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foundation**

Fairness for Future Generations

The Private Finance Initiative and Intergenerational Equity

By Professor David Parker

on behalf of

The Intergenerational Foundation (www.if.org.uk)

With a Foreword by

Margaret Hodge, Chair of the Public Accounts Committee

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Foreword

I welcome this valuable and timely report from Professor David Parker on behalf of the Intergenerational Foundation (if.org.uk), a politically independent charity, seeking to promote the rights of younger and future generations in the UK.

Over the past 20 years, successive UK governments – both left- and right-leaning – have signed 860 PFI contracts, handing to future generations a debt of £239 billion. That's equivalent to funding the NHS, at current levels, for 23 years.

PFI has been better value for the private sector than for the taxpayer. What started as a means of bringing private-sector investment and management skills into the public sector has allowed private companies to make huge profits while leaving us with a mountain of debt – a debt that is now accepted as much higher than would have been incurred if more conventional forms of public sector financing had been used.

Is this a fair legacy for future generations? Should they be responsible for servicing the contracts that our generation of public servants have so poorly negotiated? It is surely our responsibility to protect future generations from short-termist procurement policies and ensure that large infrastructure projects provide the best possible value for money in the long term. We have failed, according to this report.

As successive governments have, it seems, played fast and loose with “off balance sheet” recording of PFI contracts, it has become increasingly difficult to quantify the true liabilities. This must not continue. We also need to know more about the returns being made by investors and ensure that a fair share comes back to the public purse.

It is not right for our generation to tie our children's and grandchildren's hands by saddling them with debts and service agreements thirty or forty years into the future. We must take far greater responsibility for the debt we create, for the resources we use and for the projects we benefit from, starting now.

Margaret Hodge, MBE, MP, Chair, Public Accounts Committee

Introduction

Introduced in the autumn of 1991 as a means of protecting infrastructure investments at a time of tight fiscal constraint, the Private Finance Initiative (PFI) has evolved to become an established method of procuring infrastructure by the public sector, including in the education, housing, health, transport and defence sectors. The policy is supported by all of the main political parties in Parliament.

The problem with PFIs is the way in which they are passed into the future. This means our children and grandchildren will be given massive liabilities from the past, to pay. The Intergenerational Foundation is extremely concerned, not only at the number of new PFI contracts being tendered during a period of austerity, but also at the poor deals made on behalf of future taxpayers. These deals advantage the here and now, to the detriment of future generations.

In total, today there are estimated to be over 860 PFI projects in place in the United Kingdom. Since its inception, PFI has created around £239bn of liabilities to the taxpayer, with costs being carried forward to future generations.¹

Under PFI, the public sector enters into long-term contractual arrangements, which typically involve private-sector companies designing, building, financing and operating infrastructure assets. For example, PFI was introduced into the housing sector in 1998 and has been a small but significant part of total investment in social housing since. PFI projects in housing are long-term contracts between local authorities and private consortia to deliver and maintain housing to a specified standard. The costs are paid by the local authorities to the private consortia through annual payments.

In housing, the Department for Communities and Local Government is responsible for policy and governance, and for allocating funding to projects. As in other areas of PFI, the Treasury is responsible for overall PFI policy. The Treasury sets guidance on how departments assess value for money and approves significant projects.

¹ Debate on the Private Finance Initiative, *Hansard*, 24 June 2011, column 143. .

Procuring Infrastructure

Under more traditional forms of Government procurement, typically the public sector designs the project and the private sector builds to this design, using either cost-plus contracts (with their well known moral hazard problems) or fixed-price contracts (which the private sector understandably dislikes in the face of unpredictable cost inflation).

By contrast, under PFI, typically the public sector sets the goals of the project (for example in terms of the general specification of a new bridge, tunnel or hospital), but allows the private sector to come forward with differing ways of achieving the specification. Private finance projects usually define the outputs required, allowing some flexibility over the solution.

Also, typically the private sector becomes responsible not only for constructing but for managing and running the facility for a specified number of years. This means that the “whole-life costs” of the project are internalised. This is considered to be an important advantage of PFI over more traditional forms of public procurement. If the private contractor is sparing in terms of the quality of the initial build, it bears the higher costs of maintenance and repairs during the life of the contract.

More traditional public sector procurement methods were, it has been argued, prone to incentives to minimise construction costs with limited attention paid to whole-life costs.

Typically PFI contracts are for around 25 or 30 years. In the UK, HM Treasury has consistently stated that when deciding on whether to use the private sector or to provide a service in-house the decision will be based on “a rigorous assessment of value for money with no bias in favour of any particular procurement route”.²

² HM Treasury (2003) *PFI: Meeting the Investment Challenge*, London: The Stationery Office.

Central to the interpretation of Value for Money (VfM) is the concept of shifting *risk*. In essence, PFI schemes are intended to shift project risks (notably delays and cost overruns) from the public sector, and hence taxpayers, on to the private sector, and hence company shareholders and loan financiers.

In return for taking on the risk, the private sector is rewarded by the opportunity to profit from its project management skills. Table 1 provides a summary of the potential benefits and disadvantages of using PFIs taken from the recent House of Commons Treasury Select Committee report on PFI.

Table 1: Theoretical benefits and disadvantages of PFI

Potential benefits include...	Potential disadvantages include...
Encouraging the allocation of risks to those most able to manage them, achieving overall cost efficiencies and greater certainty of success.	Higher cost of finance, which has increased since the credit crisis.
The delivery of an asset which might be difficult to finance conventionally.	The prospect of delivering the asset using private finance may discourage a challenging approach to evaluating whether this route is value for money.
Potential to do things that would be difficult using conventional routes. For example, encouraging the development of a new private-sector industry.	Reduced contract flexibility — the bank loans used to finance construction require a long payback period. This results in long service contracts which may be difficult to change.
Delivery to time and price. The private sector is not paid until the asset has been delivered, which encourages timely delivery. PFI construction contracts are fixed-price contracts with financial consequences for contractors if delivered late.	The public sector pays for the risk transfer inherent in private finance contracts but ultimate risk lies with the public sector.
The banks providing finance conduct checking procedures, known as due diligence, before the contract is signed. This reduces the risk of problems post-contract.	Private finance is inherently complicated, which can add to timescales and reliance on advisers.
Encouraging ongoing maintenance by constructing assets with more efficient and transparent whole-life costs. Many conventionally funded projects fail to consider whole-life costs.	High termination costs reflecting long service contracts.
Encouraging innovation and good design through the use of output specifications in design and construction, and increased productivity and quality in delivery.	Increased commercial risks due to long contract period and the high monetary values of contracts.
Incentivising performance by specifying service levels and applying penalties to contractors if they fail to deliver.	
Fewer contractual errors through use of standardised contracts.	

Source: Adapted from NAO, Lessons from PFI and other projects, Figure 1; House of Commons Treasury Committee (2011), Table 1, p.5.

To the champions of PFI, PFI contracts offer the prospect of a “win-win” in public procurement. The result is a fair return to investors, and better-quality and lower-cost infrastructure for the taxpayer. For Government, there has been the additional advantage that the cost could be taken “off balance sheet” so far as the public-sector accounts are concerned. The rules were tightened in 2009. Even so, PFIs may still be preferred in Whitehall so as to hold down the headline public debt figure.

The Origins of PFI

The very early 1980s was the time of the beginnings of “privatisation” and “Thatcherism”, when the tide of public policy began to run in favour of private over public investment. It was also believed that the private sector could provide much needed project management skills that were missing within Government.

The treatment of private capital for public projects was reviewed by the Treasury. This led to certain “rules” or criteria that Government departments were expected to take into account when deciding whether to use private capital to fund public projects.

The rules were formulated by Sir William Rylie, a senior Treasury official, and were released in 1981 by Leon Brittan, the Chief Secretary of the Treasury. Brittan summed up their central message in the following words: “funds for investment should be taken under conditions of fair competition with the private sector; that is, that the latter should not obtain a normal equity profit without accepting a normal equity risk.”³

In effect, when examining the case for private over public financing of infrastructure projects, under the rules the possible cost savings from private-sector management were to be set against the higher costs of private financing.

The UK Government has an AAA credit rating, while private financing has a “risk premium” in its cost of capital. This means that the private sector pays a higher interest rate on its debt than the British Government on equivalent gilt-edged stock. Private financing offers value for money when the benefits associated with the transfer of project risk and superior management skills outweigh the additional costs of private over public financing.

³ Cited in P. de Pelet (1988) “Private Finance and Management of Infrastructure”, in E. Butler (ed.) *The Mechanics of Privatization*, London: Adam Smith Institute.

The “Ryrie Rules” required that any benefits in terms of lower costs and the transfer of risks to private investors should be greater than if the investment was directly publicly financed, by at least enough to cover the increased cost of raising risk capital from the financial markets.

The gains from private-sector management needed to more than offset the additional cost of raising finance from the private sector compared to gilt sales.

In other words, if the project delivery was reasonably efficient under traditional forms of public procurement, and the use of private finance would not credibly transfer risk to the private sector, private provision would be more costly. In this case there was no economic case for using private financing.

As there was considerable scepticism within Government that the higher financing costs would be compensated for, there was little interest in private financing of infrastructure schemes during the 1980s. A major exception was the successful proposal for a new privately-financed Dartford River Crossing in March 1986.

In the 1980s, there was a presumption within Government that PFI schemes were usually more expensive due to the lower costs of gilt-edged borrowing over private-sector

A Rethink

An economic recession and the continuing drive to privatise Government functions combined in the early 1990s and led to a rethink. The benefits of private financing were now seen as potentially so large that they would more than offset the higher financing costs.

In addition, some economists questioned whether the costs of public and private-sector financing were being fairly compared. They contended that Government borrowing through

the sale of gilts was only cheaper than private-sector financing because current and future taxpayers underwrote the downside risks.⁴

While a risk premium is explicit in the private sector cost of capital, it is hidden when public sector debt is used. The argument tilted the playing field in favour of using private capital.⁵

The PFI programme was launched by Norman Lamont, the Chancellor of the Exchequer, in his 1992 Autumn Statement and elaborated upon in guidance to departments published in December of that year. What was referred to as “operating lease agreements” by Lamont would be used where they offered “good value for money” and where it could be shown that “risk stays with the private sector”.⁶

After a faltering start, the programme gathered momentum from the mid-1990s. The Treasury began to refuse to approve public spending on capital projects unless the private finance option had been fully explored.

In the 1995 Budget, Kenneth Clarke, Lamont’s successor as Chancellor, effectively relaunched the PFI initiative and announced £9.4 billion of priority projects. By the summer of 1995 the planning within Government was for the total value of signed PFI projects to rise from around £100 million to almost £800 million annually by the early 2000s.⁷

Interestingly, however, questions were already being raised within Government about the economics of the PFI.⁸ On 22 January 1996 Sir George Young, Secretary of State for Transport, the Department responsible for many of the PFI deals signed, wrote to the Chief

⁴ The argument remains contentious; for a discussion M. Hellowell (2010) “The UK’s Private Finance Initiative: history, evaluation, prospects”, in (eds.) G.A. Hodge, C. Greve and A. Boardman, *International Handbook on Public-Private Partnerships*, Cheltenham: Edward Elgar, pp.319—320.

⁵ D. Parker (2012) *The Official History of Privatisation Volume 2: Popular Capitalism 1987—1997*, London: Routledge, ch.14.

⁶ *Hansard*, 12 November 1992, column 998; House of Commons Treasury Committee (2011), *Private Finance Initiative*, 17th Report, Session 2010-12, Volume 1, HC 1146, August, London: The Stationery Office, p.36.

⁷ Parker (2012).

⁸ *Ibid.*

Secretary to the Treasury, William Waldegave. He acknowledged that PFIs had helped to ease short-term cash flow problems for Whitehall departments, but cautioned: “The risk is that the ‘savings’ thus achieved are not properly seen in the context of what they imply if carried forward year on year, namely a lasting and possibly very substantial reduction in programme outputs, with all the social and economic consequences that flow from that.”

Young also expressed concern that the risk of project failure might, in reality, not be transferred to the private sector as intended: “The ‘theory’ is that all is well if risk transfers to the private sector. It is difficult to see how this happens in the case of services which are free at the point of delivery, and where ultimately the Government has a statutory duty or political imperative to pick up the pieces if there is a default.”⁹

In a similar vein, Norman Lamont, who had overseen the launch of the PFI programme, later wrote in his memoirs: “there is the risk that the private sector may provide finance up front but that the long-term consequences will be the silting-up of public expenditure with a stream of never-ending rental payments. I suspect that in the long run some of these projects will go wrong and appear again on the Government’s balance sheet, adding to public spending. We shall see.”¹⁰

⁹ Ibid..

¹⁰ N. Lamont (1999) *In Office*, London: Little, Brown, p.309.

PFI and the Labour Government

Notwithstanding such reservations, the Labour Government elected in May 1997 enthusiastically embraced PFIs, under the banner of “public-private partnerships”. The Prime Minister, Tony Blair, believed that competition drove up standards and that public-sector procurement could learn from the private sector.¹¹ On 28 November 1995 in Parliament he had stated that “The PFI is right in principle.”¹²

It was under Labour that the PFI programme really took off. By 2003/4, PFI schemes accounted for some 39% of capital spending by Government departments, although this fell back to 11% in 2005/6. In the five years to April 2010, approximately £30 billion per year was invested in UK infrastructure projects under long-term contractual arrangements between public authorities and private-sector companies.

There were major PFI programmes in transport, health, education and housing, as the Labour Government turned to the private sector to tackle transport congestion and to help turn around the decaying stock of hospitals, schools and affordable homes. The vast majority of new NHS hospitals built after 1997 were built under PFI contracts. The Ministry of Defence was another adopter of numerous PFI schemes.

Overall, from 1997 private financing constituted between 15% and 37% of annual capital expenditure by the public sector.

¹¹ T. Blair (2010) *A Journey*, London: Hutchinson, p.317, 669.

¹² *Hansard*, 28 November 1995, column 1077.

Off Balance Sheet Financing

One attraction of PFI to the Labour Government (and the previous Conservative administration) was to keep debt off the Government's balance sheet. Labour's "fiscal rules", finally destroyed by the 2007/8 international financial crisis, included that public-sector net debt should not exceed 40% of GDP over the economic cycle.¹³

By adopting PFI financing rather than traditional Government debt funding for public investment, the borrowing did not need to be scored when calculating public borrowing and the National Debt, even though an appreciable and growing liability on future generations was amassing.

In 2005, just under one half of PFI projects were estimated to be off the Government's balance sheet and therefore did not count as public-sector debt in the national accounts.

In 2009/10, there was a change brought about by the adoption of International Financial Reporting Standards (IFRS). This resulted in almost all PFI debt being included in the financial accounts of public-sector authorities for financial reporting purposes. However, in central government, capital expenditure is measured according to the European System of Accounts (ESA 95).¹⁴ This means that the vast majority of PFI investments could continue to be excluded from the Public Sector Net Debt (PSND) calculations. In other words, they could be kept off balance sheet in the National Accounts.

Therefore, there remains an incentive in the way the public-sector accounts are drawn up for Government to use private finance over other procurement options.

¹³ There were two fiscal rules: the so-called "golden rule" that over the economic cycle government would borrow only to invest, and "the sustainable investment rule" that over the economic cycle the ratio of net public-sector debt to GDP would be no more than 40% of GDP.

¹⁴ Departmental budgets are drawn up in accordance with the ESA and National Accounts definitions of balance sheet rather than those used by IFRS.

This occurs even though the total payments from the public purse may come to a much larger amount over the life-time of the project than if more traditional forms of public procurement had been used.

Unlike direct public financing of projects, where the cost of the project is met from the departmental budget when the asset is created, PFIs lead to periodic payments called “unitary charges”. These are paid from the department’s current budget in the year they are paid.

Government departments and other public bodies have an annual budget split between a current (resource) budget and a capital budget. Where a department has insufficient capital budget to achieve its investment goals, the response is to turn to some form of private financing. Departmental Expenditure Limits may mean that PFI is the only route for departments to obtain the investment funding they need to achieve their project plans.

But as PFIs create contractual payments which come out of future current budgets, the cost is postponed, though not avoided. As the House of Commons Treasury Select Committee noted: “The incentive for government departments to use PFI to leverage up their budgets, and to some extent for the Treasury to use PFI to conceal debt, has resulted in neglecting the long term value for money implications. We do not believe that PFI can be relied upon to provide good value for money without substantial reform.”¹⁵

The Committee also concluded: “PFI continues to allow organisations and government the possibility of procuring capital assets without due consideration for their long-term budgetary obligations.”¹⁶

Most PFI debt is still invisible in the calculation of the PSND and therefore not included in the headline debt statistics. The unitary charges involve commitments into the future on departmental budgets that could constrain future budgetary flexibility.

¹⁵ House of Commons Treasury Committee (2011), p.58.

¹⁶ Ibid., p.55.

From the perspective of Government departments and other public bodies, PFIs can seem more affordable, even though they may prove more costly over the life of the project. This becomes more acutely the case as capital budgets are cut as part of the Coalition Government's austerity measures. The October 2010 Comprehensive Spending Review provided details of cuts in the capital budgets of departments totalling 29% in real terms over the next five years. By contrast, current spending was reduced by a sizeable, but much lower, 8.3%.

The Government now publishes figures of PFI liabilities alongside the national accounts, providing for some improvement in transparency. But off balance sheet financing continues to give a distorted view of the true PSND position, while the incentives remain weighted in favour of departments and public authorities selecting the PFI route.

The change in accounting practice has only partially addressed the complaint that PFI liabilities are hidden in the national accounts.

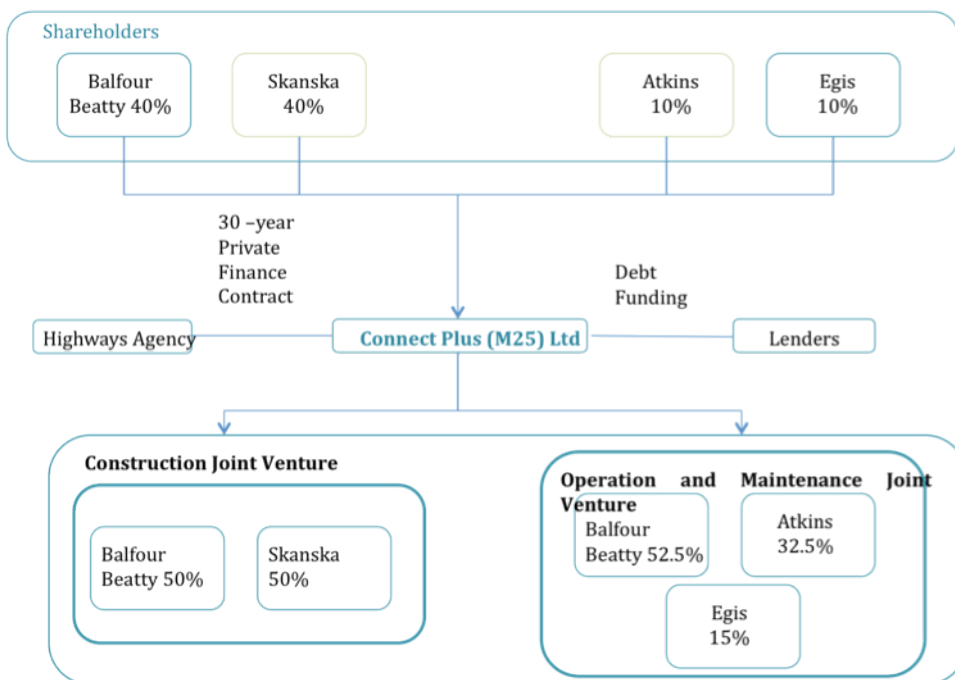
Financing PFI

Under PFI, the private sector manages the design, build, finance and operation (DBFO) of investments in new public infrastructure. Typically, consortia of firms bid for PFI contracts, bringing together the necessary skills. Generally a consortium will include construction companies and facilities management firms and financial investors, including investment arms of banks and equity providers.

PFI transfers to the consortium specific risks to do with the design, construction and life-time operation of the assets, alongside market risks, such as an economic recession affecting revenues.

On signing the contract, the consortium creates a Special Purpose Vehicle (SPV) to deliver the asset and services in accordance with the contract. The SPV is responsible for both the construction and operation. Figure 1 provides an actual example of the organisation of a PFI project, for the M25 contract discussed later. Connect Plus (M25) Ltd is the SPV.

Figure 1: Organisations involved in the M25 contract



Source: NAO (2010) *Procurement of the M25 private finance contract*, p5

The costs of construction and operation, including the return on equity and interest on debt capital, are met by the unitary charge that the public authority pays. The charge is paid from the time at which the contracted facility is available for use. Alterations to the charge can be provided for in the contract to cover specified cost rises or changes in deliverables.

An attraction of SPVs to private investors is that they ensure that lending is “non-recourse”. If the project fails financially, the investing companies can avoid liability for the debts of the SPV.

The SPV enters into subcontracts with firms, usually the construction companies and facilities managers in the PFI consortium. Also, the SPV raises equity and subordinated loan capital from its member companies, and senior debt from banks and other financiers.

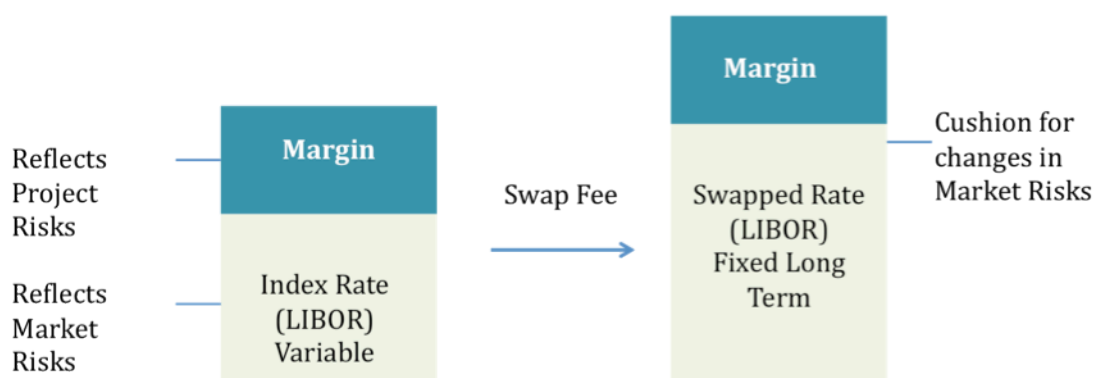
The vast bulk of the capitalisation is in the form of debt. PFI projects typically depend around 90% on debt financing and only 10% on equity financing, and are therefore highly geared (leveraged). The debt financing is provided by bank loans and bond issues. The interest charged on a bank loan is generally a combination of a “reference rate” (typically the interbank rate) and a loan margin. The interbank rate reflects general market risks, while the loan margin reflects project specific risks.

Bond financing can be expected to be split across a number of bonds, which can then be traded in the capital market. Analyses by credit rating agencies assist investors when considering whether to buy the bonds.

Shareholder loans are at higher risk than other debt. If the project company fails, repayment of these loans is junior to the external debt. The external debt is known as senior debt, and is repaid first. The senior debt has first call on the project resources if there is a cash shortfall or contract termination.

One early development in the life of PFI was the refinancing of projects once construction had occurred. Short-term interest rates often exceed long-term rates during the life of a project because the biggest risks generally occur during the construction phase. Advantage was taken of the lower long-term rates once the project construction was completed. Also, variable-rate bank loans could be swapped to fixed rates (Figure 2).¹⁷ This made the debt particularly attractive to institutions such as pension funds looking for reasonably secure long-term receipts.

Figure 2: How a variable rate loan is converted to a fixed rate



Source: NAO (2010) *Financing PFI projects in the credit crisis and the Treasury's response*, p5.

Once the project was refinanced, the financial returns to investors from the PFI project were then well above what the public bodies had intended or expected at the time the contracts were signed.¹⁸

¹⁷ A swap fee is payable to convert the variable rate loan to a fixed-rate loan.

¹⁸ For an example of a refinancing, NAO (2000) *The Refinancing of the Fazakerley Prison PFI Contract*, HC584, Session 1999—2000, London: The Stationery Office.

After a National Audit Office (NAO) report in 2001 on the “windfall” returns achieved by SPVs through refinancing their loans, in 2002 the Office for Government Commerce and several of the major investors in PFI projects agreed a code of practice. This included terms to share 50:50 with the public-sector gains made as a result of refinancing the debt. However, gains achieved on the sale of equity stakes were not included.

The equity financing is provided by the project’s principal contractors and financial institutions. If equities are sold by “primary” to “secondary” investors after the construction period has been completed, this can give rise to a capital gain, the post-tax value of which will, under current arrangements, accrue entirely to the primary investor. The Treasury is currently consulting on voluntary profit sharing in relation to the returns to equity investors from refinancing.

- **Contracting and incomplete contracts**

PFI is expected to provide benefits over traditional forms of public procurement. The benefits come in terms of risk transfer and better management of the project, including lower whole-life costs.

In Britain the standard approach to arranging PFI contracts is for the relevant public body (government department, NHS trust, etc.) to announce the proposed scheme and advertise for bids from the private sector. The bidders are then short-listed, based on ability to deliver and price tendered. A “preferred bidder” is then chosen.

During the initial stage of the competitive tendering, bidders are not required to submit fully worked-up bids. Typically, firm financing has yet to be put in place. Following selection of a preferred bidder, a period of exclusive negotiation occurs.

Some months can then pass during which the preferred bidder seeks the remaining information it needs to finalise the bid, and puts the financing in place. It is during this period that the final details of the contract in terms of price and deliverables are agreed.

The delay introduces a difficulty. The final contract price can vary significantly from the amount initially bid. It is not uncommon for there to be changes to the project specification in terms of deliverables, and to price. The changes may be initiated by the public bodies. Equally, the preferred bidder may attempt to reduce its risks.

In response, the public body could decide to reject the bid and go back out to contract. But if it does, so many months will have been lost. The delay caused by re-bidding can be expected to add to costs. It may also mean that the project has to be withdrawn entirely, if in the meantime public-sector budgets have tightened.

As departments will be reluctant to see prized schemes delayed or even lost, they can be expected to be reluctant to re-open the bidding. The incentives, therefore, are very much weighted in favour of the public body accepting the revised bid or pairing it down only slightly, so as to avoid the preferred bidder walking away.

This introduces moral hazard into the PFI tendering process. It would be surprising if the preferred bidder did not factor into its calculations the likelihood of the public body reopening the bidding.

In addition, it is far from obvious that PFI tenders produce healthy competition even in the first round. In part this is because of the bidding costs.

The House of Commons Treasury Select Committee refers to written evidence that it received that failed bids cost businesses approximately £2m per school and £12m per hospital. It also cited a 2007 NAO study which suggested that in a third of the PFI projects they surveyed between April 2004 and May 2006, only two detailed bids had been tabled. In the same period, only 20% of the PFI projects received four or more bids. This was put down to lengthy tendering periods and the high costs of bidding. On average the overall tendering period lasted 34 months.¹⁹

¹⁹ House of Commons Treasury Select Committee (2011), p.30.

One possible reason for the small number of bidders, in addition to the costs of bidding, may be that senior debt providers are reluctant to back bids from firms with a limited track record of managing PFIs. This reduces entry into the PFI market.

- **Transaction costs**

Economic transactions involve transaction costs. The term transaction cost is used by economists to refer to the costs of tendering, bidding and writing contracts and monitoring their performance. Transaction costs can be expected to be appreciable where contracts are incomplete.

Infrastructure projects are long-term and can be expected to be subject to unforeseen and perhaps unforeseeable events over their life time. It is unrealistic to assume that a PFI contract can include conditions relating to all possible future events. For example, accurately predicting building use and the demand for bed spaces over 25 or 30 years is problematic when arranging PFIs for hospital building.

The difficulties inherent in incomplete contracts are revealingly illustrated by one reported case involving the running of hospital services. The PFI contract specified that the private operator would provide toast for patients' breakfasts, but no one thought to include marmalade. Later the NHS trust agreed to pay extra for the marmalade, and for litter clearance that it had also neglected to specify in the original contract.²⁰

If the PFI contract is a true 'partnership' then the public authority and the private sector have trust in one another and are open to low-cost adaptation to new events. Transaction costs are reduced because "opportunistic behaviour" during the contract's life time is avoided. The public and private sectors work harmoniously together on the project, adapting and compromising as they go along.

²⁰ R.Clark (2005) "The worst of both worlds", *The Spectator*, 4 June, pp.20—21.

But trust may be lacking. The holders of equity in the PFI are unlikely to be keen to change profitable contracts, while there is little obvious incentive for the dominant capital providers, lenders, to facilitate change.²¹ Equally, understandably Government may favour detailed contract specification, to protect the Exchequer from later demands from the contractor for more financing and to protect against shoddy work.

There is extensive evidence of a lack of trust at the heart of a number of PFI contracts. Sometimes “partnerships” between the private and public sectors have fallen apart as events have unfolded. A number of PFI schemes have collapsed following bitter dispute over the contract commitments or because the private sector has miscalculated the profitability of a project.

In so far as there are grounds for mistrust at the outset of the contracting, the contract needs to be tightly specified or more complete, leaving less scope for adaptation later.

Treasury guidance recognises that PFI procurement involves significant transaction costs, often exceeding those of more traditional forms of procurement. Nevertheless, this appears not to have dimmed the Government’s desire to proceed with PFI projects.

- **Procurement skills**

Typically, annual price increases are permitted under the contract to reflect inflation. Other circumstances warranting price changes, such as a change in service specification, are generally subject to negotiation during the life of the contract.

Both the initial award of contracts and the later monitoring and renegotiating require high level procurement skills. Numerous studies over the years have drawn attention to the lack of adequate expertise within Government departments and other public bodies.

²¹ House of Commons Treasury Select Committee (2011), p.27.

The NAO has frequently drawn attention to deficiencies. This includes a lack of direct PFI experience in public-sector project teams. The House of Commons Treasury Select Committee has commented on the Government's over-reliance on external consultants for advice.²²

The lack of expertise within Government means that the taxpayer may not be best protected. The lack of expertise has also led to complaints from the private sector that the result is overly costly bidding rounds and delay in contracting signing.

²² "The need to improve procurement and project management skills in the public sector is something that all are agreed on. In some ways PFI may have exacerbated problems in this area.... We are also concerned that PFI may have resulted in the balance of expertise within the centre of government being tilted too heavily towards financial skills with less input from those with experience in design and construction." House of Commons Treasury Select Committee (2011), p.60.

The Value for Money Test

The case for using PFI over more traditional forms of public procurement, where the Government finances the project up front and engages contractors to do the work for fees, turns on better value for money (VfM). The Treasury has maintained, in the face of some justifiable scepticism, that the decision to undertake PFIs is taken on VfM grounds alone. The fact that the investment may be “off-balance sheet” is supposedly irrelevant.²³

Before the PFI route is chosen, departments complete a VfM assessment, comparing the PFI to a more conventional procurement option with funding provided by central government. This is known as the PSC (Public Sector Comparator).²⁴

The PFI route to procurement is often preferred over the PSC. In part this can be explained by the budgetary advantages for Government departments of using PFIs, as discussed elsewhere. But also the Treasury Guidance on calculating VfM presumes that PFIs will generate valuable additional Corporation Tax receipts. This is despite evidence that SPVs are adept at minimising their taxes, including the use of transfer pricing and off-shore registration.

A particular, and ironic, case in point involved a PFI for the management of the entire estate of offices of HM Revenue and Customs. This was negotiated with a property holding company registered in Bermuda, a tax haven. The House of Commons Treasury Select Committee, based on evidence received, concluded that the ultimate ownership of over 90 PFI projects has moved offshore.²⁵

²³ HM Treasury (2006) *Value for Money Assessment Guidance*, London: The Stationery Office, para.1.17.

²⁴ HM Treasury (2006) *Benchmarking and market testing guidance*, London: The Stationery Office. The Guidance requires that departments submit an Outline Business Case setting out for ministers the rationale for the PFI project. This should include an evaluation of the PFI route compared to more conventional ways of procurement.

²⁵ House of Commons Treasury Select Committee (2011), pp.40—41. The Committee recommended that the NAO “should perform an independent analysis of the VfM assessment process and model for PFI. It should audit all of the assumptions within the model, and report on whether or not these are reasonable.”

The discount rate used when evaluating the Net Present Value of PFI projects against the PSC is significant given the long life over which the unitary charges are paid. When a change in the official discount occurred, the Treasury acted to prevent PFI schemes from seeming less competitive to the PSC by introducing the concept of “Optimism Bias”.

This amounted to the imposition of an assumption in the VfM appraisal exercise of cost over-runs under the PSC option²⁶ This rebalanced the VfM assessment in favour of PFIs.

- **Do PFIs offer better value for money?**

There have been large numbers of studies into the performance of PFI contracts by both official bodies and academic researchers which help to answer the question. The National Audit Office has been particularly active in reviewing and critiquing aspects of various PFI schemes.

In October 2009 the NAO reported on the performance of PFIs in construction. It found that the large majority of projects completed between 2003 and 2008 had been delivered on or close to the contracted timetable.²⁷ Of those projects delivered late, 43% incurred price increases. However, the NAO stressed that PFI projects were not uniquely prone to delays and cost overruns. An earlier report, in 2001, had revealed that some 73% of traditionally procured central government construction projects had come in over budget.

Such evidence is favourable towards PFIs, but it needs to be set against the findings of other NAO reports. For example, a NAO study published in 2010 into the widening of the M25 motorway by the Highways Agency revealed a number of weaknesses. The Agency

²⁶ Ibid., p.32.

²⁷ NAO (2009) *Performance of PFI Construction: A Review by the Private Finance Practice*, London: National Audit Office. This report updated an earlier one, in 2003; NAO (2003) *PFI: Construction Performance*, HC 371, 2002—03, London: The Stationery Office.

needed a solution to high levels of congestion on the M25, and in May 2009 signed a 30-year private finance contract with the SPV Connect Plus (M25 Ltd).

The deliverables included widening two sections of the M25 (of around 40 miles), designing a solution for congestion for two further sections of the M25 (around 25 miles), refurbishing the Hatfield Tunnel, and operating and maintaining the M25 (including the Dartford Crossing plus 125 miles of connecting roads at junctions). The contract had a present value cost of £3.4 billion.

The NAO criticised delays in arranging the contract, which in turn led to higher financing costs.

The NAO concluded that the savings between the privately financed deal and a different form of road widening, conventionally procured, were not as clear cut as the Highways Agency maintained.²⁸

The NAO has also been critical of PFI housing schemes. The NAO reported a large percentage of the projects investigated had been subject to cost increases, sometimes of over 100%. All signed projects for which the NAO had data had been delayed and were signed later than expected. The delays ranged between five months and five years and one month. The average was two years and six months.

While performance and costs varied between the different housing projects, there was broad agreement from local authorities, providers and advisers, that PFI procurement could be excessively costly and generally took too long compared to other procurement routes.²⁹

²⁸ NAO (2010a) *Procurement of the M25 private finance contract*, HC 566, Session 2010–2011, November, London: The Stationery Office. The NAO identified hard shoulder running as an alternative solution.

²⁹ NAO (2010b) *PFI in Housing*, HC 71, Session 2010–2011, London: The Stationery Office.

In 2007 the NAO looked specifically at value testing within Government. After investigating a small number of PFI projects, it concluded: “in some of these initial cases the value testing had demonstrated that value for money was being achieved, but in other cases the outcome was uncertain.”³⁰ A number of difficulties were identified. These included a lack of adequate benchmarking, including a lack of market testing data, to assess the merits of PFI over other forms of procurement. The NAO also criticised the time taken to undertake value testing, typically nine to 25 months.

In a further study in 2007, the NAO concluded that key elements of the PFI tendering process had not improved and in some respects had worsened since an earlier report, while there were signs that the private sector was becoming more selective in developing detailed bids. One in three projects that closed between 2004 and 2006 had received only two detailed bidders.³¹

The NAO’s most recent report on PFI, published in April 2011, concluded that there was insufficient data to determine whether the use of private finance had led to better or worse value for money than other forms of public procurement. In particular, there was limited data to assess whether investors’ returns were aligned with the risks they were taking.³²

- **PFI and quality improvement**

One argument that has been made for the use of PFIs is improved quality of services. However, a study that looked into the build quality of eight PFI hospitals and eight comparator hospitals built using more traditional forms of public procurement, discovered no meaningful differences in quality reported.³³

³⁰ NAO (2007a) *Benchmarking and market testing the ongoing services component of PFI projects*, HC 453, Session 4 June, London: Stationery Office, p.1.

³¹ NAO (2007b) *Improving the PFI tendering process*, HC 149, Session 2006—2007, London: The Stationary Office.

³² NAO (2011), *Lessons from PFI and other projects*, HC 920, Session, 2010—2012, London: The Stationery Office.

³³ M. Hellowell (2010), p.322.

Nor were the services necessarily delivered more cheaply. A study of support services in hospitals, using data for 2005, concluded that with the exception of portering, services provided under PFI were more costly than in non-PFI hospitals. Only in the case of security was the higher cost associated with an increase in quality.³⁴

Other investigations have failed to find in favour of PFIs. In August 2011 the House of Commons Treasury Select Committee concluded that the PFI schemes for new schools and hospitals had been poor value for money and that it was “illusory” that they shielded the taxpayer from risk. The out-turn costs of construction and service provision were broadly similar between PFI and traditionally procured projects.

The Committee’s report confirmed that there was little evidence that PFI-funded projects were of higher quality or more innovative in their design than those procured by other means, or that contractors were incentivised to maintain finished buildings to a higher standard. Indeed, in some cases the evidence presented to the Committee suggested that design innovation was worse in PFI projects and building quality was of a lower standard.

The Committee concluded that “the Government should be looking to use PFI as sparingly as possible until the VfM (Value for Money) and absolute cost problems associated with PFI at present have been addressed.”³⁵

The chair of the Committee, the Conservative MP Andrew Tyrie, was reported as saying when the report was published: “We cannot carry on as we are, expecting the next generation of taxpayers to pick up the tab. PFI should only be used where we can show clear benefits for the taxpayer.”³⁶

³⁴ Ibid., p.324.

³⁵ House of Commons Treasury Select Committee (2011), p.3.

³⁶ <http://www.bbc.co.uk/news/uk-politics-14574059>

Academic research has been similarly critical. Hellowell and Pollock (2009) chronicle a litany of PFI failures in the NHS and a worrying future financial burden for unsuspecting taxpayers.³⁷ Research by Professor Jean Shaoul of Manchester University has drawn attention to numerous examples of PFI failures.³⁸

Mark Hellowell (2010) attributes the failure of the private sector to provide innovative new methods of build quality to the pressure exerted by senior debt providers in PFI schemes. Senior debt providers may be keen to avoid over risky, if innovative, forms of design and construction, wishing to ensure that there is sufficient cash flow to service their loans.

Certainly there have been some spectacular PFI failures. For example, the upgrade of the Jubilee London Underground line went massively over budget and was late. A total of £614 million was spent before the scheme was transferred to the public authority Transport for London, in the summer of 2010.³⁹

A highly controversial upgrade of the London Underground using PFI, vigorously opposed by the then Mayor for London Ken Livingstone, ended up costing two and a half times more than originally planned. In July 2007 one of the PFI operators, Metronet, collapsed after severe cost overruns.⁴⁰ There was no likelihood that a replacement private sector contractor would take the contract over, and the functions returned to Transport for London.

The Airtanker PFI contract negotiated by the Ministry of Defence with a private contractor apparently went some £1.5 billion over budget. The Ministry of Defence has announced that it is reopening three major contracts.

³⁷ E.g. M. Hellowell and A.M.Pollock (2009) "The Private Financing of NHS Hospitals: Politics, Policy and Practice", *Economic Affairs*, vol.29, no.1, pp.2—5.

³⁸ E.g. J. Shaoul (2002) "A Financial Appraisal of the London Underground Public-Private Partnership." *Public Money and Management*, vo. 22, no.2, pp. 53-60; J. Shaoul (2005) "A critical financial analysis of the Private Finance Initiative: selecting a financing method or allocating economic wealth?" *Critical Perspectives on Accounting*, vol.16, no.4, pp.441—471; J. Shaoul, A.Stafford and P.Stapleton (2008) "The Cost of Using Private Finance to Build, Finance and Operate Hospitals", *Public Money & Management*, vol.28, no.2, pp.101—108.

³⁹ <http://mediapoint.press.net/article.jsp?id=7909484>

⁴⁰ Office of the PPP Arbiter, Press Notice 03/07, 16 July 2007.

As the NAO observed in the Foreword to its report in 2009 on the use of PFIs in construction: “Our long-held view on PFI is that it is neither always good value for money, nor always poor value for money. It has the potential to deliver benefits but not at any price or in any circumstances. In practice its value is contingent on a wide range of contract, sector and market specific factors.”⁴¹

- **Risk transfer**

The argument for PFI often turns on risk transfer as well as VfM. PFIs can shield the taxpayer from the consequences of delays and cost overruns where prices are fixed. John Laing plc recorded a £68m loss on a project involving the National Physical Laboratory, agreed in 1998. A PFI contract to refurbish eight schools in the North West of England brought the construction company Jarvis plc to its knees in 2004; seemingly, Jarvis had made the mistake of quoting too low for what was, in effect, a fixed-price contract.

However, sometimes the public sector has picked up at least some of the costs when there have been contract failures, as in the case of Metronet, suggesting that risk transfer is not guaranteed. Also, usually the main risk of delays and cost overruns is at the construction stage of a project. Other forms of procurement to PFI can transfer risk to the private sector contractor, such as fixed price contracts and “turn key” contracts. Risk transfer is not a particularly convincing argument for the use of PFIs.

⁴¹ NAO (2009), p.5.

The International Debt Crisis

What is unequivocal is that PFIs are storing up costs for future generations; and that the costs have risen due to the international debt crisis.

The international debt crisis beginning in 1997/8, and with no end in sight, has seriously impacted on the economics of PFIs. The recent dramatic changes in the financial markets appear to have had an appreciable effect on the financing costs and therefore on the VfM calculation.

Between 1999 and 2007, with the ready availability of bank finance and competition between banks offering loans lowering PFI financing costs, contracts could be let with relatively low financing charges. The PFI loan margin, the part of the interest charge relating to project risk, averaged around 1% or less. The financial crisis changed all that.

Before the financial crisis, credit insurance would improve a bond's rating. This would make a bond more attractive to investors such as pension funds. Also, the banks made scope for new loans by selling existing debt in whole or in part to other banks, in a process known as syndication.

The collapse of Lehman Brothers in September 2008 halted loan syndication and the collapse of the credit insurance market increased the risk of holding bonds. The difficult conditions in the capital market since 2008 have meant that first bond financing and then bank financing have become appreciably more difficult and costly to obtain.

Bank lending dried up after the collapse of Lehmans, and where lending has since occurred, the banks have favoured higher cash generating PFI deals. The cost of senior debt has risen sharply as banks have reduced their exposure to risk and repaired their balance sheets.

The cost of bank finance has increased by one-fifth to one-third in terms of interest charges, and banks have sought to de-risk their lending to projects, including renegotiating borrowing terms with preferred bidders, so as to lower the proportion of debt in projects and to increase cover ratios.

Banks have also required private investors to inject risk capital earlier and placed more restrictive conditions on when the investors could withdraw cash. As the terms of financing deals have become more onerous, contracts have become harder to finalise.⁴²

In late 2008, bank lending became so restricted that no sizeable PFI contracts could be let. Fearing that the slowdown in infrastructure investment would damage the economy, and with important planned PFI projects at risk - for example to improve school facilities and tackle road congestion, in March 2009 the Treasury announced the creation of the Infrastructure Finance Unit.⁴³

According to the NAO, uncertainty in the financial markets has raised the costs of debt financing by between 20 to 33%, and the overall financing costs have increased the annual contract charge under typical PFI projects by 6 to 7%.

The House of Commons Treasury Select Committee in its recent report concluded that the long-term expense of PFI deals was now much higher than conventional forms of public sector project financing as a result of the international financial crisis. The cost of capital for a typical PFI project was put at over 8%, or twice the long-term gilt rate. Evidence to the Select Committee suggested that paying off £1bn of debt incurred through PFI may cost the taxpayer the equivalent to a direct government debt of £1.7bn.⁴⁴

⁴² NAO (2010c) *Financing PFI projects in the credit crisis and the Treasury's response*, HC 287, Session 2010—2011, London: The Stationery Office.

⁴³ The Treasury's Infrastructure Finance Unit is a wholly government-owned private limited company established to provide senior debt to projects on "commercial terms", until more normal conditions return to the financial markets.

⁴⁴ House of Commons Treasury Select Committee (2011), p.3, 18.

This suggests that there could be around a 70% increase in investment if Government rather than private financing was used. Alternatively, the potential saving from using Government financing could be in the order of 42% (Table 2). The calculations by the Committee suggest that PFI financing involves a significant opportunity cost.

Table 2: The comparative financial cost of capital expenditure

	Cost - Present Value (@ 4.2% discount rate)
Private finance	£421 million
Government finance	£246 million
Savings and benefits PFI needs to deliver in other areas to offset the extra cost of private finance	£175 million
Potential increase in investment possible if using government financing, assuming no offsetting efficiencies from PFI (%)	71% increase
Potential saving from using government financing, assuming no offsetting efficiencies from PFI (%)	42% saving

Source: House of Commons Treasury Committee (2011), Table 2, p.18.

Intergenerational Equity

Procuring infrastructure assets creates long-term commitments for the public finances. Nevertheless, there is no outward suggestion of any lessening of support for PFIs on the part of the new Coalition Government. Indeed, fiscal constraints can be expected make PFI even more attractive to Government. Government is keen to see more investment in the economy, while unable or unwilling to authorise a higher Public Sector Net Debt (PSND).

Although there is Treasury guidance within Whitehall on assessing the VfM of PFI projects, despite the change in financial accounting treatment in 2009/10 the method of calculating PSND can be expected to continue to act as an incentive to use PFI.

Gauging the true long-term costs of PFI deals, and therefore the impact on future generations involves contrasting the benefits obtained from PFI (Bpf) projects compared to the benefits that would have accrued had the projects been publicly financed (Bpp) – public financing being the counterfactual. The result is then set against the relative costs of PFI funding (Cpf) over more traditional forms of public procurement (Cpp).

An alternative counterfactual is that the projects would not have been publicly funded because of fiscal restraints and therefore would not have proceeded. However, where there is a pressing need for infrastructure projects, abandonment is not a credible policy option, at least for long. Also, the failure to fund a project that would provide net public benefits (benefits over costs) is not rational from an economic perspective. Abandonment occurs only because of capital rationing within Government. For this reason, this counterfactual is not pursued.

The assessment within Government when choosing the method of procurement on VfM grounds should be the present value of the net benefits (the net benefit each year over the life of the project discounted to present value). Discounting makes sense for someone deciding whether to invest in a project today that generates future revenues and costs, but intergenerational equity is concerned with the welfare effects at a particular time in the future.

Take children born today who become adults in 18 years. Suppose that they benefit from the project and become taxpayers once they are adults. Suppose that the project has a life of 30 years from construction. The issue is what is the net benefit from the investment that they receive as an adult? In terms of a choice between public and private financing this is given by the following formula:

$$\sum_{n=18}^{30} (B_{pf} - B_{pp}) - (C_{pf} - C_{pp})$$

In other words, they receive the net benefit from the project financing from years 18 to 30. This is a stylised example to make a point but in practice making such a calculation is hazardous. In particular, future benefits are likely to be difficult to quantify with any real certainty. Infrastructure assets become obsolete or unwanted. However, as we have seen, the evidence on the VfM of PFI schemes over more traditional forms of public procurement suggests that overall the benefits may be roughly the same. Some projects appear to have led to improved services but others not.

Assuming that the benefits are broadly comparable averaging over all PFI projects, then the calculation reduces to a comparison of the relative costs of provision:

$$(C_{pf} - C_{pp})$$

But the evidence is that public financing is less costly than private financing, and especially so since the start of the international financial crisis. Of course, financing costs may change in the future. Nevertheless, it does not seem unreasonable to conclude that for our child born today:

30

$$\sum (C_{pf} - C_{pp}) > 0.$$

N=18

As it is clear that the costs of public financing are appreciably less than the costs of PFI financing, it follows that future generations bear a higher cost of infrastructure provision due to the adoption of PFI.

HM Treasury publishes summary data on UK Private Finance Initiative (PFI) projects twice yearly. The latest data relates to the position by 16 March 2011, and is summarised in Table 1.1. The figures show expected annual PFI payments between 2011-12 and 2030-31 of between £8.1bn and £9.7bn a year. The numbers then tail off, as existing PFI contracts come to an end. But as new contracts enter the figures after 2030-31, they can be expected to rise sharply.

Table 3: Signed projects*

		Forecasts	£ million
2011-12	8569	2030-31	8107
2012-13	9064	2031-32	7618
2013-14	9497	2032-33	7155
2014-15	9646	2033-34	6491
2015-16	9700	2034-35	5895
2016-17	9645	2035-36	5058
2017-18	9747	2036-37	4474
2018-19	9325	2037-38	3854
2019-20	9489	2038-39	3545
2020-21	9549	2039-40	2876
2021-22	9396	2040-41	2188
2022-23	9269	2041-42	1639
2023-24	9257	2042-43	1212
2024-25	9415	2043-44	677
2025-26	9382	2044-45	565
2026-27	9142	2045-46	260
2027-28	9056	2046-47	267
2028-29	8957	2047-48	274
2029-30	8657	2048-49	20

* Figures based on departmental returns.

Source: Relevant Departments and Devolved Administrations – March 2011; HM Treasury (2011a) UK Private Finance Initiative Projects: summary data, pfi_data_summary_march2011, Table 1C.

In total, the Treasury's figures in Table 3 suggest outstanding liabilities in terms of contracted future payments under PFI contracts totalling a staggering £239 bn.

This total, however, overestimates the true net liabilities passing to future taxpayers from PFI projects, because allowance needs to be made for interest payments that would have been due had public funding, through the issuing of gilts, been used instead. The net figure of the burden on future generations will therefore be lower.

Even so, given that gilt funding is cheaper than private sector financing, it is unmistakable that future generations will bear an appreciable cost.

The additional cost will be borne by future citizens in the form of higher taxes or lower totals of other Government spending. Insofar as the public is resistant to higher taxes, PFI liabilities threaten the future viability of departmental budgets, as some ministers worried in private as early as the mid-1990s.

This is already apparent in the NHS. Over the last decade private companies have built new hospitals and other health service facilities under PFI terms, with NHS Trusts entering into contracts to make annual payments for up to 50 years. Once the last scheme signed so far is paid off, in around 2049, it is estimated that more than £70bn will have had to be paid to the private sector in PFI charges.

In September 2011 the Government revealed that it considered 22 Health Trusts already to be at risk because of the expense. Part of the cost relates to the provision of services, such as building maintenance, cleaning, catering and portering. But even after these sums are taken out, the total payment is expected to far exceed the value of the building projects.

Health Secretary Andrew Lansley is reported as saying: “The truth is that some hospitals have been landed with PFI deals they simply cannot afford.”⁴⁵ It is thought that PFI schemes could cost the NHS £20bn more than if PFI had not been used. This liability rises as new NHS PFI projects are signed.

It seems clear that decisions made over the last decade or so have been made selfishly. This has involved providing new infrastructure now, while handing down to our children a significant proportion of the costs of provision.

⁴⁵ <http://www.bbc.co.uk/news/health-15015381>

Conclusions and Recommendations

PFI has become a preferred method of providing for new infrastructure in Britain since the 1990s. There are currently around 800 PFI contracts. The new Office of Budget Responsibility (OBR) has estimated that the total capital liability, on and off balance sheet, is close to 2.9% of GDP. If all current PFI liabilities were included in the National Accounts, then the OBR estimates that National Debt would be increased by £35 bn or 2.5% of GDP.⁴⁶

The Treasury estimates that the current commitments on PFI contracts are in the region of £230bn. Nevertheless, the Coalition Government remains committed to PFI. In total, 61 new PFI projects were being procured as of March 2011, with a total estimated investment value of £7bn.⁴⁷

Departments and other public bodies are expected to make the case for choosing PFI over more traditional forms of public procurement on VfM grounds. But reviewing the evidence demonstrates that there are no strong grounds for arguing that PFI projects provide reliable benefits in terms of superior delivery, lower life-time costs or quality of provision.

Nor is there convincing evidence of effective risk transfer. The private sector may be able to abandon public projects, but public authorities do not have the same discretion. What is clear is that PFIs involve a form of financing which is far more expensive than direct public funding.

In other words, the case for the use of PFIs on economic grounds is highly questionable. Meanwhile, PFI payments pose a burden on the budgets of government departments and public authorities, stretching into the future. In the NHS this may mean cuts in health services to make ongoing PFI repayments.

⁴⁶ Cited in House of Commons Treasury Committee (2011), p.12.

⁴⁷ House of Commons Treasury Committee (2011), p.4; HM Treasury (2011b) *PFI Projects in Procurement*, London: The Stationery Office.

As the House of Commons Treasury Select Committee recommended, there is an urgent case for the Government to commission independent research into the PFI policy and its effects on the public finances. This should include an exploration of the impact on future Government taxes, charges and spending.

In addition, Government needs to publish more accurate and reliable data on the condition of PFI assets and the future liabilities, including accounts that reveal asset creation and asset depreciation. Also, the net liabilities need to be fully and properly exposed in the national accounts. The accounting changes in 2009/10 do not go far enough. They still leave a big incentive for the Treasury to favour PFIs over public borrowing.

The promotion of PFIs has, and continues to, threaten to place, an unfair and growing liability on future generations. One possible way of addressing this, as suggested by the Treasury Select Committee, would be to refinance the debt.⁴⁸ The Treasury Committee estimated that for every percentage point that the interest rate on the debt was reduced, the annual savings to taxpayers could be in the order of £400 million.

The refinancing could be arranged so as to place more of the liability on current taxpayers. However, it is to be expected that this would be strongly opposed by the politicians. Current taxpayers have votes, new future taxpayers do not.

Another possibility, again explored by the Treasury Select Committee, would be for the Government to buy up the debt in PFI projects, and perhaps the equity, once the construction stage is over. Once construction is completed, the case for PFIs on grounds of risk transfer greatly recedes. The PFI liabilities would be made more visible and the interest costs would fall significantly because of the lower costs of Government financing.

Another alternative would be to set aside a fund, added to annually by current taxpayers, to meet an estimate of the net liabilities future generations will face under existing and new PFI projects because of the dearer private financing.

⁴⁸ House of Commons Treasury Committee (2011), p.44, 60.

Currently the Bank of England is buying up securities as part of its Quantitative Easing policy. Perhaps some of these securities could be transferred to the Treasury to form the nucleus for the fund. What is clear is that unless action is taken, PFIs risk imposing a real economic burden on future generations.

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