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Private Finance Initiative

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Additional written evidence

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3.3 Affordability

3.3.1 Our first findings on the adverse effects on services of PFI affordability problems were published in 1997 and subsequently in a series of case studies. Dunnigan and Pollock (2003) undertook a systematic assessment of the impact of PFI on hospital capacity in Scotland.

3.3.2 Pollock, Price and Liebe (2011) showed that the NHS is facing serious revenue pressures if it is to meet the target of £15–20bn efficiency savings by 2013–14. A major source of revenue pressure for trust budgets in England is the annual PFI charge, which is ring-fenced and indexed to inflation. Although PFI charges pre-empt between 0.4% and 18.6% of annual hospital trust income, PFI contractors are insulated from efficiency targets. This, coupled with serious deficiencies in contract monitoring, compliance, and contract enforcement at departmental level, means that there are real concerns over the value for money of the policy. Lack of control over PFI costs has serious implications for quality and levels of NHS care.

4. *How far can risk really be transferred from the public to the private sector?*

4.1 Pollock and Price (2008) drew attention to failures by the NAO to audit risk transfer and rates of return. The study found that of the 622 PFI deals signed by October 2007, the NAO has examined the relationship between risk transfer and risk premiums in only three. They concluded that the government's justification for the policy was largely unevaluated and unscrutinised by Parliament, raising wider issues of public accountability for public expenditure.

4.2 In 2007 Pollock, Price and Player highlighted substantial flaws in Treasury claims about risk transfer under PFI. UK government procurement policy rests on Treasury claims that the PFI has reduced cost and time overruns. The five studies cited by the Treasury in support of this claim were reviewed and it was found that only one purports to compare PFI with traditional procurement. The results of this single study are uninterpretable because of selection bias, small sample size (only 11 out of 451 PFI projects are included), and fundamental flaws in the analysis. There was therefore no evidence to support the Treasury cost and time overrun claims of improved efficiency in PFI. We concluded that Treasury appraisal guidance, the Green Book that compares PFI with other methods of procurement, was not evidence based but biased to favour PFI.

4.3. In 1999, Gaffney, Pollock, Price and Shaoul showed that the use of land sales and capital charges to fund investment meant that local affordability, not national priorities, determined investment; that the high costs of private sector financing increased affordability problems at national and local level; and that the increased costs of the private finance initiative were being met from hospital closure programmes, reductions in services and capacity, subsidies from the Treasury, NHS block capital allocations, and trusts' operational budgets.

4.4. In 2002 and in various papers since, I have drawn attention to weaknesses and bias in economic appraisal methodology.

June 2011

Written evidence submitted by Professor David Heald

Introduction

My memorandum concentrates on those issues raised by the Committee's request for evidence on which I have specialist expertise. I make some brief comments about other matters within the remit of this Inquiry.

Responses to Questions

Committee Question 2A: *If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much?*

The answer is categorically "No".

I refer the Committee to the table showing the October 2007 classification of UK Private Finance Initiative (PFI) projects as on- or off-balance sheet for financial reporting. This was included in the memorandum of evidence I submitted to the Committee in the previous Parliament, in relation to the 2008 Budget Report (Heald, 2008, p Ev67).

At the request of the then Chairman, I submitted supplementary evidence on accounting for PFI after the oral evidence session on 14 December 2009 (Heald, 2010). That memorandum provides a concise summary of the conclusions of my academic research on PFI accounting (Heald and Georgiou, 2010, 2011).

It is inconceivable that such a pattern across functional departments could have emerged as a result of the objective characteristics of particular projects. Education (0% on-balance sheet) and Health (2%) contrasted markedly with Justice (93%) and Transport (88%) (Heald, 2008). This pattern arose because of (a) public expenditure control arrangements, and (b) auditor appointments. The then Comptroller and Auditor General (Sir John Bourn) drew Parliament's attention to departments indicating on their websites that PFI projects had to be off-balance sheet, notwithstanding the Treasury's declared policy that accounting treatment would not influence project choice. The National Audit Office (NAO) took a more restrictive line than the appointed auditors of the Audit Commission. The fact that this could happen resulted from the availability of arbitrage between the Accounting Standards Board's FRS 5A (ASB, 1998) and the Treasury Technical Note 1 (Revised) (TTN1R, Treasury Taskforce, 1999). It is also noticeable that the Northern Ireland Audit Office followed the NAO approach whereas Audit Scotland and the Wales Audit Office did not (Heald and Georgiou, 2011).

The consequences were (a) inconsistent treatment across sectors and countries, and (b) probable loss of Value-for-Money (VFM) because accounting treatment became a dominant consideration in project choice (Heald, 2003).

It is important to note that this accounting arbitrage ended with the adoption of International Financial Reporting Standards (IFRS) from 2009–10. The adoption of the mirror image of IFRIC 12 (IASB, 2006), changing the criterion from risks and rewards to control, brought almost all PFI projects on-balance sheet for financial reporting. However, the Treasury (2009b) announced in June 2009 that Spending Review 2010 would be conducted on a national accounts basis, exploiting the lax criteria in the Eurostat (2004) rules. All that is required to keep PFI projects off the national accounts public sector balance sheet is the transfer of construction risk and availability risk to the private sector consortium (Heald and Georgiou, 2011).

Committee Question 2B: *How should PFI deals be accounted for?*

I have written extensively on this topic (Heald, 2010; Heald and Georgiou, 2010, 2011), so I will here concentrate on the major issues without providing full justification for my conclusions.

The crucial point to note is that there are two separate types of accounting for government activity: that for financial reporting (now IFRS, as modified by the Treasury's Financial Reporting Manual and approved by the Financial Reporting Advisory Board) and national accounts (ESA 95 being the governing regulation).

My view is that the PFI financial reporting problem—arbitrage being rife—has now been resolved in the United Kingdom. This took 10 years, and alertness is required to ensure that PFI schemes are not modified to escape from the remit of the mirror image of IFRIC 12 (IASB, 2006; Heald and Georgiou, 2011). The bringing of PFI on balance sheet to the public sector client has been attributed by the Treasury to the move from risks and rewards as the criterion under UK GAAP to that of control under IFRS. I am not convinced by this argument as most projects would have been On-balance sheet under UK GAAP if FRS 5A had been properly applied and not arbitraged by TTN1R. The switch to IFRS provided a convenient cover for a change that had long been necessary.

The new UK arbitrage is between IFRS-derived financial reporting (almost all PFI is on the client balance sheet) and budgetary treatment following national accounts. The June 2009 announcement that Spending Review 2010 would treat PFI on a national accounts basis (Treasury, 2009b) also ran counter to the objectives of the "Clear Line of Sight project" (Treasury, 2009a). Misleadingly, the Treasury has claimed that it must follow national accounts treatment for budgeting purposes: the United Kingdom has long used control aggregates which, though national accounts based, deviated from them in various ways (Heald, 1995). The important issue now is to ensure that there are clear reconciliations between various presentations.

In summary, my answer to the direct question is as follows:

— I support the existing financial reporting treatment.

— I believe that the budgeting treatment will create a new phase of project distortions, with (a) PFI being preferred to conventional procurement for "accounting" rather than VFM reasons, and (b) PFI schemes that satisfy the Eurostat rules for off-balance sheet treatment being preferred to those which do not.

Committee Question 3: *How far can risk really be transferred from the public to the private sector?*

Committee Question 4: *Are there particular kinds of risk which are particularly appropriate for transfer through PFI deals, or particular projects which are suited for PFI?*

Questions 3 and 4 should be taken together. A standard decomposition of risk in relation to PFI projects is as follows:

— construction risk;

— design risk;

— demand risk;

— third-party revenue risk;

— penalties for under-performance;

— penalties for non-availability;

— potential changes in relevant costs;

— obsolescence; and

— residual value risk.

Under PFI, construction risk can be transferred to the private sector and, in most UK PFIs, this has been done. This was not relevant to financial reporting treatment under FRS 5A because it is extinguished prior to accounting recognition by the public sector client. However, it is relevant to VFM calculations (Heald, 2003) if such risk transfer cannot be achieved under conventional procurement. Importantly, this opens up a wider question of why the UK public sector finds it difficult to transfer construction risk on conventionally-financed projects. This emphasises the importance of considering PFI, not in isolation, but within the context of overall public procurement policy.

In international discussions, terminology poses a serious obstacle to understanding. The United Kingdom regards PFI as a sub-set of a broader set of public-private interactions, labelled as “Public-Private Partnerships” (PPP). In most other countries the term PPP is used either for all asset-based long-term contractual service delegations (PFI in the United Kingdom) or only for those service concessions (such as motorways and tunnels) where there are third-party payers.

The critical issue is whether the public sector client can actually transfer risk to the private sector which operates through a Special Purpose Vehicle (SPV). Attempts to transfer risk inappropriately to the SPV will (a) be expensive, and (b) increase the probability that the SPV might default. Australian States have made extensive use of PPPs for tolled infrastructure, transferring some or all demand risk. Experience has shown that what is really important is that there are mechanisms through which a PPP project can be smoothly passed from a failing operator to a new operator, without cost to the public sector or inconvenience to users. In New South Wales, these transitions have been accomplished in relation to three transport infrastructure PPPs, showing that (some) demand risk had been transferred.[102]

In the above cases, the credibility of demand risk transfer was clearly related to (a) the existence of third-party payers, (b) features of contractual design, and (c) the facility being sufficiently free-standing. Without such features, demand risk transfer is likely to be (i) extremely expensive (transfer is not VFM), and (ii) ineffectual (the SPV lacks the capacity to sustain the risk when it materialises).

Those risks associated with the operational phase of the PPP are more conducive to transfer, subject always to the condition that the SPV must be able to withstand the materialisation of such risks, either from its own resources or through insurance or parental guarantees. In this category are to be found: penalties for under-performance; penalties for non-availability; and potential changes in relevant costs.

Typically, the physical asset may have an expected economic life of 60 years, in comparison with the PFI duration of 30 years, after which that asset reverts in good condition to the public sector client. It is for this reason that residual value risk is regarded as so important in relation to balance sheet treatment for financial reporting. Issues of design risk (the facility is not well-designed for purpose) or obsolescence risk (the facility becomes less functionally suitable because of changes in service delivery patterns) will also manifest themselves in effects on residual value at reversion date. Whether residual value risk can be transferred to the SPV will depend, *inter alia*, on whether the public sector client would have access to alternative facilities at the reversion date.

Residual value does not figure in the Eurostat (2004) rules regarding national accounts treatment. However, it figures importantly in financial reporting treatment under the “mirror-image of IFRIC 12” treatment required by the Treasury and which is proposed in the International Public Sector Accounting Standards Board’s Exposure Draft 43 (IPSASB, 2010). Tightening financial reporting treatment may lead to some reconfiguration of PFI projects so that they fail on the control tests of the mirror-image of IFRIC 12 (ie fall outside its scope) (Heald and Georgiou, 2011). If so, this would repeat the earlier experience of PFI projects being designed, possibly in ways damaging to VFM, to fail the risk and rewards test of FRS 5A.[103]

An overriding point is that it should not be an objective of PFI to transfer risk to the private sector but only to transfer those risks which the private sector is better equipped to handle, either in terms of managerial action that reduces the amount of risk or of being able to bear that risk in less costly ways. Attempting to transfer inappropriate types of risk will instead lead to excess costs and to potential default, with the materialising costs falling on the public sector. This echoes an important lesson from outsourcing in the petroleum industry: if the responsibility—legal and reputational—remains with the “principal”, the loss of operational knowledge and control may offset the apparent cost savings. Especially in an institutionally fragmented public sector, it is difficult to be an intelligent client and to sustain that through a 30-year PFI.

[102] Three New South Wales Government PPPs have run into financial difficulty. In each case the operator went into receivership (due to patronage not meeting initial expectations) and the receiver subsequently sold the business to a new operator:

— The Cross City Tunnel is a 2.1 km road tunnel under the City of Sydney. It opened in August 2005. The operator went into receivership in 2006 after the traffic volumes failed to meet initial expectations. The receiver sold the operation to a new operator in December 2006. The tunnel will transfer to the State at the end of the 30-year term of the PPP.

— The Lane Cove Tunnel is a 3.6 km road tunnel at Lane Cove, a Sydney suburb. It opened in March 2007. The operator went into receivership in January 2010 after traffic volumes failed to meet initial expectations. The receiver sold the operation to a new operator in May 2010. The tunnel will transfer to the State at the end of the 30-year term of the PPP.

— Four privately-operated railway stations opened on the new (State-operated) railway to Sydney Airport in May 2000. The operator went into receivership later that year due to passenger volumes failing to meet initial expectations. The receiver eventually sold the stations to a new operator in March 2007. The stations will transfer to the State at the end of the 30-year term of the PPP.

This information has been provided to the author by the New South Wales Treasury.

[103] It is not possible to be conclusive on this point. Alternatively, it could be argued that it was so easy to arbitrage FRS 5A by reference to TTN1R that project redesign was unnecessary.

Committee Question 5: *If PFI debt had been on-balance sheet rather than off-balance sheet would PFI projects have been used as much?*

I have answered this Question at 2A and 2B above.

Committee Question 6: *In what circumstances are PFI deals suitable for delivery of services?*

The PFI should be regarded as one option in the armoury of public procurement. It should be neither ruled out *ex ante*, nor imposed through the operation of budgeting and authorisation rules, as was widely understood to have occurred with NHS and schools projects in much of the 2000s. The VFM of PFI schemes can only be effectively assessed if there is a mixed procurement model, when the Public Sector Comparator (PSC) is credible because it is fundable. Where it is known in advance that no public funding is available, whatever the numerical results of a Green Book (Treasury, 2003) project appraisal, it is predictable that the PFI project will almost always be pronounced best VFM. Moreover, in such circumstances, the lack of recent experience with conventional procurement means that the PSC is not credible, either to advocates or critics of PFI.

During an extended period of fiscal austerity, the "shortage of public capital" argument will again have influential advocates, such as PricewaterhouseCoopers (2011). In most circumstances this argument is invalid.[104] Although VFM judgements are difficult to make, depending on forecast events over long time horizons, decisions on the role of PFI should be driven by VFM considerations, not by the desire to evade budgetary restrictions. Governments learn how to present narratives: the official rationale for the policy being VFM while it is widely known that the driving factor is budgetary and accounting treatment. Not only is this damaging to transparency but it is also likely to damage achieved VFM.

Further Observations

Whereas it is now clear how accounting treatment—both financial reporting and national accounts—does treat PFI projects, the satisfactory resolution in relation to financial reporting (almost all UK projects are rightly on-balance sheet) will not be matched by national accounts treatment. The international context of changes in national accounts means that the present lax arrangements will remain in place indefinitely. However, that does not prevent the United Kingdom from being fully transparent in its own budgetary presentations, including the publication of clear reconciliations.

Assessing VFM from PFI remains problematic, both at the *ex ante* project appraisal stage (for the reasons discussed above) and *ex post*. The long duration of PFI projects means that a definitive assessment is necessarily long-term, after which much else will have changed and there will be inevitable disputes about the relevance of findings about projects executed many years previously. Nevertheless, given the scale of UK PFI, it is imperative that there are systematic empirical studies of cohorts of projects across functional areas of government at key stages in their life: e.g. commissioning; early operation; mature operation; and reversion. Restrictions on resources and access to information mean that academics are unable to undertake such studies. This puts an enormous responsibility on public audit offices across the United Kingdom to undertake such studies and on the Parliaments and Assemblies to demonstrate interest in dispassionate work. It would be expecting too much for such studies to eliminate political disagreement about the desirability of the PFI but such work can aspire to provide a sounder factual basis for policy discussions.

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[104] Some countries, particularly in the developing world, may not have access to capital markets. In the case of non-tolled PFIs, the "shortage of public capital" argument is frequently used without regard to the fact that the PFI unitary charges will have to be met from future budgets.

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Further written evidence submitted by the Foundation Trust Network (FTN)

ISSUES AROUND ACCESS TO CAPITAL FOR NHS FOUNDATION TRUSTS AND AN NHS BANKING FACILITY

Introduction

1. The Foundation Trust Network is the independent membership organisation for authorised and aspirant foundation trusts. We represent 212 public provider organisations in the acute, mental health, ambulance and community services.

2. We understand that the Committee received oral evidence on 14 June from the NHS Confederation and following that has requested a supplementary note on an NHS banking function. This is a critical issue for FTN members and we have been considering the role of a banking function for some time. Below we outline some of the emerging issues from our perspective, which we hope is helpful to the Committee's deliberations and which we consider complements the NHS Confederation paper.

3. Our members have a particular concern for the access of public sector providers to capital and working capital in future. There is undoubtedly a need for banking functions for the NHS to support re-structuring, day to day risk management and longer term capital investment programmes. Adequate amounts of capital are unlikely to be available from the public purse alone.

Background

4. The original form of the Health and Social Care Bill proposed significant changes to the environment for financial activities, including:

- All NHS Trusts to become Foundation Trusts (FTs) by 2014—even though this has now been "softened" and the deadline will be extended for some.
- More freedoms for FTs including removal of prudential borrowing limits and the Private Patient Income Cap; clarification on the responsibilities of FT Directors; and extended roles for FT governors (although this will not now be in force until 2016 as Monitor's jurisdiction has been extended to this date);
- A new sector regulator with the duty to set prices;
- Proposals for a new asset steward / investment management function to oversee the £23 billion of PDC in provider organisations to be known as the NHS Investment Agency (NHSIA).

5. For those organisations working towards FT status, access to capital on the pipeline will be critical.

6. There were some changes to the Bill following the pause that are less helpful and where uncertainty remains. These changes are to the original proposals covering continuity of services and a special administration / failure regime which were meant to be developed under the purview of the regulator.

7. Whilst no policy has finally been decided, it now appears that the failure regime will not be independent and that the Secretary of State will have step in or veto rights within it. Additionally, the system for protecting patient services and who pays for such protection remains an unanswered question, but is much more likely to be controlled by the NHS Commissioning Board. Taken together with greater powers of challenge for Health and Wellbeing Boards with Overview and Scrutiny Committees remaining intact, it will be even more difficult for providers to successfully reconfigure services in order to avoid failure.

8. It had been planned that the NHSIA will take over the functions of the existing Foundation Trust Funding Facility. It is not yet clear how much the NHSIA role and scope will change as a consequence of the recent