detention centres, roads, transit, highway service centres, data centre, sports facilities, education facilities and police station.

3.13 Central procurement units have allowed public sector managers and stakeholders to set out their requirements for a project at its outset and retain their focus on delivering services to the public, as the management of the procurement process is left to procurement specialists.

3.14 In the past Local Authorities have procured PFI school projects. The first PF2 programme, the Priority Schools Building Programme, will, however, be procured by a central unit in the Department for Education called the Education Funding Agency (EFA). Other departments with PF2 pipelines will be encouraged to establish a central procurement unit when they embark on a PF2 programme. The Government recognises that departmental centralisation of procurement, while representing a significant step forward, does not go as far as establishing the single PF2 procurement unit. The business case for such a unit will, however, remain open and will be revisited through the IUK and MPA assessments when future PF2 pipelines are confirmed.

Box 3.B: Centralised procurement - the Priority Schools Building Programme

The privately financed part of Priority Schools Building Programme is to be centrally-procured by the Education Funding Agency (EFA) on behalf of the Department for Education. EFA are engaging with the schools in the programme during the pre-procurement phase to develop the project's design brief. During the procurement process, the EFA project team will liaise regularly with schools and their representatives so they are fully aware of how the procurement is progressing but will manage engagement with bidders independently allowing schools to concentrate on the business of running their school.

The centralised approach to procurement will enable the following benefits:

- the deployment of a central team of experts to run the individual procurements and negotiate the commercial, financial and technical deal. Lessons from one deal to the next will also be able to be applied and further experience developed;
- bidders will be presented with one procuring authority with a single set of requirements enabling procurements to run more swiftly and with fewer project specific changes;
- schools can be batched in larger numbers and across local authority areas to ensure efficient procurement; and
- standard form documentation which needs very little tailoring can be fully employed, again improving the speed and efficiency of the procurement.

Firm commitments to procurement timescales

3.15 On future procurements public sector procurement teams will set transparent and robust procurement timescales and will stick to these. This approach will enable both the public and private sector to plan and prepare efficiently.

3.16 To ensure this best practice is adopted in all PF2 projects, the Government will require Departmental Ministers to state their commitment to an ambitious procurement timetable, that runs from issuing the project tender to financial close ,when PF2 business cases are submitted to the Treasury for approval (at the Outline Business Case stage).

3.17 This project specific commitment will also be paired with a commitment from the Government that no PF2 projects will be allowed to take longer than 18 months for the procurement phase from the issue of the tender notice to the appointment of a preferred bidder. This is the most expensive phase of the procurement. After the 18 month point funding will not be approved by Treasury unless an exemption to the commitment is granted by the Chief Secretary. The Government will retain discretion to make a contribution to failed bid costs of shortlisted bidders where it sees fit. This blanket commitment aims to prevent PF2 projects being delayed in the dialogue phase of procurement and sets a firm limit on this phase.

Chart 3.B: Key milestones in the PF2 procurement process

PIN	• The Prior Information Notice (PIN) gives the market general details of a procuring authority's future procurement intentions.
OJEU	• Issuing a tender in the Official Journal of the European Union (OJEU) begins the formal procurement process.
PQQ	• The Pre-Qualifying Questionnaire (PQQ) is used to identify a shortlist of bidding contractors to proceed with in the procurement.
ITPD	• The Invitation to Participate in Dialogue (ITPD) sets out formally the procuring authority's detailed requirements, the commercial conditions and evaluation criteria.
Submission & evaluation of bids	• The procuring authority assesses the responses from bidders against the criteria in the ITPD. There may be more than one down selection round depending on the PF2 project.
Selection of the preferred bidder	• The procuring authority selects its preferred bidder following the evaluation
Standstill Period	• Notification of the outcome of the procurement tender process and the intention to enter into a contract with a preferred contractor
Contract Award	• Signing of commercial and financial contracts.

Source: HM Treasury

Streamlining the PFI procurement process

3.18 The Government is committed to eliminating inefficiencies in the procurement process which unnecessarily increase public and private sector procurement costs and procurement timescales.

A comprehensive suite of standard documentation

3.19 To streamline the procurement process a comprehensive suite of new standard documentation will be launched. This will include:

- new draft PF2 guidance titled Standardisation of PF2 Contracts;
- a standard facilities management output specification for PF2 accommodation projects;
- a standard payment mechanism for PF2 accommodation projects; and
- new PF2 Lean Sourcing procurement guidance.

3.20 The Government believes that the enforcement of standard procurement and contracting guidance for existing PFIs has achieved real success in ensuring greater consistency of approach across sectors and in settling the risk allocation between the public and private sectors. See Box 3.C for further details of the new guidance that has been published alongside this policy document.

3.21 The standardised service output specification template and payment mechanism, as set out in Chapter 4, have also been developed. These will reduce the time spent on the individual development and negotiation of these documents.

Box 3.C: Standardisation of PF2 Contracts

Standardisation of PF2 Contracts, published today in draft form, provides mandatory contract guidance for the new PF2 model. Contract standardisation ensures consistency across sectors in setting the risk allocation between the public and private sectors. This reduces the length and cost of the procurement process for all involved. Standardisation of PF2 Contracts provides detailed drafting provisions to be incorporated into PF2 contracts either on a "required" basis (where the exact wording should be used), or on a "recommended" basis (where the drafting should be used as a basis for adaptation to different sectors). The updated guidance:

- provides new guidance and drafting on all aspects of the new model. This includes details of the new approaches to: preparing projects for market, hard facilities management services and lifecycle, soft facilities management services, utilities risk, allocation of insurance risk, provision of information and transparency and funding requirements;
- has been updated to deal with developments in the market and changes of law since 2007; and
- has been restructured so it is now more accessible and easier to navigate.

It is accompanied by a guide to the new provisions entitled "PF2 : A User Guide".

A standardised Lean Sourcing process for PF2

3.22 At the end of 2010, the Minister for the Cabinet Office announced a 'Lean Review' to uncover wasteful practices and unnecessary complexity in the procurement process and to suggest actions to rectify them. The Lean Review found that significant savings could be made in time and cost by working in a more efficient and effective way.

3.23 The Government's new Lean Sourcing process was then launched to provide a standardised and efficient approach to running procurements across central government. To enable PF2 projects to follow the Lean Sourcing process, the government will publish an amended version of the Lean Sourcing guidance for PF2 projects that reflects the complexity of these transactions and the additional procurement steps often required.

3.24 The Government's Lean Sourcing process advocates many of the changes the private sector called for during the call for evidence for PFI reform, such as improved pre-procurement preparation, greater market testing and a shorter dialogue period.

3.25 The Department for Transport are currently successfully using the Government's Lean Sourcing approach in procuring a new Search and Rescue Helicopter service for the UK (see Box 3.D for further details). While this is not a PFI project, the Search and Rescue Helicopter is an example of applying the Lean Sourcing principles to a complex privately financed project.

Box 3.D: Case Study – Search and Rescue Helicopters Lean Sourcing

The Department for Transport is currently procuring a new Search and Rescue Helicopter service for the UK (UKSARH) as a civilian service to replace the existing service which had largely been provided by the Ministry of Defence. The 16 month procurement using Lean Procurement principles and processes is for a contract of approximately 10 years and a cost ceiling of around £3bn. The project is on target to let the contract in March 2013.

- Extensive early market engagement was used pre-OJEU publication to help establish key factors including the structure of the deal; the length of the contract; the location of the bases and to assist in identifying the minimum technical requirements.
- The procurement strategy adopted was competitive dialogue (endorsed by the Cabinet Office) using a five phase process.
- The programme included a seven week boot camp of intensive dialogue using Cabinet Office Lean Procurement principles. It centred physically on a hub room, bidder's information room and dialogue rooms for three dialogue streams (commercial, technical and financial) running in parallel sessions.
- Extensive planning was the key to delivering the process to programme. This included ensuring that team members signed off their dialogue strategy with the Senior Responsible Owner.
- Real time IT connections greatly assisted communications both internally and externally.
- The project included in its specification sections on supporting SMEs and the Growth Agenda.

Ensuring design requirements are proportionate

3.26 The Government is aware that one of the major drivers of increasing private sector bid costs is the design process. Experience from the Building Schools for the Future programme particularly demonstrated that bidders were encouraged to carry out excessive design work in competition in order to win a bid. This contributed to unnecessarily high bid costs due to the volume of wasted design work.

3.27 Going forward procuring authorities will be required to give due consideration to their design requirements to ensure they are appropriate. Steps are already being taken on the Priority School's Building Programme to reduce the amount of design carried out in competition. In respect of a batch of schools put out to procurement, bidders will be asked to produce a design for a secondary and a primary school in competition and explain how these designs could be replicated across all the schools in the batch. Excessive design development by bidders will be actively discouraged as the EFA will not take into account additional specifications and designs which have not been formally requested. This approach will lead bidders to concentrate their efforts on producing functional designs which are replicable across the batch and which respond to a clear set of predetermined requirements.

Strengthening the scrutiny of project preparation

3.28 In the past public bodies and Government Departments have sometimes rushed into a formal bidding process before they had fully decided on their requirement from the project. In contrast, a number of central procurement agencies in other European countries and experienced private companies talk to their suppliers first to identify what outcomes can realistically be delivered within a given timeframe and cost. Where this level of pre-procurement engagement happens procurements are subsequently faster and more straightforward because bidders can develop their bid to reflect these discussions.

3.29 The Government's PF2 Lean Sourcing procurement process will require projects to undertake extensive pre-market engagement. Projects will also be required to produce full bidders' pack (specification, selection and award criteria, terms and conditions and timescales) at the point of going to market alongside the Official Journal of the European Union (OJEU) Contract Notice and a full due diligence pack for the bidders invited to participate in dialogue.

3.30 To ensure the Lean Sourcing approach is followed, additional Treasury checks will be introduced as part of the business case approval process to scrutinise project preparation prior to issuing project tenders. This will ensure that projects do not go to market before they are fully prepared. A summary of the project preparation checks are listed in Box 3.E.

3.31 The Treasury and MPA will continue to work together in the integrated assurance process to ensure that the additional Treasury checks do not duplicate a project's existing assurance processes. The additional checks aim to ensure that good procurement practice takes place and so should not present a significant burden on a well run project.

Box 3.E: Treasury Project Preparation Check

Departments will be required to demonstrate the following preparations have been undertaken prior to issuing project OJEUs:

- a planning and development brief has been produced that adheres to the preparation guidance set out by Department of Communities and Local Government;
- a full site information pack has been obtained;
- a site acquisition plan for any land has been obtained;
- evidence there are clear plans to address any employment issues;
- a market sounding report has been prepared that details the various methods the procuring authority has employed to test the market's interest in its project;
- a commitment to comply with standard contract guidance and the standard facilities management output specification and payment mechanism;
- ministerial and senior project officials commitment to the procurement timeline and the detailed milestones within this;
- final project team procurement skills check;
- an Integrated Assurance and Approval Plan; and
- confirmation that all stakeholders involved are signed up to a project's business plan.

4 Flexible service provision

In order to improve the flexibility of service provision, the range of services included in PF2 projects will be reduced. Services excluded from the contract can be provided separately through shorter-term contracts to provide the public sector with the flexibility to alter service specifications over time:

- soft services, such as cleaning and catering, will be removed from all future contracts, other than where exceptional integration benefits exist which are essential to achieving project outcomes;
- procuring authorities will have discretion over the inclusion of certain minor maintenance activities, such as redecorating, at the project outset. There will also be additional flexibility to add or remove certain elective services once a contract is in operation; and
- to provide flexibility at contract expiry, authorities will be able to adapt their requirements in relation to the condition of assets at the end of the contract.

To improve the transparency of the provision of services and the associated expenditure, measures will be taken to ensure the public sector understands exactly what it is paying for and that any aggregate lifecycle surpluses are shared with the procuring authority. These reforms include:

- an open book approach to lifecycle costs will be adopted between the procuring authority and the contractor; and
- a gain share mechanism for surplus lifecycle provision will be introduced to ensure that any surplus lifecycle funding is shared at the end of the contract.

To improve the efficiency of service delivery throughout the life of the contract and to avoid the unnecessary duplication of bespoke service-related documentation during procurement:

- a standardised services output specification template and payment mechanism will be developed; and
- periodic efficiency reviews of service provision will be introduced in the contract.

Services

4.1 Typically in PFI contracts the private sector has taken full responsibility for maintenance and for soft services, such as cleaning, catering and security, over the term of the contract. The private sector has priced for delivering these services in accordance with the specifications developed as part of the procurement process. These services are often subcontracted to specialist facilities management providers.

4.2 The contractor is also responsible for the replacement of elements of the asset, such as the boiler, and will put in place a lifecycle reserve funded through the annual unitary charge. The private sector bears the risk of the lifecycle fund being insufficient to meet the replacement and lifecycle obligations. If there is a shortfall the private sector has make up the difference; equally if there is a surplus, the private sector will retain this.

4.3 Combining asset design and construction with responsibility for maintenance and renewal was intended to improve the consideration of longer term requirements upfront, leading to better design outcomes and lower maintenance and operational costs. This principle of incentivising the contractor to optimise whole life asset design and maintenance efficiency has been one of the key successes of past PFI projects. PF2 will continue to adopt this integrated approach to maintenance, in which both the construction and maintenance of assets are incorporated in a single contact. This will ensure that the contractor continues to be incentivised to minimise future operational costs.

4.4 There have however been a number of concerns with the provision of services in past projects:

- service provision has been insufficiently flexible both operationally and in budgetary terms. When the public sector has to reduce its outgoings, it wants to make efficiency savings and reduce spending across all of its cost base. This has not been possible under PFI contracts as all of the services have been contractually committed on a long-term basis;
- the public sector has also not been convinced that it has been getting the best deal from the service elements of the contract, especially when it has come to making minor changes to its requirements;
- there have been many examples where the cost of individual items has been significantly higher than the public sector would have expected to pay. This has eroded the public sector's confidence in these services (see Box 4.A); and
- there have also been concerns in past projects regarding the transparency and the management of the lifecycle fund as the public sector has considered that it has not had visibility of incurred lifecycle costs. This has led to suspicions that the lifecycle fund has often been overpriced and the private sector has made windfall gains.

Box 4.A: The costs of small works in PFI projects

In a report published in January 2008[1], the NAO noted that small works in PFI projects were often expensive compared with industry benchmarks. The NAO identified that within their sample the base costs of additional electrical sockets were higher than benchmark prices. The NAO noted that although there will naturally be a range of prices according to a number of different factors, the average base cost for the installation of electrical sockets under PFI contracts was around 54 percent higher than the published comparator.

Improving flexibility of services provision

4.5 To improve the flexibility of service provision the range of services included in the PF2 model will be reduced. Soft services, such as cleaning and catering, will be excluded from the contract, other than in exceptional circumstances. These services will be provided separately via shorter term contracts or directly by the authority, which will provide the public sector with the flexibility to alter service specifications over time. Procuring authorities will also have discretion over the inclusion of certain minor maintenance activities at the project outset. There will be additional flexibility to add or remove certain 'elective services', such as external window cleaning, once a contract is in operation. These elective services will be at a pre-agreed price, and can be added or removed from the project without the need to re-run the financial model. In order to provide

[1] National Audit Office, *Making changes in operational PFI projects,* January 2008

greater flexibility at contract expiry, authorities will be able to adapt their requirements for the handback condition of the asset to ensure it meets their expected future needs.

Box 4.B: Example of operational flexibility under PF2 contracts

Under a PFI contract, using a school outside of school hours has to be agreed with the PFI contractor, because the contractor's security staff must open and close the school, and there may be additional charges for cleaning and related services. These costs are charged to the public sector.

Under PF2, services such as security and cleaning will be excluded from contracts. This will enable schools to open up their facilities for use outside of core school hours, without incurring these additional charges, enabling greater local use of the community facilities.

4.6 An overarching summary of the treatment of services in future projects is set out in Table 4.A below.

Table 4.A: Responsibility for service provision in PF2

ALL SERVICES Required by the Authority in order to operate the building effectively		
SERVICES INCLUDED IN PFI CONTRACT Charged on a fixed monthly basis	**SERVICES WHERE THERE IS FLEXIBILITY ON WHETHER THEY ARE INCLUDED IN THE PFI CONTRACT**	**THE SERVICES NOT INCLUDED IN THE PFI CONTRACT** Managed directly but the Authority using other service providers on short term contracts, or by using their own resources.
MAINTENANCE Maintenance Management Planned Maintenance Reactive Maintenance Statutory Maintenance	**MINOR MAINTENANCE OBLIGATIONS** Internal wall finishes, ceiling finishes, floor finishes, interior door and window repair, lighting consumables , graffiti removal and other minor maintenance	**SOFT SERVICES** Cleaning & Waste, Pest Control, Catering, Security, Laundry , Mail
ENERGY MANAGEMENT Tracking and reporting energy consumption, and identifying energy saving opportunities	**ELECTIVE SERVICES** Services which the Authority can choose to add to the PFI on an annual or one-off basis such as: Portable Appliance Testing Periodic Redecoration External Window Cleaning Snow and ice clearance Grounds Maintenance Handyman Service and Other minor maintenance obligations	**MANAGEMENT SERVICES** Contract Management, Utilities Costs, Insurance, Business Rates
HELPDESK Provision of a central system to respond to requests and plan and monitor performance		**OTHER SERVICES** ICT Services, Reception, Telephony, Health & Safety, etc.
LIFECYCLE RENEWAL Planned replacement of assets to maintain the efficiency and appearance of the building		

Source: HM Treasury

Removal of soft facilities management services

4.7 Soft facilities management services ('soft services') generally relate to the day-to-day supporting services required in the operation of an asset (see Box 4.C). In the past soft services were included in the majority of PFI contracts. To improve the flexibility of service provision, soft services will, however, now be excluded from contracts going forward and instead will be provided via short term contracts with the private sector or by the public sector directly.

4.8 The only exception to this rule will be where there are significant integration and interface benefits from procuring all services as a single contract. If procuring authorities consider that the inclusion of soft services is integral to the delivery of a project, a clear value for money case will need to be demonstrated and approved by the Treasury.

Box 4.C: Examples of soft facilities management services

Soft facilities management services generally relate to the day-to-day supporting services required in the operation of an asset. Examples include:

- Cleaning
- Catering
- Portering
- Laundry
- Security
- Mail and postal services
- Waste

Flexibility at the project's outset

4.9 To increase further the flexibility of the maintenance activities at the project's outset the procuring authority will have the opportunity to consider whether it is appropriate to include or exclude specific maintenance activities. There will be a number of considerations for the authority when making this decision, these may include whether:

- the cost of the authority providing these maintenance services is lower than the expected cost charged by the contractor;
- there are potential flexibility benefits of excluding these maintenance activities from projects;
- the procuring authority has existing resources capable of carrying out the maintenance activities (such as caretakers or janitors); and
- the exclusion of certain maintenance activities has the potential to create interface risks, where the authority would need to consider whether the benefits of excluding these maintenance activities outweigh the interface risks.

4.10 A list of example activities which the authority can elect to include or exclude is included in Box 4.D below.

Box 4.D: Example list of maintenance activities which the authority can elect to include or exclude

- Redecoration of the interior of the facilities – wall and ceiling finishes
- Replacement of floor coverings (e.g. carpets and vinyl)
- Routine emergency lighting testing
- Lighting consumables replacement
- Initial response in the event of faults or failures to water, heating, ventilation and electrical systems
- Routine water temperature testing and flushing of water appliances
- Minor washroom repairs
- Inspection and minor repairs to internal doors and windows, and door and window furniture
- Graffiti removal

Flexibility during the contract

4.11 To improve flexibility during the contract term, the procuring authority will be able decide on an annual basis whether certain 'elective services' will be delivered by the contractor or whether to deliver the services separately. Contractors bidding for the project will be asked to develop a catalogue of pre-priced elective services which can be added or removed (outside of the financial model).

4.12 The range of elective services will be proposed and agreed prior to financial close of the project. If the authority elects for the contractor to deliver these services, the contractor will take the risk that the services can be delivered at the price in the catalogue (subject to annual indexation).

Box 4.E: Examples of elective services

- Portable Appliance Testing
- Periodic redecoration
- External window cleaning
- Snow clearance and gritting
- Grounds maintenance

4.13 Elective services should be services which can reasonably be provided within the normal skill set of the contractor and could provide value for money for the authority if they are delivered by the contractor. This can include authority maintenance activities previously excluded from the project, being brought back periodically into scope for the contractor to perform.

4.14 For further detail on the range of services to be provided by the private sector contractor and those which may be retained by the procuring authority, see Chapter 7 (Services and Service Commencement) of the Standardisation of PF2 Contracts.

Flexibility at the end of contract

4.15 One of the key features of PFI was the principle of whole life costing, to ensure that assets were appropriately maintained over the project's life. This meant that at the project's outset it was necessary for the public sector to prescribe the end-of-project-life asset hand back conditions.

4.16 While this approach ensured the asset was maintained over the long term, it did not allow flexibility for the authority's priorities or requirements for the asset to change over the period of the contract. In future PF2 projects the public sector will continue to prescribe the asset hand back conditions at the project outset, but authorities will be given flexibility to change these hand back requirements if this better meets the authority's needs or provides an opportunity for savings for the public sector. Further information about the approach to handback is set out at 9.6 (Relaxation of Handback Requirements) of the Standardisation of PF2 Contracts.

Improving transparency and a mechanism to share savings

4.17 To increase the visibility of lifecycle costs in PF2 projects, an open book approach to lifecycle costs will be adopted between the procuring authority and the contractor. This will ensure that the provision of services and associated expenditure is transparent and the public sector understands exactly what it is paying for.

4.18 To accompany this client-contractor transparency and to ensure that any unforeseen surplus lifecycle funding is fairly addressed, the public and private sector parties will review the actual and planned lifecycle expenditure every five years. Any genuine surplus that is identified will be recorded and any aggregate lifecycle surpluses at the contract expiry will be shared equally between the procuring authority and the contractor. The authority will have the option of requiring an independent lifecycle review.

4.19 The lifecycle surplus will be calculated through a comparison of anticipated lifecycle spend with actual lifecycle spend. By leaving the surplus in the project company lifecycle fund, the surplus will still be available for 'topping up' purposes if the actual lifecycle expenditure is higher than anticipated, but the open book approach will ensure that any reduction in the surplus is justified.

4.20 For more detail on the lifecycle provisions refer to sections 9.2 (Lifecycle fund) and 9.3 (Expiry of the contract) in the Standardisation of PF2 Contracts.

Improving efficiency of service delivery

4.21 The Government is also taking steps to improve the efficiency of service delivery. To increase the speed of procurement and avoid the unnecessary duplication of bespoke documentation, a standardised service output template and payment mechanism is being developed. In order to incentivise efficiency of service delivery throughout the life of the contract periodic efficiency reviews will be introduced into the new model.

Standardisation of services output specification and payment mechanism

4.22 A standardised services output specification template and a pro-forma payment mechanism, suitable for most accommodation projects, have been developed by the Treasury. These are intended to achieve consistency of approach across accommodation projects, ensure that requirements reflect the reasonable requirements of the public sector but are not "gold plated" and to avoid the expensive duplication of bespoke documentation on a project-by-project basis.

4.23 The standardised services output specification and the payment mechanism are intended for accommodation-based project only, although they may not be suitable for every sector, such as housing. The principle of greater standardisation of service requirements will apply to all sectors, and to the extent that non-accommodation programmes and projects emerge, the Treasury will consider whether new sector-specific standards should be developed.

4.24 The standardised output services specification is in two parts. Part 1 covers the main requirements and should remain in a standard form; part 2 allows for the inclusion of project specific requirements. The standardised services output specification and pro-forma payment mechanism will be schedules 3 and 5 respectively of the Standardisation of PF2 Contracts, and will be published for consultation early next year.

Efficiency reviews of service provision

4.25 Reviewing service requirements is one of the key areas in which the Operational PFI Savings Programme is identifying savings in existing PFI contracts. This programme has emphasized the important of reviewing the scope and specification of services against the public sector's requirements, taking account of projected future requirements, past usage and performance. The operational reviews undertaken to date have analysed services specifications and considered opportunities for more efficient service provision. This has identified a number of opportunities for achieving operational efficiencies, examples of which are set out in Box 4.F.

Box 4.F: Lessons from operational efficiency reviews

Examples of potential savings from reviewing service specifications against requirements identified from early reviews:

- Reducing hospital domestic services which had been specified at a higher level than those being applied more generally in the market;
- Changing collections of household waste to bring the PFI contract into line with some of the local authority's other collection systems. This change has been facilitated by increasing the frequency of kerbside recycling from four weekly to two weekly;
- A local authority review with its PFI service provider identified that investing to save in a central management system and LED lamps for its street lighting would deliver a significant reduction in energy usage, taking advantage of improvements in technology since the contract was signed; and
- A review of the inspection regime in transport infrastructure PFI contract identified that it would be possible to reduce the frequency of asset surveys without having a significant effect on the accuracy of the data.

4.26 Periodic efficiency reviews are, therefore, being introduced into new contracts, to assess whether the project is meeting the public sector's requirements and to recommend any appropriate service and efficiency improvements. The efficiency reviews will be undertaken every two to three years, and should align with the five yearly review of actual and planned lifecycle expenditure where appropriate to minimise costs.

4.27 The contractor will be responsible for ensuring that these efficiency reviews are undertaken, and as such will pay the private sector costs incurred. Any savings made will be shared between the authority and the contractor, with 75 per cent of savings going to the authority and 25 per cent to the contractor. It is important to note that these efficiency reviews should not preclude the contractor or the authority proposing efficiency measures at other times during the lifetime of the contract and should not substitute for other standard performance reporting mechanisms.

5 Greater transparency

Transparency will be at the centre of PF2 arrangements. The Government will introduce a significant number of measures that will transform the approach taken to transparency in future projects. These include:

- increasing the amount of project information made available to taxpayers to give confidence that value for money is being achieved; and, at the same time, being more open with industry about the Government's project approval processes so that companies can plan ahead with greater certainty. Specifically:
  - publishing an annual report detailing full project and financial information on all projects where Government is a shareholder;
  - requiring the private sector to provide actual and forecast equity return information for publication;
  - increasing transparency and control over the liabilities created by future PF2 projects by introducing a control total for commitments arising from off balance sheet PF2 contracts signed. Progress will be reported at the Budget 2013;
  - introducing a business case approval tracker on the Treasury website providing a status update on the progress of projects through the public sector approval processes; and
  - publishing readily accessible and easily understood information on current PFI and future PF2 projects, and on the infrastructure and construction pipeline.
- improving the transparency of projects to procuring authorities, ensuring they have better information to enable them to manage their contracts effectively, while minimising any increase in information requirements on the private sector. Measures include:
  - strengthening the information provisions and the procedures for ensuring timely delivery of information;
  - introducing an open book approach to the lifecycle fund; and
  - providing the procuring authority, or other local representative, with observer status at project company board meetings.

5.1 Transparency is at the centre of PF2 arrangements. The Government is introducing a number of measures that will transform the approach taken to transparency in future projects. These changes will address the numerous concerns of a wide range of stakeholders, including: Parliament, which has called for greater transparency and accountability of PFI arrangements; procuring authorities, which require timely and accurate information from private sector partners in order to enable effective management of contracts; and industry, which requires better information from the Government to facilitate effective business planning and service delivery. The reforms outlined in this chapter are, therefore, designed to address these concerns while aiming to align information provisions with existing best practice and minimising any increase in requirements on industry.

Improving the external transparency of PF2

5.2 Improving the external transparency of PF2 arrangements is essential to ensure that the taxpayer is confident it is getting value for money from these arrangements; and the private sector has the relevant information it needs to enable efficient business planning and service delivery.

Achieving project transparency through public sector co-investment

5.3 As set out in Chapter 2, investing public sector equity in future PF2 projects will facilitate the achievement of greater transparency and accountability of project delivery and operation. Through project company board membership at Director level, the public sector will receive financial information related to project performance, in order to make the decisions necessary in this role. Access to this information will help address concerns around a lack of transparency of the financial performance of projects. The Treasury will publish an annual report on the public sector's investments, including the actual and forecast equity returns of individual projects and of the portfolio.

5.4 In addition, the procuring authority, or other local representative, will have observer status at board meetings of the project company, which is also aimed to improve transparency and facilitate the sharing of information and perspectives between the public and private sectors.

Publishing private sector equity rates of return

5.5 As set out in Chapter 2, the price of public sector equity will be matched to a private sector equity rate of return in the project. Matching equity rates of return in this way provides transparency over the forecast and actual equity rates of return being achieved by private sector investors. However, there may be instances of different equity returns between private sector equity investors, for example in the event of one of the investors selling their shareholding in the project company. Therefore, in the interests of complete transparency in this area, private sector investors will be required to provide actual and forecast equity return information to the Treasury, which the Treasury will publish periodically. To ensure this information can be easily understood and compared across projects, the new standard contractual guidance[1] sets out the precise way in which this information should be calculated and provided.

Increasing transparency of Government's business case approvals process

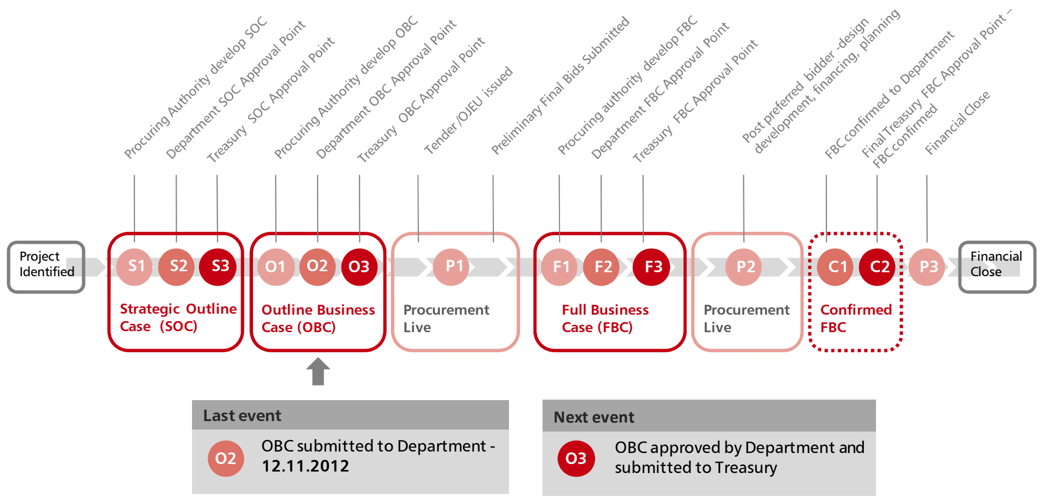
5.6 It is important that all spending commitments are properly scrutinised to ensure that value for money is being achieved. Projects may need to go through several approval stages, and expenditure above departmental delegated limits will require Treasury approval. There was strong feedback from the private sector during the call for evidence process that Government's approval processes appear to be drawn out, and in particular that there is no visibility to the private sector about where a business case sits at any point in time. This is particularly relevant in the pre-procurement phase, when industry is keen to understand the progress of potential projects coming to market, and during the competitive process when extended approval processes can impact directly on the private sector's costs of bidding.

5.7 As part of a wider commitment to ensuring industry has the information it needs for business planning purposes in relation to public sector projects the Government intends to

[1] Standardisation of PF2 contracts

increase the visibility of its approval process. A business case approval tracker for PF2 projects, and for PFI projects in procurement, will be published on the Treasury website in spring 2013. It will provide a status updated of a project's progress through the approval process. Chart 5.A illustrates what this will look like.

Chart 5.A: Illustrative project approvals tracker



Source: HM Treasury

Improving transparency of off-balance sheet liabilities

5.8 The fiscal aggregates, on which the Government measures its fiscal mandate, are measured using components derived from the UK National Accounts using the European System of Accounts 1995 (ESA95) framework. A criticism of PFI has been because of the treatment of PFI under the National Accounts framework many PFI contract liabilities are not shown in Public Sector Net Debt (PSND) as they are designated to be off the Government's balance sheet. In 2011 the Government published for the first time the Whole of Government Accounts (WGA), which included an assessment of PFI liabilities consistent with accounting standards.

5.9 In order to increase transparency and control over the liabilities created by future PF2 projects, the Government will introduce a control total for the commitments arising from off balance sheet PF2 contracts signed. The Government will report against this control total in the future. We will report on progress in Budget 2013. This will form part of a wider set of reforms to the framework for managing off-balance sheet liabilities which will see the UK at the forefront of international best practice.

Increasing the accessibility and usability of project information

5.10 The Treasury already publishes a significant amount of PFI information in the form of the WGA (see Chapter 1) and separately collects information on individual projects[2] through an annual data collection. The information on individual projects includes name, procurement status, unitary charge payments, sponsoring department, project company name and its equity holders. The Government will do more to increase the understanding of the information for all users, for example by providing an explanation of the differences between WGA and PFI data collection numbers and publishing a simple guide to understanding some of the more technical

[2] PFI data is available at: http://www.hm-treasury.gov.uk/ppp_pfi_stats.htm

details of public private partnerships including the financing arrangements. These will be included as part of the next annual update in spring 2013.

5.11 The private sector highlighted during the call for evidence engagement process that information on the pipeline of projects is important for business planning purposes. Alongside the National Infrastructure Plan 2011 Government published for the first time detailed data on the infrastructure investment and government construction pipelines[3]. These pipelines have been collated within the Government to provide industry with greater visibility over the future pipeline of Government funded construction projects, wider regulated and private sector infrastructure. The Government is continually working to improve the granularity, quality and coverage of the data in these pipelines. They are updated regularly in order to ensure that they provide up to date and accurate information of the Government's plans.

5.12 In addition to information on pipeline, the Government has introduced a requirement for departments to publish all new central government tenders and contracts over £10,000 on GOV.UK, using Contracts Finder[4]. For construction projects this will continue to be achieved through a link to the published Government Construction Pipeline[5]. All new central government project tender and contract documents for PF2 should, therefore, be published on Contracts Finder or through the linked Government Construction pipeline.

Improving transparency of PF2 for procuring authorities

5.13 Good information is required by procuring authorities to enable the monitoring and management of their contracts. The information that a procuring authority is entitled to receive will be set out in their contract. Typically, PFI contracts provide that the project company should provide financial and management information, but this often relies on the procuring authority requesting the information in the first instance. There is limited regular periodic reporting, other than that required under the performance and payment mechanism.

5.14 Many procuring authorities do not make full use of their existing rights to request information, often because it is not clear what information exists or what they should ask for. Feedback, as part of the call for evidence, highlighted that some of the relevant provisions set out in the current standard contractual guidance were seen as unnecessarily complex or ambiguous. There is a risk, therefore, that procuring authorities do not have sufficient clarity of or confidence in the ongoing value for money of their contractual arrangements.

5.15 To address these issues, the new standard contractual guidance[6], will improve the clarity of the information requirements and provisions required for each contract, whilst minimising any increase in information requirements on the private sector. Timely receipt of clear and relevant information will help aid procuring authorities in effective contract management, planning and optimisation of the use of their assets and services in order to deliver better and ongoing value for money. Box 5.A sets out some of the key information enhancements in the new standard contractual guidance.

5.16 As set out in Chapter 4, to further improve transparency an open book approach to the lifecycle fund will be adopted between the procuring authority and the contractor to increase the visibility of lifecycle costs in PF2. This will ensure that the provision of services and associated expenditure is transparent and the public sector understands exactly what it is paying for.

[3] The infrastructure and construction pipelines can be found at: http://www.hm-treasury.gov.uk/infrastructure_pipeline_data.htm

[4] https://www.gov.uk/contracts-finder

[5] http://www.hm-treasury.gov.uk/infrastructure_pipeline_data.htm

[6] Standardisation of PF2 contracts, Chapter 3

Box 5.A: Enhanced information requirements

The following reforms have been introduced in PF2 to enhance the information requirements:

- to make the contract easier to understand the information requirements will be brought together into one place to enable the contract manager to understand what information they are entitled to and when and in what form it can be expected;
- the private sector will provide a practical guide to using the contract, summarising key points of the contract, immediately following contract signature to aid the public sector's contract management;
- phrases which have caused some ambiguity and potential dispute between contracting parties have been removed. For example, the authority being required to act "reasonably" in its requests, the contractor needing to provide information in an unspecified "summary" rather than provide the original data, with the result that the authority may not get all the necessary information it needs;
- the clarity of what constitutes commercially confidential information has been improved through signposting of the Ministry of Justice's Freedom of Information Act (FOIA) guidance on the issue; and
- clarification will be provided that provision of information is part of the contractual service and that accordingly failure to provide it will constitute poor performance, resulting in financial deductions being made to the payment received by the contractor with the possibility of contract termination in the case of persistent breaches.

6 Appropriate risk allocation

Risk allocation

Under PF2, changes will be made to the risk allocation to improve value for money through the greater retention and management of certain risks by the public sector. In PF2:

- the risk of additional capital expenditure arising from an unforeseeable general change in law will be taken by the public sector;
- utilities consumption risk will be taken by the public sector subject to a two year handover test;
- the risk of the site being contaminated by offsite sources will be taken by the public sector where it has provided the site;
- procuring authorities will be required to undertake adequate investigations into legal title for sites made available to bidders and provide a warranty to the contractor; and
- where the authority provides the site for the project, the authority will also be required to procure ground condition surveys and make them available to all bidders with the benefit of a warranty.

Insurance

To improve the value for money of insurance:

- the Government will amend the current provisions dealing with sharing the premium risk of core required insurances in the operational phase of projects, so as to allow the authority to take a bigger share and reduce the contractor's need to build up reserves against market movements; and
- the Government will explore moving to a model whereby the procuring authority will retain the risk of material damage and business interruption of facilities in their operational phase (rather than insuring in the market) for PF2 projects/programmes which have a dispersed asset base and predictable claims history.

Risk allocation

6.1 Effective risk management is important in all forms of procurement but is particularly so for PPP contracts. These contracts seek to optimise value for money by agreeing an allocation of risks between the public and private sectors over the course of a long term contract. However in the past, under PFI, some risks were transferred to the private sector that did not offer value for money.

Improving the value for money of risk allocation in PF2 contracts

6.2 Under PF2 changes will be made to the risk allocation to improve value for money through the retention and management of certain risks by the public sector that were previously transferred under PFI. Risks will be allocated so as to optimise value for money rather than to maximise risk transfer. Specifically changes will be made to the risk allocation for change of law risk, the consumption of utilities, land contamination and warranties for due diligence reports.

Change of law risk

6.3 Additional capital expenditure arising from an unforeseeable general change in law occurs on a very occasional basis. Contractors have, however, been required in the past by funders to ensure that funds were in place to absorb the cost if the risk were to occur. As a result the public sector has been paying a high premium to transfer a risk that in practice has rarely materialised. Under PF2, the public sector will retain that risk and secure better value for money.

Utilities risk

6.4 In the past, PFI guidance encouraged transfer of utility volume risk to the contractor but in practice many contracts included complex bespoke risk sharing provisions. Such provisions took time to negotiate and were resource intensive to manage. It was not clear, therefore, that these arrangements offered value for money to the public sector. With the removal of soft services from PF2 as set out in Chapter 4, the argument for revisiting this approach is clear as there is even less scope for the contractor to manage the usage of utilities when its responsibilities are limited to hard FM maintenance.

6.5 In future, under PF2, variations in the consumption of utilities costs will be allocated to the public sector subject to the contractor retaining responsibility for the efficiency of the design of the building (against the energy efficiency standards developed through the procurement process). This will be done through a rigorous handover procedure incorporating a two year testing regime. If this process shows that usage of utilities is higher than the agreed efficiency standards, the contractor will be required to rectify the building or make a compensatory payment to cover the authority's loss. Tariff risk also will remain a public sector risk.

6.6 The authority should normally take consumption risk after the extended two year acceptance regime, to avoid imposing this risk on the contractor. Exceptions to this general rule may be possible only in particular sectors where:

- appropriate metering systems (which do not involve disproportionate cost) are included in the design as standard;
- the physical built environment and usage pattern is simple; and
- risk sharing arrangements are developed which are acceptable to the market and do not involve the contractor making significant ongoing reserves against the risk.

6.7 For more details see the Standardisation of PF2 Contracts Section 19.9.

Risk of site contamination by external source

6.8 In many of the responses to the call for evidence, contractors and funders expressed concerns about the allocation of the risk of sites being contaminated by a source not on the site. Contractors and funders suggested that where the site has been provided by the authority the contractor is not in a position to do anything to manage the risk and hence transferring responsibility is not efficient risk allocation. In the future, under PF2, this risk will no longer be transferred to the private sector but will be held by the public sector.

Warranty for due diligence and land titles

6.9 Under PFI, the procurement process was frequently delayed by problems relating to the legal title to the site even when the site had been in authority ownership prior to the procurement. To reduce the due diligence burden on bidders and the time and cost of procurement, in the future where the authority provides the site for the project, the authority will also be required to procure ground condition surveys and make them available to all bidders with the benefit of a warranty. Similarly, in future, procuring authorities will be required to undertake adequate investigations into legal title for sites made available to bidders and provide a warranty to the contractor. (See Chapter 13 of the Standardisation of PF2 Contracts (Warranties)).

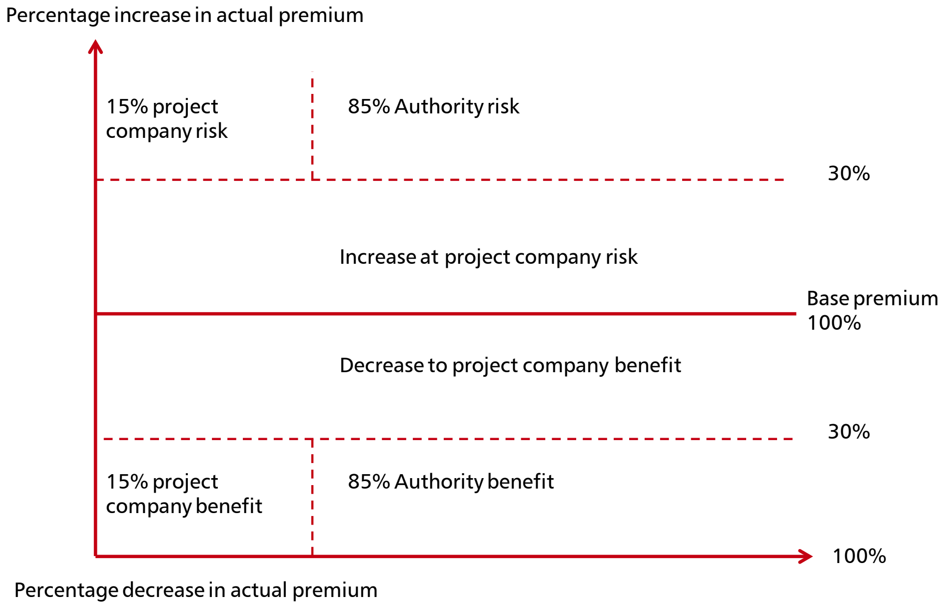
Insurance

6.10 Insurance is taken out to guard against the occurrence of particular risks and is especially useful to deal with low incidence, high impact risks (such as the loss of a building or the death of a person). Accordingly, it has been standard practice for contractors to insure PFI facilities and to pass the cost of this back to the public sector authority[1]. The underpinning assumptions for this are that:

- risk is best taken by the party best able to manage it. Under PF2, it is the contractor who is responsible for designing, financing, building, repairing, and rebuilding the facility (if it is damaged or destroyed). The authority will only pay for the service if it is provided. The risk, therefore, of guarding against events which interrupt the service sits naturally with the contractor; and
- lenders require insurances (of a detailed nature) to be taken out for facilities which they have financed; key insurances for lenders are material damage and business interruption.

6.11 Since 2006, standardised drafting for insurances and in particular, premium risk-sharing for operational period insurances have been applied to PFI contracts. Under these arrangements construction phase insurances are priced and fixed at financial close and operational insurances are estimated (with the authority taking 85 per cent of the risk of price change resulting from general market movement beyond a 30 per cent nil change band up or down) and priced in the financial model. This is illustrated below:

Chart 6.A: Insurance



Source: HM Treasury

[1] The contractor's estimated insurance costs being included as one of the costs in the financial model which determines the monthly unitary charge.

Improving the value for money of insurance arrangements

6.12 The Government believes, however, that improvements can be made to the previous model, in particular for insurances in the operational phase of projects, which may offer improved value for money. The public sector will be allowed to take a greater share in the risk of market changes in insurance costs, thus reducing the need for contractors to build up reserves against them. It will also be acceptable to make changes to the balance of certain risks in projects in their operating phase to allow the procuring authority to cover these, instead of the contractor insuring them in the market.

Greater share in the risk of market changes to reduce reserve costs

6.13 Authorities will now be given a discretion to vary the standard risk-sharing premium arrangements by choosing their own "nil change" band of between 5 per cent and 30 per cent up and down from the assumed base premium baseline (instead of the current compulsory 30 per cent); this should reduce levels of contingency which contractors currently retain against premium increases.

Authority self insurance of certain risks

6.14 For projects with particular risk characteristics, a new approach will be explored under PF2 whereby authorities may offer to cover certain risks themselves, instead of requiring the contractor to insure these in the market. This would apply to Material Damage and Business Interruption insurances in the operational phase of PF2 projects (but not to third party or other insurances). This does of course affect the balance of risk in the contract and will only be appropriate for projects with the following risk characteristics:

- dispersed asset base; and
- reduced risk of single catastrophic claim; or
- specialist assets or assets used in hazardous situations such as some Ministry of Defence assets (where the market may not be deep or efficient).

6.15 It is recognised that local authorities, without the funding resources of Government Departments, would only wish to pursue an indemnity approach where the risk of catastrophic loss was remote. Road projects and housing projects may fall into this category. The scale of losses on roads projects in particular tends to be small, predictable and recovery rates (from third parties causing damage) high. Government Departments with national programmes may, however, wish to consider such an approach.

6.16 Adjusting the insurance arrangements on PF2 contracts to move to an indemnity basis, is, however, complicated from a risk management, regulatory, contractual and value for money perspective and should initially, therefore, be taken forward on a pathfinder basis. For more detail on insurance see Chapter 17 of Standardisation of PF2 Contracts.

7 Efficiency and value for money

PF2 will offer improved value for money for the public sector and the taxpayer. The reform measures taken to achieve this include the introduction of:

- public equity co-investment in future projects to ensure better alignment of objectives, greater transparency and improved value for money;
- an improved procurement process to accelerate delivery, ensuring procurement is faster and cheaper than in the past, and improved public sector procurement capability;
- flexible service provision through the separation of soft facilities management services and the public sector having discretion on the inclusion of some minor maintenance activities;
- an open book approach to lifecycle costs together with a gain share mechanism for any surplus lifecycle funds;
- increased flexibility on the level of capital grant that authorities can make to projects, without disrupting the transfer of risk to the private sector; and
- measures to encourage the assessment and use of a greater range of debt financing sources to secure affordable, value for money long-term debt finance.

The Government announced its commitment, in July 2011, to deliver at least £1.5 billion in savings from operational PFI projects in England:

- contracting authorities have reported over £1.5 billion of committed efficiencies and savings with a further £1 billion in discussion; and
- valuable lessons have been taken from the review of existing projects and incorporated into new PF2 policy, including transparency to enable projects to manage contracts efficiently.

There are a variety of contracting options which, compared to PF2, adopt different approaches to the allocation of design, construction, financing, asset maintenance and operational responsibilities between the public and private sector. Assessing the value for money of contracting approaches requires a comparison of alternatives. The Government will update the existing Value for Money Assessment Guidance to reflect a wider range of contracting options. The updated guidance will be published for consultation in spring 2013.

7.1 PF2 will offer improved value for money for the public sector and the taxpayer. The reform measures taken to achieve this, and set out in this policy document, include:

- public equity co-investment in future projects to ensure better alignment of objectives, greater collaboration, improved transparency and overall better value for money;

- accelerated delivery through streamlining the procurement process, ensuring procurement is faster and cheaper than in the past and improving public sector procurement capability;
- ensuring flexible service provision through the separation of soft facilities management services from the PF2 contract and enabling authorities to undertake certain minor maintenance activities;
- an open book approach to lifecycle costs together with a gain share mechanism for any surplus lifecycle funds;
- significantly increasing the level of capital grant that authorities can make to projects, without disrupting the transfer of risk to the private sector, improving both value for money and affordability; and
- encouraging the assessment and use of a greater range of debt financing sources including public and private bonds, with the aim of securing affordable, value for money long-term debt finance matching long-term project commitments.

7.2 Given the scale of the existing portfolio of projects, it is important that lessons are learned from past projects and incorporated into policy for future projects, in addition to taking steps to address some of the wider concerns related to PFI.

Efficiencies and Savings from Operational PFI Projects

The Operational PFI Savings Programme

7.3 As stated in section 1 the Government announced its commitment, in July 2011, to deliver at least £1.5 billion in savings from operational PFI projects in England.

7.4 This programme supports the efficiency, transparency and growth agendas, its overarching objectives are to:

- improve efficiency and value for money by delivering maximum benefit from reviewing the portfolio of privately financed contracts in England, with a minimum initial commitment of £1.5 billion in savings as set out by the Commercial Secretary to the Treasury;
- improve performance by identifying examples of good practice and learning to feed into the market to improve delivery and support their integration into PF2 to support the efficient delivery of future social infrastructure and contribute to supporting economic growth; and
- improve relationships by developing and embedding a voluntary code of conduct to set ground rules for engagement between contracting parties as part of a plan to improve transparency, understanding and behaviours on both sides and to support effective relationships in long term contracts.

7.5 There are over 700 operational projects within the scope of the programme with a remaining nominal revenue commitment of more than £200 billion. These contracts are spread across the whole of the public sector with over 75 per cent owned by local bodies including local authorities and NHS Trusts.

7.6 A central team within the Treasury has been established to co-ordinate the activities of departments and teams working on individual projects to set direction, provide guidance and enable communication across the sectors. The team is working to ensure that all projects benefit from being able to leverage the full support of government and the shared knowledge gained from across a wide spectrum of deals.

7.7 It is the ambition of the Government that all contracting authorities should carry out a comprehensive review of their projects to identify potential opportunities for efficiencies and savings across the following headline areas:

- contract terms;
- contract management;
- financing;
- operational service element (scope); and
- non-operational service elements (e.g. insurance).

Progress to date

7.8 As of today contracting authorities have reported over £1.5 billion of committed efficiencies and savings with a further £1 billion in discussion. These savings have been signed by both parties since July 2011 and build on savings already delivered under this administration prior to this date. In parallel, significant levels of cost have been avoided by increased central department involvement in, and support to, local projects in procurement prior to signature.

7.9 These savings come from work carried out by public sector bodies in more than a hundred contracts. Comprehensive reviews have been carried out in more than 15 projects and are underway or in planning in around 60 more. Of these around two thirds are from central government and around one third are in local bodies. Work completed and underway on these reviews represents around 10 per cent of the number of projects and about 30 per cent of the remaining unitary charge value.

7.10 These savings are being achieved without cutting the provision of critical services .The savings are retained by the contracting authority to support the continued delivery of high quality frontline services.

7.11 Savings included in the programme totals are nominal to reflect the indexation of the contract prices over time and must meet the following criteria:

- consider any risk retained and be presented net of actual costs;
- show current or near term gain (cash, reduced price or relevant quantifiable benefit) to justify the expense of delivery; and
- demonstrate long term value for money.

Box 7.A: Examples of efficiencies and savings identified

The following categories of efficiencies and savings have been identified:

- Renegotiating the scope of contracts, through:
  - removing services no longer required;
  - reducing over-specified performance levels;
  - changing the profile of planned maintenance; and
  - cancelling contracts for which there is no longer a requirement.
- improving risk allocation by:
  - taking back energy consumption risk;
  - reducing requirements for hand-back condition to reasonable levels; and
  - sharing in insurance premium reductions.
- improving efficiency by:
  - increasing occupancy levels of buildings;
  - improving energy efficiency through improved technology;
  - using government purchasing power to lower utility and consumables costs; and
  - merging contracts with the same provider into one to reduce management costs and introduce economies of scale.
- cutting waste by:
  - preventing out of hours overtime work;
  - improved processes reducing unnecessary administrative costs;
  - mothballing unused facilities;
  - finding alternative uses for underutilised assets; and
  - reducing inflation mechanisms which do not reflect actual cost increases.
- avoiding additional costs through:
  - better contract management to remove unnecessary in-service changes; and
  - simplifying procedures and charges for variations.

7.12 At this stage the majority of savings have been identified in larger central government contracts. Following evidence from early reviews, it is expected that more local projects will undertake reviews. While it is expected the potential for savings is unlikely to be on the scale of those in larger contracts, savings will be significant enough to be both worthwhile and necessary in the current economic climate.

7.13 What has been demonstrated to date is that committed engagement by all contracting parties is needed to deliver improved outcomes. The availability of staff with the necessary commercial and specialist capabilities is critical to enable the effective delivery of efficiencies. In addition, the relationships and behaviours that have characterised some contracts which are not delivering demonstrable value for money need to be addressed. These issues can apply to the public as well as the private sector. Changes are needed to improve the cost effectiveness of the services for both sides as well as for the benefit of the taxpayer.

7.14 A key element of the work to improve the relationships is the development of a Voluntary Code of Conduct. This is intended to embed ground rules for both sides which represent a commitment to engage constructively and collaboratively to support greater transparency and understanding between the parties.

7.15 Initial engagement with a cross section of the private sector has shown an understanding of the need for such an instrument and a general willingness to sign up to many of the principles. It has highlighted a concern about the degree to which proposed commitments on the sharing of data could put an unnecessary burden on the private sector and increase costs unnecessarily.

7.16 The Government remains committed to the intent of a code which will support improved behaviours in a number of areas including greater transparency between the parties and is working to develop a version for further discussion which removes risk whilst delivering the overall intent of such a document.

7.17 It is the Government's intention to launch a code before the end of the financial year with a regularly updated list of signatories on HM Treasury's website.

Selecting the right delivery option

Past experience of PFI

7.18 A key objective of the review of PFI has been to ensure better value for money in future projects. PFI has been applied across a wide range of projects from accommodation based projects, such as schools and hospitals, to more complex projects such as waste management and military equipment. This rich experience has continued to develop governments' knowledge as to where private finance delivery solutions work best.

7.19 Many of the suitability criteria identified for PFI will continue to apply and should be considered as part of the project appraisal process. For example, long-term planning horizons and confidence that the infrastructure and services will be required throughout the life of the contract will continue to be essential considerations. The decision to invest in a capital asset, however financed, is a significant commitment. However, the costs of unwinding a long-term privately-financed contract are greater than a conventionally funded alternative and so particularly careful consideration needs to be given to the initial investment decision. Recent experience has shown that caution should also be exercised in other areas, for example we have seen that projects can become so large and complex that the private sector may struggle to bear the risks inherent in the project.

Box 7.B: Project characteristics for which PF2 may be suitable

Project characteristics for which PF2 may be suitable include where:

- there is a major capital investment need, requiring effective management of risks associated with construction and delivery;
- a stable policy environment and long term planning horizons exist, so there is a high degree of confidence the infrastructure and services will be required throughout the life of the contract;
- the nature of the requirement allows the public sector to define its needs as service outputs that can be adequately contracted for in a way that ensures effective and accountable delivery of public services over the long term, thus ensuring risk allocation between the public and private sectors can be clearly defined and enforced;
- the nature of the assets and services identified as part of the scheme, as well as the associated risks, are capable of being costed on a whole life, long term basis;
- a slow rate of technological change – as projects involving a high IT content are unlikely to provide the stability in demand required for a PF2 approach;
- a capital investment in excess of £50 million – as less capital intensive projects seldom justify the procurement and management costs involved; and
- a project is not so large or complex that the private sector is unable to bear the risks being transferred.

Alternative contracting approaches

7.20 Governments have always been clear that PFI should only be used where it is value for money. Assessing the value for money of contracting approaches is a relative concept, requiring a comparison of the options and their expected outcomes to be identified, defined, estimated, and compared to alternatives.

7.21 Value for money is assessed at various stages throughout the life of a project. In the early stages of a project appraisal there will be a high degree of estimation as to the likely cost and performance outturn of alternative delivery options. The use of historic evidence is important, drawing on outcomes and outturn data from similar projects, but inevitably assessing the relative value for money of alternative delivery options requires a considerable degree of judgement, particularly at the early stages of the appraisal process.

7.22 There are a variety of contracting options which adopt different approaches, relative to PF2, to the allocation of design, construction, financing, asset maintenance and operational responsibilities between the public and private sector. These include prime contracting, design and build, institutional leases, joint ventures, strategic partnerships, concessions and alliancing among others. In addition, the Government is keen to encourage new approaches such as employee-led mutuals, and social or charitable led enterprises, as part of its plans for modernising public services. This will add to the existing delivery options available, but also add further complexity to project appraisal and consideration of alternatives. The Government's overriding objective is to secure value for money.

Appraising the options

7.23 In common with appraisal and evaluation practice across central government, decisions about when to use PF2 need to be made in accordance with the principles set out in the Green Book[1]. Business cases should present more than one viable delivery option and provide a balanced assessment of the strengths and weaknesses of each approach. Selection of the preferred contracting approach will be on the basis of a project specific qualitative and quantitative assessment of the options available. As decisions about the relative value for money of alternative contractual approaches inherently involve the exercise of judgement, it is essential that there is clarity and transparency about the way a value for money judgements are taken. Procuring authorities need to clearly identify the comparative evaluation of different contracting approaches.

7.24 PF2 is complementary to other contracting options and should be given equal – but not greater – consideration as part of the structured options appraisal within the economic and commercial case presented for a project or programme. Separate appraisal methodologies and guidance were developed specific to PFI because it was seen as relatively complex when compared against many of the alternatives. As a consequence more guidance exists for PFI than for many other contracting options.

7.25 Despite a clear focus in government's business case guidance on the need to give due consideration to all reasonable options for delivering a project, the existence of separate, detailed appraisal guidance for PFI has led to a tendency for appraisers to undertake in-depth appraisal of PFI while giving insufficient weight to the potentially viable alternatives. In addition, the existence of PFI credits[2] – ring-fenced funding available to support PFI but not other forms of delivery – exacerbated this, as there was a clear budgetary incentive for procuring authorities to pursue PFI. This Government therefore abolished PFI credits in autumn 2010 to create a level playing field for all forms of public procurement, thus seeking to ensure that procuring authorities consider all reasonable options for meeting their requirements.

Procurement Routemap

7.26 The Government has developed an Infrastructure Procurement Routemap, in conjunction with infrastructure clients, industry and academics for the delivery of major economic infrastructure projects and programmes, which will be published for consultation in January 2013. Building on this, and to address weaknesses in appraisal practice, the Government will extend the existing Value for Money Assessment Guidance[3] to cover a wider choice of contracting options.

7.27 The extended value for money guidance will set the alternative contracting structures in context, alongside PF2, explaining the delivery options available, how these work and when they are most suitable. This will assist procuring authorities to understand better how the private sector can be engaged most effectively based on the risk characteristics of a particular project and to make more informed decisions. The updated guidance will be published for consultation in spring 2013.

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[1] HM Treasury, *Green Book*, 2003

[2] Under the PFI credit regime departments wishing to support a programme of local government PFI projects were given a provisional allocation of PFI credits at a Spending Review. PFI credits represented a notional capital sum and were intended to support the capital costs of a project, met through Revenue Support Grant.

[3] HM Treasury, *Value for money assessment guidance,* 2006

Role of quantitative analysis

7.28 Quantitative appraisal is an important part of the overall consideration of how to deliver a project. Each option should be costed as accurately as possible using outturn data. Where there is uncertainty about inputs, or outputs are highly sensitive to the input variables, it is important to improve the confidence of these wherever possible, but also importantly to undertaken appropriate sensitivity and scenario analysis.

7.29 The current approach to appraisal of PFI sets out that qualitative considerations – viability, desirability, achievability – should frame the approach to the quantitative assessment. The intention is that the quantitative assessment should form part of the overall value for money judgement rather than be seen as a stand alone pass/fail test; neither the quantitative or qualitative assessment should be considered in isolation. The NAO has, in the past, expressed concerns that too much weight is given to the cost modelling assessment[4]; they have put considerable emphasis on the fact that financial appraisal is just one part of the overall assessment of the contracting approach, and have sought to discourage appraisers striving for disproportionate levels of accuracy.

7.30 The previous government sought to address this by developing a simpler quantitative assessment tool reflecting a more proportionate approach to quantitative assessment, with the intention of allowing alternative delivery routes to be chosen at the outline business case stage if these were deemed to offer better value for money. In practice, however, the quantitative assessment tool has encouraged procuring authorities to compare a PFI solution against a conventionally funded – and in some cases undeliverable – alternative, rather than consider alternative contracting approaches. All too often it has continued to be interpreted as a pass/fail test with insufficient weight given to the qualitative judgements.

7.31 The Value for Money Assessment Quantitative Assessment Tool[5] will be withdrawn from 5 December 2012. Procuring authorities should continue to undertake appropriate quantitative assessment, in accordance with the principles set out in the Green Book, supported by in depth consideration of the qualitative factors that influence the choice of contracting route. Further advice about how to apply the Green Book principles when selecting a contracting option for a project, and the relationship between the economic and commercial cases of a business case, will be provided in the updated value for money guidance.

Future application

7.32 The first confirmed programme to which PF2 will be applied is the £1.75 billion privately financed element of the Priority Schools Building Programme (PSBP). The Treasury and the Department for Education have been working together closely in the development of PF2.

7.33 In addition, the Treasury is working with the Ministry of Defence as they finalise their basing strategy and infrastructure investment plans for a more cost effective estate that meets 'Future Force 2020' requirements, to explore how much of this investment – including construction and maintenance activity – can be delivered through PF2.

7.34 In the health sector the Sandwell and West Birmingham Hospitals NHS Trust project is working with the Department of Health to assess the suitability of PF2 to deliver significant new investment, enabling consolidation of services from multiple sites and reorganisation of activity between hospital and community settings

[4] National Audit Office, *Private finance projects,* October 2009

[5] HM Treasury, *Value for money quantitative assessment tool,* December 2011 (http://www.hm-treasury.gov.uk/infrastructure_ppp_vfm.htm)

7.35 While the immediate PF2 pipeline is focused on accommodation projects, an asset class which has been a particular focus of the PFI reforms, the Government wants to ensure that all suitable projects take advantage of the benefits of PF2. Looking forward the Treasury will work with departments to assess which future projects are eligible for PF2.

8 Future debt finance

Government remains committed to the use of long-term financing for long-term projects.

Long-term bank debt markets remain constrained. The cost of long-term borrowing for infrastructure projects has increased sharply and the availability of long-term bank debt has materially diminished. While banks continue to offer short-term loans, Government does not believe that the refinancing risk represents value for money in Government backed projects. PF2 will:

- retain the benefits of private finance project due diligence by seeking finance from a wider range of long-term debt and equity sources;
- enable banks to play an important role in the financing of PF2 projects, whether through long-term loans or products to support institutional investment, including construction guarantees or mezzanine facilities providing credit enhancement; and
- encourage the use and assessment of a range of debt financing sources including public and private bonds, commercial bank debt and multilateral debt products.

Benefits of lenders' role in projects

8.1 Debt funders have historically played in an important role in undertaking project due diligence on PFI projects. Debt funding is exposed to potential loss from poor performance, for example, if the project fails during construction or operational performance criteria are not met, as the public sector will not be obliged to pay some or all of the project's unitary charge. Debt providers' returns are also effectively capped as the repayment of principal repayments and interest charges are fixed at the project's outset, in particular:

- debt providers take a conservative view of risk and, prior to contract signature, ensure disciplined risk mitigation and allocation taking a firm view in dealing with problems revealed by due diligence reports;
- during the construction and operational phase of the project they continue to play an important role in monitoring of project performance and timely resolution of any issues arising; and
- lenders provide an interface between the project investors and the public sector client. In conventionally procured projects the public sector has often in the past accepted price increases as a result of cost overruns or delays. Banks play a vital role in providing corporate funding and often support contractors with whom they have a business relationship. Consequently the contractor is heavily incentivised to act swiftly in resolving any project performance issues and thus insulating the public sector from any such exposure.

8.2 These vital due diligence and monitoring disciplines have contributed significantly to the successful delivery of robust contract structures resulting in extremely low default rates on project finance loans for infrastructure assets.

8.3 However, whilst the due diligence provided by the debt providers has been, and remains, valuable, the highly geared capital structures in past PFI projects[1] has tended to restrict operational project flexibility. The driver for highly geared project structures tended to be competitive pressures for bidders to offer lower unitary charges to the public sector authorities[2]. However, the high proportion of fixed payments to meet debt service requirements left little flexibility for equity to respond to public sector requirements.

8.4 PF2 will retain private sector disciplines in undertaking a robust approach to whole life project due diligence but will seek to enhance flexibility. This is described further in 8.16 to 8.19 below but it is important to set this in the context of a brief recent history of debt sources for PFI projects and why current market circumstances present an opportunity for new sources of debt and equity investment.

Global debt market conditions

8.5 Prior to 2008, there was an active bond market for UK and international PFI/PPP projects, providing both fixed and inflation linked debt. These bonds benefitted from a guarantee[3], or 'wrap', provided by one or more monoline credit insurers. Bond investors therefore invested in a AAA product, on the basis of the monolines' credit ratings, with the monolines assuming the project risk in return for a fee.

8.6 Project bonds provided an alternative funding source to bank loans and this competition drove down debt pricing. During this period the margin on a bank loan and the coupon on a bond (plus the monoline guarantee fee) often equated to around 1.00 per cent p.a. during construction and operations and in some cases even less.

8.7 As part of other business activities monolines also provided guarantees of other cashflows including mortgage book securitisations and other collateralised loan obligations. In 2007, the 'credit crisis' hit debt markets, initiated by loan defaults on 'sub-prime' mortgage books. Exposures to these losses resulted in the downgrade, or withdrawal of rating, of all monolines[4] active in the European project finance markets. Following the loss of the monolines' AAA credit rating investors ceased investing in monoline wrapped project bonds.

8.8 Since the demise of the monoline industry, PFI projects have been largely dependent on the bank loan market as the provider of long-term debt finance. Banks continued to lend to PFI projects following the onset of the financial crisis, recognising the credit quality of these assets, albeit it at a higher loan margin reflecting their rising cost of borrowing in the inter-bank (LIBOR) market. Loan pricing stabilised during late 2009 at margins of c.2.50 per cent p.a. and even began to fall in 2010 before the euro sovereign debt crisis combined with a downturn in the global economy had a major impact on debt markets. It became increasingly challenging to raise private finance for projects.

8.9 At the same time, in response to the financial crisis, a new global regulatory standard on bank capital adequacy, stress testing and market liquidity is being introduced. Basel III will require banks to set aside more capital against their risk-weighted assets. The consequence of this regulatory requirement is that loan pricing will increase to reflect the banks' own higher cost of capital. For long duration loans the impact on pricing is much greater. Additionally, many banks have previously borrowed short-term money to lend long term, causing them to recognise losses when short-term funding costs increased sharply. Management of these banks have

[1] In excess of 90:10 debt to equity.

[2] Projects were able to achieve these highly geared ratios due to the contractual payment mechanism (which allowed bidders to form an accurate forecast of project revenues) combined with subcontracting arrangements which pass on performance deductions.

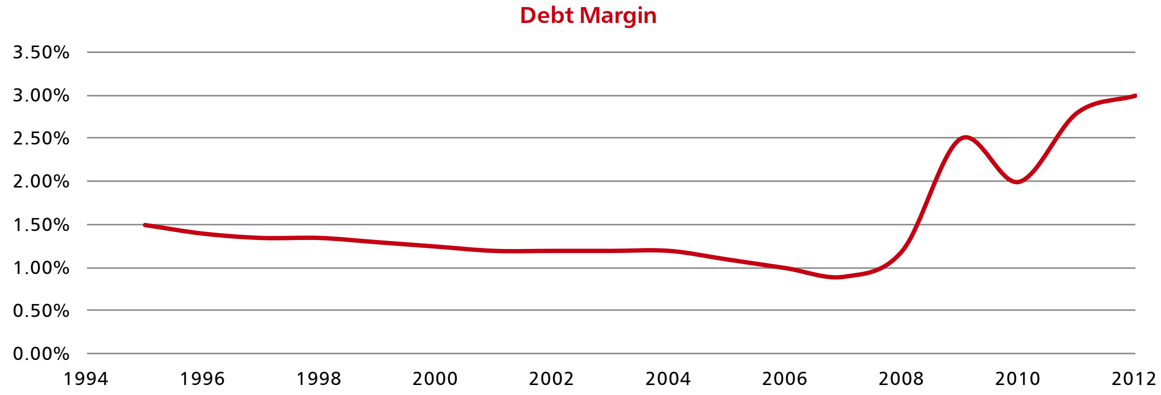
[3] Guarantee to pay interest and principal as they fall due.

[4] Only one monoline credit insurer active in these markets maintains a rating higher than BBB+.

reassessed their long-term loan businesses and in some cases have withdrawn from the market for now, after significant write downs of historic business.

8.10 As a result, the cost of long-term borrowing for infrastructure projects has increased sharply and the availability of long-term bank debt has materially diminished. In some cases traditional project finance banks have withdrawn from the market altogether. Where long-term bank finance is available, margins are now generally priced in excess of 3.00 per cent p.a. in the construction phase and include a margin ratchet mechanism to incentivise early refinancing. This pricing is not indicative of the actual project risk by any reasonable historic benchmark but instead is a reflection of banks' own long-term cost of funds.

Chart 8.A: Illustration of PFI debt margins



Source: HM Treasury

8.11 PFI projects were typically structured to be on the boundary of investment grade (i.e. in the BBB/Baa range). It could be argued that debt pricing observed in mid 2000 was actually underpriced in relation to project risk, therefore, historically the tax payer has received better value for money from PFI projects during this period. It is unrealistic to expect debt pricing to revert to pre-2008 levels but equally Government expects pricing to be reflective of actual project risk and not banks' funding costs.

Government intervention

8.12 Government has already responded positively to these conditions with a number of interventions to ensure that projects are not delayed as a result of an ability to raise finance at affordable pricing. These initiatives are set out in Box 8.A below.

Box 8.A: Government initiatives to promote delivery of infrastructure

- The UK Guarantees programme to avoid delays in nationally significant infrastructure projects caused by constrained credit conditions. Guarantees are available to infrastructure projects meeting the Treasury's criteria including nationally significant, ready to start construction, financially credible, dependent on a guarantee to proceed and good value to the taxpayer.
- Co-lending to support PFI projects, lending alongside other lenders on commercial terms to ease capacity constraints in the market.
- Increased capital contributions to PFI projects and phased during the construction period to reduce financing costs and ease debt capacity constraints. This has been approved on several projects in procurement.
- Signed a memorandum of understanding with the Japanese Bank for International Cooperation (JBIC) to promote investment in infrastructure projects, further deepening and developing economic relations between the UK and Japan. JBIC has invested in the Intercity Express rolling stock programme and committed to fund renewable energy projects including offshore wind.
- The Green Investment Bank (GIB), capitalised with £3 billion, has been established to address market failures affecting green infrastructure projects in order to stimulate a step up in private investment. It is already actively involved in a large number of projects.
- The Government is also working with the Association of British Insurers through the Insurers' Infrastructure Investment Forum to understand and address the issues facing this investor group.
- Housing guarantees to assist construction of new homes in the affordable private rented sector and social housing providing much needed support to the construction industry and help meet demand for homes.
- The NAPF and PPF signed a memorandum of understanding to create the Pension Investment Platform (PIP) last year. It forms part of plans to encourage private sector finance for UK infrastructure. Seven of the largest UK pension funds have now signed up to the PIP which is expected to launch in the first half of 2013.
- A Government proposal to double the amount that UK local government pension funds may invest through limited partnerships (from 15 per cent to 30 per cent) to enable more investment in key infrastructure projects and unlock additional funding for housing, road and high speed rail projects.

8.13 However a number of these measures have a finite lifetime and, therefore, PF2 needs to be built on the solid foundations to enable a long-term sustainable financing model.

8.14 Banks have continued to present proposals to finance projects with shorter-term bank loans including both soft[5] and hard[6] mini-perm options. Government considers that a short-term bank debt approach is not appropriate for future projects for the following reasons:

- budgetary uncertainty of any public sector underpinning of refinancing risk and future affordability issues where cost of finance is not fixed;

[5] Longer contractual date of maturity although refinancing is heavily incentivised through margin ratchet mechanisms and cash sweeps to repay debt in advance of contractual date of maturity

[6] Shorter date of maturity enforcing a refinancing of the project

- complexity of separating out market risk (general changes to market interest rates) from performance risk (changes to interest rates as a result of project performance);
- the limited appetite of the private sector to accept this risk and potential for windfall gains where it does take this risk in return for a premium;
- the potential negative impact on lenders' due diligence focus over the long project life; and
- a desire to maximise the investment of long-term sources of capital at the outset in PF2.

8.15 PF2 seeks to address the project flexibility and cost of equity issues caused by financing whilst at the same time providing solutions to adverse debt market conditions and capitalise on the appetite of institutional investors to invest in UK infrastructure through long-term debt. This is set out in further detail below.

Financing of PF2

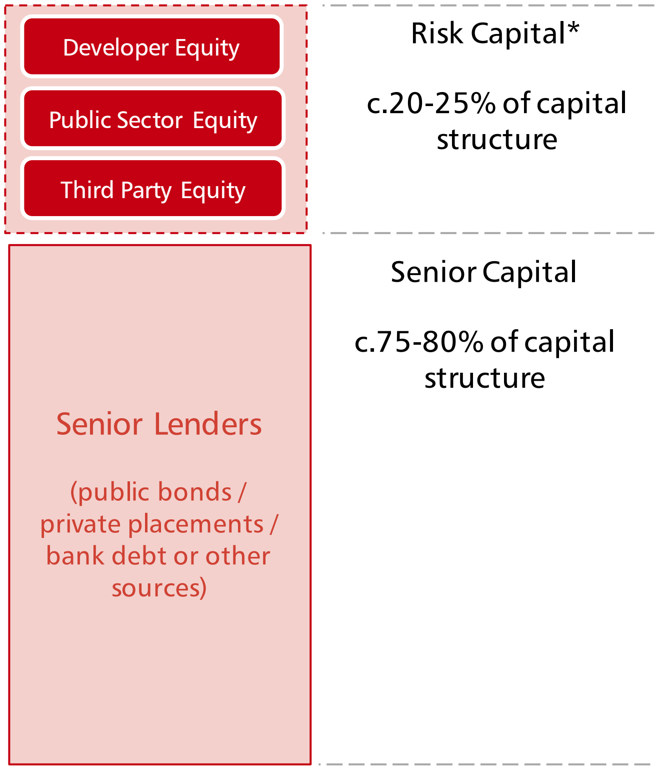
8.16 PF2 will retain private sector disciplines in undertaking a robust approach to whole life project due diligence. It will enable projects to gain access to alternative sources of long-term debt finance in view of the constrained long-term bank debt market.

8.17 PF2 is designed to widen the sources of equity finance and encourage longer-term investors, such as pension funds, into projects at an earlier stage. Equity funding competitions will be introduced at the preferred bidder stage to attract these long-term investors. This also has the potential to drive down equity returns over time and reduce the overall cost to the public sector (see Chapter 2).

8.18 Encouraging longer term investors from the outset of projects is also specifically aimed at reducing the number and size of secondary market transactions. These have often been the subject of criticism because of equity gains which are viewed as being excessive. The Government is also taking other measures to reduce the ability of equity to make windfall profits and these are summarised in Chapter 2.

8.19 Whilst private finance will continue to provide the cornerstone of the financing of PF2 projects, the Government is keen to enhance value for money of the financing by investing an element of public sector financing through a public sector equity participation. This provides for better alignment of objectives promoting more effective public private partnerships and results in better value for money for the public sector (see Chapter 2) in overall terms.

Chart 8.B: Project Company Capital Structure



* May include mezzanine finance (or other second loss tranche) to provide credit enhancement to senior debt

Source: HM Treasury

Access to a wider range of debt finance

8.20 In response to changes in the global debt market conditions the Government has sought to encourage access to a wider range of sources of debt finance to secure long term debt on cost efficient terms. PF2 will, therefore, be structured in such a way that it facilitates access to the capital markets, capitalising on the appetite of institutional investors, or other sources of long term debt finance. Capital markets, whether public or private, have a deep pool of investors who are attracted to the relatively low risk infrastructure asset class. The large market capacity provided by the capital markets in competition with other sources of finance including traditional bank debt should reduce the cost of debt for projects.

8.21 Government has engaged directly with institutional investors, banks, credit rating agencies and the EIB to assess the range of alternative financing options available to support infrastructure delivery and the credit requirements and project characteristics required to meet investor requirements.

Institutional investors

8.22 PF2 projects are therefore expected to source debt finance from sources other than bank debt. The tender process will require bidders to develop a long term financing solution where bank debt does not provide the majority of financing requirement. Therefore it is expected that institutional investors will become an important source of finance for PF2.

8.23 Institutional investors face a number of issues in taking up the financing challenge including:

- resourcing and expertise – historically institutional investors have provided very little debt for PFI projects that was not guaranteed by monolines, leading to a shortage of skills required to assess project risks;
- construction risk – some investors have steered clear of greenfield construction risk. However, low project default rates and the attraction of optimising yields means investors are now changing their views where suitable construction support packages can be arranged to mitigate risks; and
- Solvency II – in much the same way that Basel III will require the banking industry to hold more capital against risk-weighted assets, the insurance industry is faced with a similar challenge with the future implementation of the European Commission's Solvency II Directive. Long duration loans of lower credit quality will attract higher capital requirements. To reduce the capital required and avoid unaffordably high interest rates being charged to the borrower, projects will need to achieve a higher credit quality than that which PFI projects have achieved in the past.

8.24 In order to stimulate demand for infrastructure related capital markets issuance amongst institutional investors, projects are likely to need to achieve a credit rating in the A- to BBB+ range for the reasons set out above. Credit enhancements will be needed to achieve this rating requirement. These credit enhancements include *inter alia* changes to the capital structure, increased contractor support or changes to the typical risk allocation of projects. Additionally mezzanine debt and guarantees can also provide credit enhancements to facilitate the raising of long term senior debt. Government is aware of a number of private sector initiatives and supports their continued development.

8.25 Government has engaged with the finance community, including rating agencies, institutional investors and banks, to understand key drivers to project ratings. It recognises that different investors and rating agencies have different views including whether the largest risks occur during construction or in operations. Consequently, to solve both construction and operational risk concerns, projects are likely to be structured with additional risk capital to absorb project risks and fluctuations in project cashflows. In the Government's view PF2 projects are likely to require approximately 20-25 per cent of risk capital for standard accommodation type projects; however, this could be higher for other sectors or projects which are perceived to contain additional risks. This risk capital could be provided as a combination of equity and subordinated debt or other forms of financing instrument providing protection to the senior lenders.

8.26 Government expects the cost of debt to further reduce as the PF2 market matures and more investors become attracted to the asset class through the delivery of robust contract structures and demonstrated project successes.

European Investment Bank

8.27 Since 2000 the European Investment Bank has signed finance contracts worth over £6 billion for UK based PPP and project finance projects. This is a very significant contribution to UK investment and economic growth. These investments in the UK have ranged from motorways and rail, to waste treatment, energy schemes, schools, hospitals and universities. Some specific examples include the building and extension of the Docklands Light Railway, the construction of Crossrail, the construction of new hospital and university facilities in Bristol and Birmingham, respectively, and recently the Intercity Express Programme.

8.28 It offers a number of products designed to facilitate infrastructure delivery including direct loans, intermediated loans, guarantees, credit enhancement facilities and development grants. The EIB offers its products at low rates[7] and therefore can help projects meet authority affordability requirements. Government encourages project sponsors to continue to use EIB funding in PF2 projects.

Commercial banks

8.29 As set out above, many project finance banks have withdrawn from long-term lending or are offering loans at high rates to cover their own cost of funds. As a result PF2 encourages the use of alternative debt sources. There is still a role to play for banks in PF2 although, in some cases, this may require focussing on a different product offering.

8.30 Some banks are still able to offer long-term finance at affordable rates due to their funding strategy or country of origin. Where this is the case we expect that a bank loan product could still provide healthy competition to alternative financing solutions. Should banks' funding costs reduce in future and they choose to re-enter the long-term loan market, we expect the same to be true.

8.31 Banks and other financial institutions have also started to develop other propositions to support infrastructure financing which may complement institutional investment. These include:

- construction risk and other guarantees where some investors are still averse to such risks;
- mezzanine facilities to enhance credit quality of senior debt;
- short-term working capital or bridging facilities; and
- controlling creditor and trustee role where institutional investors value the experience of banks operating in this capacity.

8.32 Government supports the development of these and other alternative products and continues to encourage a variety of financing solutions to promote efficiency in infrastructure delivery and financing.

Capital contributions

8.33 Previous PFI policy restricted the use of capital contributions by procuring authorities to 30 per cent of project costs to be paid on construction completion. Following a review of this policy the Government will now consider larger capital contributions and may approve milestone payments during the construction phase where the payment of capital contributions does not upset the balance of risk transfer, maintains incentives for sponsors and lenders, and value for money can be demonstrated.

8.34 Increasing capital contributions results in a lower debt financing requirement, easing market capacity constraints and providing more competitive pricing. Payment of the contributions during the construction period removes the need for short-term bank bridging facilities and associated financing costs. The combination of these measures will reduce the overall unitary charge payment making projects more affordable. For further information see Chapter 21 of the Standardisation of PF2 Contracts.

8.35 Increased capital contributions and payments during construction have recently been approved on several projects.

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[7] reflecting its ability to fund itself at lower rates than commercial banks

Future financial structures

8.36 The Government recognises that financial structures evolve over time as new sources of finance emerge from types of investors other than those who have typically owned and managed these assets in the past. The pension fund industry has expressed interest and a willingness to invest significant financial resources, in the ownership and management of UK infrastructure assets to provide long term stable returns to match maturing liabilities.

8.37 Some pension funds have expressed a preference for lower levels of debt in the capital structure to reduce financial risk. Depending on the equity return requirements of these investors, this has the potential to reduce the overall cost of finance, resulting in better value for the taxpayer.

8.38 Government remains committed to reducing the overall financing cost and using long term financing for long term projects. It welcomes engagement with pension and infrastructure funds and other financial investors as it considers the full range of delivery options that might meet its objectives for the next generation of infrastructure investment.

A Summary of call for evidence responses

Reform of the Private Finance Initiative

A.1 On 15 November 2011 the Chancellor announced the Government's intention to undertake a fundamental reassessment of PFI.

A.2 To meet this objective and to give an opportunity for all interested parties to bring forward proposals on how best to reform the PFI model, the Government launched a call for evidence on 1 December 2011. The Treasury invited all parties with an interest in the delivery and financing of public assets and services to share their views on the reforms that should be implemented for future projects. The Treasury published a call for evidence document which set out the primary areas of focus for respondents to consider but also welcomed views on other issues not identified in the specific questions.

Responses to the call for evidence

A.3 The call for evidence closed on 10 February 2012. 139 responses were received from a range of organisations, including advisors, investors, contractors, service providers, trade unions, academics and the public sector. 16 responses were received from individuals.

A.4 Since the call for evidence closed, the Treasury has reviewed and assessed the many responses that were received. There has also been extensive engagement with public and private sector stakeholders to explore proposals in detail.

A.5 We are grateful to all of the stakeholders who have engaged in the PFI reform agenda. This includes stakeholders who provided written responses to the call for evidence for their time and consideration, as well as those who engaged in discussion and debate at bilateral and roundtable events.

A.6 The call for evidence document set out that the Government would publish the responses to the call for evidence to meet transparency commitments and these have been published alongside this policy document. This annex provides a summary of the responses received to each reform topic. A full list of organisations who responded is included in Annex B.

A.7 This annex summarises the main issues raised in the responses to the call for evidence. Many of the responses provided answers that covered several questions together and, therefore, the summaries reflect this by covering each of the reform topics rather than the individual questions. Views have not been attributed to particular individuals or organisations.

Role of the private sector

A.8 The majority of respondents to the call for evidence expressed the view that the private sector should have a role in the delivery of public sector assets. Respondents stated that this was due to a number of factors, such as the skills and experience the private sector brings to projects, commercial rigour and due diligence, as well as risk transfer and innovation.

A.9 Some respondents did say however that the private sector should not have a role in sectors such as ICT, defence, politically sensitive areas and front line service delivery.

A.10 A number of respondents proposed other delivery, procurement and financing models used to deliver public infrastructure in the UK and internationally as a means of addressing some of the perceived issues associated with PFI. These included the regulated asset base approach, joint ventures, Local Improvement Finance Trusts (LIFT), Non Profit Distributing model (NPD), Local Asset Backed Vehicles (LABV), institutional leases, charitable trusts, alliancing, Tax Increment Financing (TIF) and conventional procurement. Key features of these alternative models included their partnership based approach, regulation of equity returns, transparency, better flexibility and risk allocation, attractiveness to institutional investors and speed of procurement.

A.11 Respondents did, however, suggest a wide range of features of the PFI model that should be retained. These included the incentives to ensure good project performance, the transfer of construction and operation risk to the private sector, the provision for lifecycle maintenance and the focus on whole life costing, as well as the standardisation of contracts.

A.12 When considering how the use of private finance should be evaluated when considering the appropriate procurement route for a project, respondents suggested that, as is the case currently, the use of private finance should be evaluated on the basis of value for money. Other considerations raised by respondents included a project's sustainability, the environmental and social impacts and the certainty over the time and costs involved.

Institutional investment

A.13 An overwhelming majority of respondents to the call for evidence supported greater involvement of institutional investors in providing debt finance to support the delivery of public infrastructure, although, it was highlighted that certain changes to the existing model would be required in order to attract this investment. Most of the proposals centred on credit enhancements to achieve the higher credit ratings typically required by institutional investors. These credit enhancements included lower leverage (i.e. more risk capital), construction risk mitigation through enhanced support packages or guarantees, changes to risk allocation and tiered capital structures.

A.14 A small number of respondents suggested that no changes were required to the current model and pointed toward certain investors already active in public infrastructure investment and financial institutions currently marketing products to facilitate institutional investment through credit enhancement.

A.15 Many respondents expressed the view that institutional investors would not be willing to provide debt finance where it would be exposed to construction risk. It was suggested that a bank funded (or guaranteed) construction period followed by a refinancing with institutional debt was a potential solution. Those respondents highlighted that any change to debt pricing (or risk of no debt being available) at the time of the refinancing should be absorbed by Government. It was also suggested that bundling projects into a portfolio post construction could make investment more attractive as it provides for a larger investment, which could potentially be listed on an indices and diversifies risk through a portfolio of assets.

A.16 A number of respondents suggested Government could facilitate institutional investment through improvements to the current model. These included streamlining the procurement process, introducing a centralised and appropriately skilled procurement body, simplifying the payment mechanism, taking certain risks back to the public sector, providing for an inflation linkage, removing flexibility and providing investment through public sector equity, subordinated debt or guarantees.

A.17 Some respondents highlighted barriers to institutional investment, which included having the necessary resourcing with the skills to assess opportunities and perform project due diligence. It was suggested that in order to 'resource up', a clear project pipeline would be needed.

Government's role in project funding

A.18 A variety of views were expressed on whether the public sector should provide financing for projects and at what stage the financing should be provided. Some respondents considered that the public sector should provide all of the finance during the construction period. Once operational, the project could be then transferred into private sector ownership. Other respondents considered that private finance should be used to deliver the public infrastructure. Once operational, the project could either be transferred into public sector ownership or remain in private sector ownership and refinanced.

A.19 There were also mixed views on whether Government should be a co-lender of debt to projects. Some respondents thought that this would reduce the cost of finance, or provide vital capacity for larger projects, while others were concerned about potential conflicts of interest. It was, however, noted that these concerns may be solved by using a centralised commercial entity and agreeing appropriate control and voting rights.

A.20 In general it was considered that Government guarantees were best used selectively to cover certain risks which could either not be borne by the private sector or where these risks were being priced at a premium. Respondents suggested that risks that could be guaranteed included volume (or demand), inflation, ground condition, contamination and aspects of construction for large complex construction projects. It was also suggested that Government could provide forms of credit enhancement to access new debt investors. These credit enhancements included mezzanine debt facilities and a guarantee of debt in termination scenarios. In some cases respondents put forward proposals for Government to guarantee some or all of the senior debt.

A.21 Many respondents highlighted that public sector capital contributions can help improve affordability and reduce the financing requirement, although it was noted that this has no impact on the relative attractiveness of the project to investors and is unlikely to influence the cost of debt or equity. In some cases respondents did, however, suggest that capital contributions could impact on the operational gearing of the project, creating additional risks, which could adversely affect pricing of the debt. It was commonly viewed that capital contributions should only be used where it improved the value for money of the project, and where risk transfer and private sector delivery incentives were not undermined. A number of respondents thought that capital contributions could be extended beyond the current cap of 30 per cent of capital costs.

Debt finance

A.22 A number of respondents suggested alternative approaches to debt finance to address the issue of the increasing cost of debt arising from current market conditions and regulatory requirements of Basel III. These included proposals to access capital markets debt finance although it was generally considered that this would require credit enhancement of the senior debt or separation of the construction and operational phases of the project.

A.23 A number of the respondents highlighted the potential benefits of separating out the construction phase from the operational phase. The primary benefit of this approach would be to reduce the cost of debt finance. It was suggested that banks could provide short term debt to finance the construction period which would allow them to provide lower debt margins as their cost of funding would be lower for shorter term debt. Post construction the debt could be refinanced by institutional investors who would then not be exposed to construction risk and, therefore, expected to price debt competitively. Consequently the cost of debt would be expected to be lower when compared to the current pricing of long term bank debt. However, it was noted that separation of the construction and operational phases of the project could give rise to a number of issues, these included:

- refinancing risk – how future finance and pricing could be committed at the time of financial close;
- due diligence – bank due diligence would be focussed on the construction phase only. Bond investors would also need to undertake due diligence so could result in duplication of costs;
- changes to financing contracts – to take into account moving from a loan to a bond product;
- warranty provisions – Bond investors during the operational phase would require certain protections against problems stemming from the construction phase; and
- some respondents suggested that a portfolio approach to the refinancing of operational projects could yield pricing benefits.

A.24 Most respondents viewed that the public sector should take refinancing risk citing an increase in the price of equity premiums if the private sector was required to take this risk. However, respondents understood that it is difficult to disaggregate the impact of performance risk from market rate risk.

A.25 The majority of respondents did not consider preferred bidder debt funding competitions as being effective, although it was noted that they can yield small price benefits in certain situations. The reasons for this included increased procurement costs, delays to financial close, lack of funder engagement at the bid development phase, the potential for renegotiations of the contract terms post preferred bidder and stifling funder innovation since it is perceived that more credit is given to tried and tested bank debt solutions.

A.26 A number of respondents expressed views that including full indexation (or an inflation floor and cap) of the unitary charge in the payment mechanism could help to attract pension funds and institutional investors. Other respondents preferred that only a proportion of the unitary charge should be linked to inflation to provide a natural hedge against inflation linked and non-inflation linked components of operational and finance costs.

A.27 It was recognised that the provision of long term interest rate swaps can reduce flexibility due to the potential for additional costs known as 'breakage costs' which are borne by the public sector if projects are terminated early. Respondents suggested that a partial interest rate hedging strategy, rolling programme of shorter interest rate swaps or break points could be used to minimise costs. However, central or local government would be required to take the risk of movements in interest rates on unhedged debt.

Equity finance

A.28 The responses generally supported the principle of public sector investment in project equity to align public and private sector interests in project outcomes, subject to addressing any conflicts of interest with the role of the public sector as customer. Respondents also highlighted the effectiveness of public sector equity co-investment in some existing projects in aligning public and private sector interests, increasing transparency of project performance and giving the public sector access to a share of investment returns. These benefits were, however, weighed against the increased exposure of the public sector to project risks that would come with equity co-investment, and the potential for conflicts of interest between public sectors interests as both customer and investor.

A.29 In relation to the potential for the regulation of equity returns, respondents generally considered that regulation is most applicable in sectors where services are paid for by the end user rather than by Government. Many respondents considered that an approach of sharing of equity returns would be more effective than a capping of returns but should be balanced by sharing of downside risk too and preferably only applied where public sector equity is invested. If a sharing of returns were to be introduced then a stepped or tiered approach was generally favoured in order to retain performance incentivisation.

A.30 A number of responses expressed the view that restricting sales of equity for a minimum period would not be acceptable and would either result in some parties withdrawing from the market or increasing required equity returns to reflect an illiquidity premium.

Risk allocation

A.31 Many respondents to the call for evidence considered that under the PFI model the risk allocation sometimes departed from the principle that each risk should be allocated to the party best able to manage it. The majority of these respondents suggested changes to the typical risk allocation under the PFI model and highlighted that the retention and management of certain risks within the public sector could potentially improve value for money. The key examples identified by a significant number of respondents were the risk of additional capital expenditure arising from an unforeseeable general change in law, utilities consumption risk and the risk of the site being contaminated by sources of contamination not on the site.

A.32 In addition significant numbers of respondents felt that the public sector should be more active in takings steps to mitigate risks before or during the procurement phase. Private sector respondents suggested that procuring authorities should always undertake adequate investigations into legal title for sites made available to bidders and provide a warranty of title to the contractor and that investigations should be commenced early so as not to delay the procurement process. Some respondents suggested that where the procuring authority provides the site for the project, the authority should procure ground condition surveys and make them available to all bidders with the benefit of a warranty.

A.33 A range of views were expressed on whether the existing contractual framework was working well. Those respondents who considered that the current arrangements were operating satisfactorily expressed the view that standard contract guidance should be retained and standard sector contracts adopted. Many authorities felt that the contract derogations process was helpful, enabling them to take a robust position with contractors. It was also suggested, however, that allowing some derogation from standard terms was beneficial.

A.34 Some respondents advocated simplifying contracts and said that there was scope for greater standardisation. Some suggested that the contractual framework could be simplified by making payment mechanisms less complex and more user friendly. Simplification could also have a beneficial impact upon pricing of specification regimes and the design approval process.

A.35 In particular by reducing the number of performance standards and focussing on a smaller number of key measures, it was felt this would still provide the public sector with the levels of performance required. Further, it was suggested that greater standardisation within sectors would give bidders greater certainty.

A.36 It was suggested that in certain sectors, there should be a more transparent variations regime and more streamlined specifications in order to simplify the contractual framework.

A.37 Those respondents who did not favour contract simplification said that contracts were insufficiently flexible to accommodate unforeseen changes, and that there was limited scope to modify the contractual framework. It was also suggested that the contractual framework could not be simplified as it was driven by security and project financing arrangements.

Procurement and contract management

A.38 Many respondents considered that there was a need to improve public sector procurement skills. The most common reform suggestion raised to address the perceived skills deficit was the proposal for greater centralisation and improved professionalism of public sector procurement. Other proposals included improved guidance on the pre-procurement phase and improved training for public sector procurers.

A.39 Many responses suggested reform proposals that sought to streamline PFI procurement. A number of the responses suggested that the public sector should seek to provide greater clarity in its requirement prior to issuing the project's OJEU notice. Other responses put forward various models that supported greater contractor involvement earlier in the project and working to a brief that was less prescriptive but specified the outputs required. A number of respondents also urged government to take a more pragmatic approach to the level of detail and quantity of information required in bid submissions.

A.40 Many responses suggested greater standardisation of contractual documents could help to streamline the procurement process. Some responses suggested the use of competitive dialogue in PFI procurements had been a cause of delay and that the use of the negotiated or restricted procedure should be considered. Some responses called for the change protocol to be reviewed and simplified.

A.41 A number of responses suggested that government should set clear timetables for the procurement process and ensure projects adhere to these. Connected to this was the suggestion to introduce bid bonds or incentive mechanisms for procuring authorities. Others suggested the number of bidders should be reduced earlier in the process and that the competition could be shortened. Others considered that the approval process was a cause of procurement delay. A number of responses also requested that good intelligence on the future pipeline and transparency over the approval process was provided.

A.42 Many responses also considered that there is a need to improve public sector contract management skills. The measures proposed to address this issue included improved guidance for the contract management phase and greater training for public sector contract managers. It was also considered that investment in ongoing contract management could be a condition of claw-back grant funding. Some responses suggested that more continuity and communication between the procurement team and the contract management team would also lead to improvements.

Balancing innovation and standardisation in contract specification

A.43 Some respondents expressed a preference for an output based and a standardised specification. A number of respondents said, however, that the use of output based and standardised specifications depended on the nature of the project involved, the need for innovation, the desired level of risk transfer and the degree of cost certainty.

A.44 The advantages cited for using a standardised specification included reductions in bidding time and cost. Some respondents did suggest that there were drawbacks to standardisation in that it did not always lead to a reduction in costs and too much standardisation could prevent innovation.

A.45 Some respondents suggested that the appropriateness of standardised specifications depend on whether innovation is required. It was considered that an output specification could be appropriate for projects where private sector innovation was essential to successful delivery. Some respondents did, however, suggest that the use of outcome rather than output specifications can lead to greater risk transfer and innovation.

A.46 When considering the approach of engaging contractors in the procurement process, a number of respondents said that earlier engagement would be conducive to achieving greater private sector innovation. Consideration should be taken regarding protection of intellectual property rights and the competitive advantage of bidders.

A.47 It was considered that a range of measures foster innovation, including the use of incentives, competitive dialogue and allowing for contractors to deliver bespoke solutions. A wide range of reasons was given as barriers to innovation. These include lenders' reluctance to finance innovation, excessive over specifications, poor communications and confidentiality.

'Soft' facilities management services

A.48 A number of respondents to the call for evidence expressed the view that soft services should be excluded from any future model. The respondents highlighted that this approach would increase the flexibility of projects by making it easier to change service requirements without the need for complex contractual variation. It was also considered this approach would provide better value for money. Some of these respondents did, however, highlight that the exclusion of soft services may lead to interface risks and that this would need to be managed effectively. Some respondents suggested that the exclusion of soft services could increase institutional investors appetite in these projects.

A.49 Those respondents who favoured the inclusion of soft services in any future model considered the benefits of this to be improved asset design, greater innovation and reduced costs over the life of the project. Some respondents expressed the view that the inclusion of soft services to be beneficial only in projects from particular sectors due to the integrity of the services in operational delivery and the example of the prisons sector was raised.

A.50 Some respondents considered that the decision around the inclusion of soft services should be considered on a case by case basis.

'Hard' facilities management and lifecycle maintenance

A.51 A number of respondents expressed concerns over the lack of transparency of the build up and management of the lifecycle fund and in particular, the risk that excessive returns may be achieved by the private sector at the end of the contract. Many of these respondents felt that these issues could be overcome through greater transparency of forecast and actual lifecycle costs, through some form of open book management of lifecycle maintenance.

A.52 Many of the responses expressed a desire to have greater flexibility on the hard facilities management service specifications and the timing of hard facilities management repairs. Some responses suggested that an open book approach could lead to greater transparency as well as more efficient pricing. Alternative suggestions to improve flexibility included the use of shorter contracts, the introduction of benchmarking and market testing provisions, a pain and gain share mechanism between the public and private sector parties or for lifecycle spending decisions to be based on annual surveys. Others considered that flexibility could be improved through simplifying the approach to variations.

A.53 Some of the responses suggested that costs had often been driven by the 'gold plating' of hard facilities management service specifications and hand back conditions and that removing this could lower prices for the public sector.

A.54 There were conflicting views on whether the private sector had been able to price the lifecycle provision effectively. A number of responses provided the view that the private sector had become sophisticated at pricing hard facilities management services and as such they were accurately and competitively priced already by the private sector. Some of these responses did, however, note that there were some elements of hard facilities management services that were more difficult to price. Others held the view, however, that it was difficult to price facilities management services accurately over a twenty-five year concession. Many of these respondents also suggested it was currently too early to make judgements about the appropriateness of lifecycle pricing in current contracts, as large expenditure would be required at later stages and that there were insufficient projects at this stage to identify a trend.

Insurance

A.55 Many respondents highlighted the maturity and competitiveness of the insurance market and noted that there have been significant reductions in the cost of insurance over time. It was considered that this has partly been driven by experienced private sector bidders using existing large PFI portfolios to drive down insurance costs. As such these respondents considered that current PFI insurance arrangements represented good value for money for the public sector. A number of respondents also highlighted that insurance costs in PFI projects represented a small proportion of total PFI service charges.

A.56 Some respondents considered, however, that the low PFI claims history indicates that public sector self insurance of PFI projects would provide better value for money. A number of concerns were raised about this approach, with particular concerns about whether the public sector has the skills to manage the potential exposure to major risks. The costs of this approach were also highlighted, in both administration costs and the potential for large or multiple claims. It was also considered that self insurance may not satisfy lenders' requirements.

A.57 Some respondents felt that a framework of insurers should be introduced and variable views were expressed on whether this should be mandatory or optional. However, other respondents felt that procuring insurance from frameworks may not offer value for money and could potentially erode competition.

A.58 Other approaches put forward included the private sector taking out the insurance for the project and passing the costs through to the public sector at each renewal point, rather than requiring the private sector to take a view on the cost of insurance over the duration of the contract. Others suggested that the Government should introduce a risk sharing mechanism for insurance premium fluctuations or a mechanism to ensure that changes in insurance costs are borne by the party whose action caused the increase in insurance costs.

A.59 Some respondents also considered that responsibility for the insurance could be split between the construction and operational phases of the project, where the private sector is responsible for insuring the construction phase of the project and this passes across to the public sector for the operational phase.

Flexibility of the contract

A.60 Respondents to the call for evidence expressed a range of views on breakpoints in contracts. Some respondents thought that more breakpoints were needed so that changes in user needs during the operational phase could be responded to. It was suggested that fixed price breakpoints at periodic intervals could benefit the public sector and remove ambiguity in termination calculations.

A.61 A number of respondents, however, noted that breakpoints increased price and introduced risk, and suggested that this can reduce the willingness from investors and financiers to fund projects. The responses also made clear that the procuring authority needed to specify the extent of flexibility anticipated in the contract from the outset, as this would help determine whether PFI was suitable model for the project. It was also suggested that breakpoints can discourage a long term approach to whole life costing and make long term interest rate swaps less appropriate.

A.62 A number of respondents said that they were content with the voluntary termination compensation. A wide range of other comments included suggesting breakpoints at re-financing periods so that compensation was paid at a lower level, that termination was based on assessment of cost and liability and cost of transfer of assets and staff, and that compensation was aligned with projected losses at date of termination.

Transparency

A.63 Respondents expressed a range of views on the degree of financial transparency required for future projects, although overall greater transparency was favoured. Respondents who favoured greater transparency supported the use of open book arrangements and felt that there should be full transparency through all phases of the project. Others considered that the Freedom of Information Act (FOIA) should be extended to the private sector. Some felt that the objective of improved transparency could be achieved through public sector investment in projects.

A.64 Other respondents felt that the current transparency arrangements are satisfactory. Respondents who did not favour increased transparency said that commercially sensitive information should not be made available due to the potential implications this may have, and that the FOIA should not be extended further.

A.65 There was a wide range of comments on the potential extension of project information requirements. Some respondents said that sharing of periodic financial reporting by SPVs was acceptable and that sub contractors should be subject to full disclosure; that financial reporting information should be available on demand to the public sector and that there should be formal monthly meetings with the SPV.

A.66 Other respondents felt that current information requirements were appropriate and to go further would risk commercial sensitivity. These respondents felt that transparency should not be extended down the supply and investor chains. It was considered that the public sector should not have further information from sub contractors as information on sub-contractor outturn costs was highly commercially sensitive. It was also considered not viable to require financial reporting and disclosure from the sub contractors and that such publication could undermine the entire market.

A.67 A number of respondents supported public sector involvement in project governance. Some respondents only agreed with this view if public sector equity were involved, so that the authority had a stake in the delivery company. Other comments included that a liaison committee could help with project governance.

A.68 Other respondents said that public sector participation in governance would cause conflicts of interests on some issues and that a different approach to project governance was not the solution to improve transparency. Some respondents considered that provided the project was performing as agreed at contract close, there should be no need for public sector governance over and above usual arrangements.

B List of respondents

B.1 A list of the 136 organisations and 3 MPs that responded to the call for evidence is provided below, and these have been published in alphabetical order alongside this document. 16 individuals also responded to the call for evidence and these responses have been published on an anonymous basis.

1. Addleshaw Goddard LLP
2. ADEPT
3. Affinitext
4. Aintree University Hospital NHS Foundation Trust
5. Allen and Overy LLP
6. Amber Infrastructure Ltd
7. Amey
8. Appleyards
9. Ashley House
10. Ashurst
11. Association for Consultancy and Engineering (ACE)
12. Association of British Insurers (ABI)
13. Association of Chief Police Officers
14. Assured Guaranty
15. Association of Teachers and Lecturers (ATL)
16. Aviva Investors
17. Balfour Beatty
18. BAM PPP UK Ltd
19. Bank of Tokyo-Mitsubishi UFJ
20. Barclays Bank plc
21. Barclays Infrastructure Fund
22. BDO LLP
23. Bevan Brittan LLP
24. Bilfinger Berger Project Investments
25. Birmingham City Council

26. Blackpool Council
27. British Services Association
28. BT Pension Scheme
29. Canmore Partnership Ltd
30. Carillion
31. Confederation of British Industry (CBI)
32. Chartered Institute of Public Finance and Accountancy (CIPFA)
33. Civil Engineering Contractors Association
34. Constructing Excellence
35. CorLa Limited
36. Construction Products Association (CPA)
37. Currie and Brown UK Ltd
38. DAC Beachcroft
39. Deloitte LLP
40. Deutsche Pfandbriefbank AG
41. Dundas & Wilson LLP
42. EC Harris LLP
43. EDHEC Risk institute
44. Equitix
45. Ernst and Young
46. Essex County Council
47. European Institute of Public Administration
48. European Services Strategy Unit
49. Evolution Securities
50. Faculty of Social Sciences, Charles University, Prague
51. FCC Projects
52. Federation of Property Societies
53. Financing and Leasing Association (FLA)
54. Foundation Trust Network
55. Frank Field MP
56. Freshfields Bruckhaus Deringer
57. Gallagher Health
58. Galliford Try plc

59. Genesis Equity Ltd
60. Grant Thornton
61. Guildhouse UK Ltd
62. Hadrian's Wall Capital
63. Harvest Housing Group
64. Highway Electrical Association
65. Institute of Chartered Accountants in England and Wales (ICAEW)
66. Infrastructure Alliance - The Alliance consists of the Association for Consultancy and Engineering (ACE), the Civil Engineering Contractors Association (CECA), the Construction Products Association (CPA) and the Institution of Civil Engineers (ICE).
67. Infrastructure Journal
68. Institution of Civil Engineers (ICE)
69. International Facilities and Property Information Ltd
70. International Project Finance Association (IPFA)
71. Investec Bank
72. J^2
73. Jesse Norman MP
74. JLT Specialty Ltd
75. Kent County Council
76. Kier
77. KPMG
78. Laing O'Rourke
79. Leeds City Council
80. Legal and General Group Plc
81. Lexius
82. Liverpool City Council
83. Local Government Association
84. Local Partnerships
85. London Borough of Waltham Forest
86. London Councils
87. London First
88. Macquarie Capital
89. Manchester City Council
90. Margaret Hodge MP

91. Mill Asset Management Group
92. Morgan Sindall
93. Mott MacDonald
94. Mouchel
95. Nabarro LLP
96. National Housing Federation
97. National Union of Teachers
98. National Wealth Service
99. Newcastle city council
100. NHS Wales Shared Services Partnership (NWSSP) and Central England Audit and Consultancy (CEAC)
101. Norfolk County Council
102. North Tees and Hartlepool NHS Foundation Trust
103. North Yorkshire County Council
104. Nottingham City Council
105. Partnerships Bulletin. Contributions from K&L Gates LLP, Appleyards, Ernst and Young, FCC Construction, Grant Thornton, Laing O' Rourke, Aon, SGP
106. Pinsent Masons LLP.
107. PKF LLP
108. PPP Forum
109. Prime / CBRE
110. Procurement Management and Training Company
111. Rathbone Bros plc
112. RBC Capital Markets
113. Royal Institute of British Architects (RIBA)
114. Royal Institution of Chartered Surveyors (RICS)
115. Rock Infrastructure Ltd
116. Royal Liverpool and Broadgreen Hospital NHS Trust
117. Ryhurst
118. Salford City Council
119. Sandwell and West Birmingham Hospital NHS Trust
120. Scottish Futures Trust
121. Serco
122. Shanks

123. Skanska
124. Society of County Treasurers
125. SSE plc
126. Steeds & Co.
127. The LIFT Council
128. TheCityUK
129. Trades Union Congress (TUC)
130. Transport for London
131. Transport for London Pension Fund
132. Trowers and Hamlins LLP
133. UK Contractors Group (UKCG)
134. UNISON
135. United Kingdom Without Incineration Network (UKWIN)
136. United Learning Trust
137. University of Aberdeen and the University of Ulster
138. Wates
139. West Yorkshire Police

HM Treasury contacts

This document can be found in full on our website: http://www.hm-treasury.gov.uk

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