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Value for money tests and accounting treatment in PFI schemes

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Abstract *In Private Finance Initiative (PFI) projects, value for money (VFM) tests and accounting treatment are distinct but related issues. VFM analysis should be concerned with total risk, not just with the sharing of risk, which dominates the accounting treatment decision. A framework is developed for logical thinking about what is meant by “best VFM” in the context of PFI projects. This involves consideration of the full set of alternatives, not an artificially diminished subset. The credibility of analytical techniques can be tarnished if they are misused to legitimate a predetermined decision. A reduction in construction risk may be a powerful source of VFM gains under PFI, but, under UK accounting regulation, this should not influence the accounting treatment decision. New complications about how VFM should be interpreted arise directly from the process of public sector fragmentation: affordability to the client is not necessarily the same as VFM for the public sector as a whole. Only public auditors, such as the National Audit Office, can gain access to PFI documentation on the conditions necessary for a comprehensive assessment of both accounting treatment and VFM. However, such studies require the kind of theoretical underpinning provided in this article, as otherwise the findings are likely to be ambiguous and hence vulnerable to rebuttal. In particular, VFM judgements must make explicit the basis of comparison on which they rest.*

Introduction

In the same way that UK Conservative governments of the 1980s bequeathed public enterprise privatisation to the world, the Labour Government elected in 1997 has embarked upon extensive use of private finance in public services, portraying it as part of the “third way” (Giddens, 1998). The Private Finance Initiative (PFI) was originally a Conservative initiative, but it has subsequently been positioned by the Labour government within its programme of public private partnerships (PPP)[1]. In both cases, emulation across the world has been remarkable[2], and invisible earnings on privatisation and PFI advice have become economically valuable to the UK economy.

However, the UK position on the PFI is complicated. The Conservative Party, which in government invented it (Treasury, 1992; 1993; 1995), might prefer full privatisation of certain public services. The Labour Party, antagonistic to the PFI in opposition, has embraced it in government with noted enthusiasm. The Liberal Democrats, publicly hostile to the PFI, are encountering internal controversies (Wintour, 2002), not least in relation to recourse to the PFI where Liberal Democrats are in control of particular local authorities. Rather than there being an intelligent debate, however, the vast media coverage of the PFI usually resembles the dialogue of the deaf, with different groups speaking past each other.



Media coverage of the nature of the comparison between PFI schemes and the alternatives against which they are tested has now moved from the financial pages to the news and comment pages of newspapers. As one example among many, George Monbiot, a *Guardian* commentator ideologically opposed to the PFI, wrote on 22 January 2002:

I was recently sent a paper written by a senior planner right at the heart of the PFI bidding process. For obvious reasons, he wants his identity kept secret. His paper provides an alarming account of the way the system works. The Private Finance Initiative, he reveals, is rigged from beginning to end. Ministers have promised us that public services will only be privately financed when PFI offers better value for money than public funding. But the same ministers have also told civil servants that they will not provide any public money for new facilities. In the words of Alan Milburn, secretary of state for health, "it's PFI or bust". So the public bodies wishing to build new hospitals, schools, prisons and roads deliberately set the "public sector comparator" higher than the private sector bids they receive, in order to smooth the way for private money (Monbiot, 2002).

In political and media discussion, the PFI is often described as "the only show in town", a presentation sometimes confirmed by ministers through "nudges and winks". This differs markedly from the official presentation by the Treasury: "PPP contracts are only pursued where they represent the *best* value for money option" (Treasury, 2002c, p. 115, italics added).

Unconnected events also have an effect. The Enron bankruptcy in December 2001, especially the media attention it brought upon auditing and consultancy services, shows that there is concern within the accountancy profession about pressures which may be, or are just felt to be, exerted on auditor judgements. The concern in the PFI context is that the sources of professional advice available to purchasers are not neutral on the choice between PFI and alternatives. Not only do financial advisers secure more business from the PFI, but the Treasury Taskforce[3] was a promoter of the PFI as well as a regulator of its accounting and value-for-money (VFM) analysis. The fact that particular PFI schemes became "flagship" projects of the Treasury Taskforce increases concerns about the unstopability of projects, whatever the analytical findings, once political commitment has been given.

This article is an essay in conceptual clarification and technical precision, developing its argument using published sources[4]. The focus is upon decision rules for both VFM analysis and accounting treatment, with the principal objective being to establish the basis on which decisions and debate about decisions can be conducted. The article does not consider higher-level public policy choices, where a desire to separate or integrate the domains of the public and private sectors may figure prominently. The detailed argument proceeds in the context of UK governmental structures and of the UK system of accounting regulation. However, the analytical issues generalise to other jurisdictions as the PFI method of public procurement internationalises.

To draw empirical conclusions about accounting treatment and VFM would require extensive access to documents not in the public domain. Accordingly, the numerical examples are invented in order to illustrate specific points. Arbitrarily, though partly in reaction to much of the contemporary discussion,

they have been calibrated so that a VFM case can be made for PFI projects, even when decisions on accounting treatment and public expenditure scoring are criticised. These assumptions are defended on the basis that they guide the analysis into the most interesting territory, rather than on any claim that they are empirically valid.

The article is not primarily concerned with an analysis of the processes by which the private sector consortium might be able to use capital and labour more efficiently than the public sector organisation. If there are no such gains, a PFI project will fail to pass the criteria established in this article's analysis of VFM. Specifically, the article avoids all discussion of whether the differential between the explicit cost of capital to the public and private sectors represents either a genuine or illusory cost saving[5].

The first step is to establish the context of PFI schemes; this is done in the next section. As the PFI has been promoted in the United Kingdom explicitly on VFM grounds, an analysis of VFM precedes discussion of the principles guiding accounting treatment. However, because of the importance which has become attached to the accounting treatment decision (i.e. on-balance sheet PFI schemes will usually not go ahead), the section dealing with the implementation of accounting treatment rules precedes that dealing with the implementation of VFM tests. There then follows an assessment of the main findings of this article, demonstrating how they are located within existing literature on policy analysis. The final section provides a brief conclusion.

The role of the PFI

The Treasury has become a strong promoter of the PFI, representing a distinct break from the position it adopted in the 1980s (Heald, 1997). Over the period from their inception in 1981 until their first "retirement" in 1989, the "Ryrie Rules" were seen as an obstacle to the use of private finance within the public sector[6]. In recent years, the PFI has become a major procurement method. For 2002/2003, the capital spending component of signed PFI deals was projected as £3.7 billion, with £17.3 billion[7] then at preferred bidder stage (Treasury, 2002a, pp. 230-1). In that year, projected gross public investment was £28.4 billion and projected net investment £14.4 billion. On-balance sheet PFI counts as part of public sector net investment[8] for the purpose of the application of the government's fiscal policy rules, as set out in the *Code for Fiscal Stability* (Treasury, 1998).

An immense amount of political interest and controversy surrounds the PFI. A useful summary of these debates was provided by Allen (2001). The charges arising from off-balance sheet PFI will become an increasingly important claim against future public spending. On-balance sheet PFI will bring lower PFI contract charges than its off-balance sheet counterpart, but there will also be capital charges and depreciation. The fact that local authorities are outside the departmental resource account of the sponsoring central government department is also relevant to public expenditure scoring[9].

If, for example, prison building was undertaken by means of the PFI, the capital expenditure would not be scored within departmental expenditure limit, provided that the PFI-financed assets are off-balance sheet to the prison service (an Executive Agency of the Home Office). Thus, the critical line with regard to public expenditure scoring is not whether a prison is procured by means of PFI or by conventional direct procurement, rather whether a PFI scheme is on- or off-balance sheet to the public sector client. Exactly the same point, though with some variation in detail, applies to hospitals (NHS Trusts, effectively public corporations) or school building (schools are the responsibility of separately elected local authorities, whose ability to incur capital expenditure is controlled by central government).

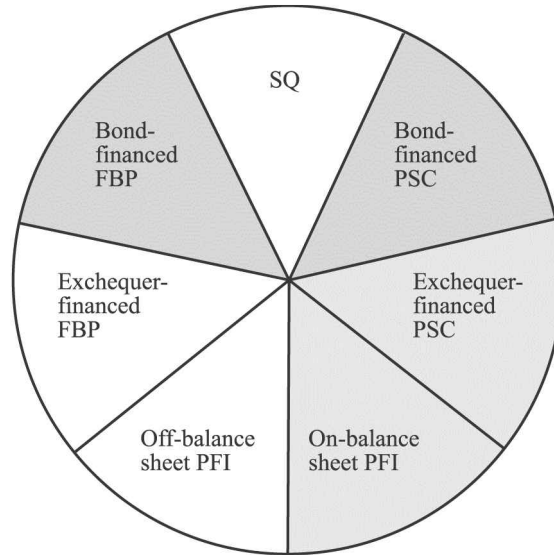
VFM in theory

The concept of VFM is related to concepts of efficiency and effectiveness in ways that are rarely made precise. Its meaning has become institutionalised in terms of what public auditors, such as the National Audit Office (NAO) and the Audit Commission, do in its name. Gray and Jenkins (1993, p. 42) noted the fundamental importance of context:

Of central importance is the political climate in which developments take place and the economic imperatives of the central executive. This leads to a policy rhetoric through which evaluation and audit are defined, organized and legitimized in a particular fashion.

The extension of audit functions away from propriety and regularity towards questions of the efficiency and effectiveness of programmes inevitably draws auditing deeper into the political arena. This creates tensions not only between those public auditors who envisage their role as objective technicians and those aspiring to be policy analysts, but also between both groups and policy makers. This latter conflict often revolves around the alleged use of hindsight and about exactly what constitutes “policy”, statutorily outside the scope of VFM audit[10].

Figure 1 illustrates the distinction between decision making (located at the parameter-setting stage) and decision taking (choosing between alternatives still remaining after certain others have been explicitly or implicitly excluded from the scope of the appraisal) (Gray and Jenkins, 1985). The full circle encompasses all possible options; it is drawn as a circle solely as a matter of convenience[11]. The representation is schematic and, at the synoptic level, all segments of the circle are available. Going down a step to decision taking excludes certain options[12]. Allowing the purchaser to issue bonds, a rejected option in the case of London Underground, is categorically excluded; this is partly on VFM grounds (the Treasury has no confidence in the purchaser’s capability as operator), but also because of the threat it would pose to public expenditure control systems (the rush of imitators would be difficult for the Treasury to resist). The Exchequer-financed public sector comparator (PSC) is implicitly excluded; it is used as the benchmark for appraising the PFI, though it is made explicit that there is no Exchequer



Key:

FBP: Fall Back Position
PFI: Private Finance Initiative
PSC: Public Sector Comparator
SQ: Status Quo

Figure 1.
The exclusion of
alternatives from
evaluation

finance available[13]. The Exchequer-financed PSC emerging as best VFM would be an embarrassment, thereby creating dubious behavioural incentives. Mayston (1999, p. 251) noted that, when public funds are known not to be available, “value for money tests against a public sector comparator become less than real”.

Before proceeding further, the concept of the fall back position (FBP) needs to be introduced. This is defined as what would happen if the PFI scheme were rejected, in circumstances in which the PSC cannot be funded and in which the FBP is preferable to the status quo (SQ). In the case of NHS Trusts for example, FBP is likely to involve selective demolition and some new construction, as opposed to a new hospital[14]. The FBP should not be regarded as a “do minimum” option, but rather as a realistic scheme which would be Exchequer-fundable.

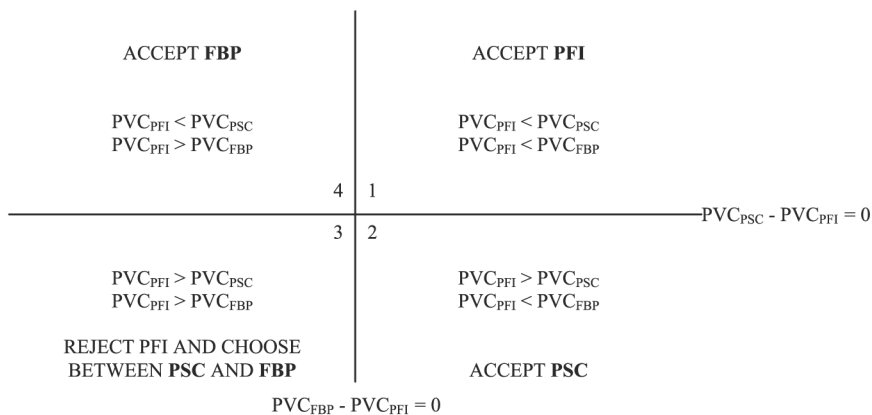
Consequently, there are now three options left:

- (1) Exchequer-financed FBP, defined as what would happen if the PFI scheme were rejected but there was no funding available for the PSC (if this was superior to the FBP);
- (2) the PFI scheme; and
- (3) SQ.

By this stage, there is usually general agreement that SQ is intolerable[15], again creating dubious behavioural incentives. Thus the choice at the decision-taking stage is between the Exchequer-financed FBP, itself subject to uncertainties about funding, and the off-balance sheet PFI scheme. In a climate where those opposed to the PFI are taken to be included amongst the “wreckers” of public sector reform[16], there is enormous pressure to make the numbers work out “right”. The choice set rapidly empties of all except SQ and the off-balance sheet PFI scheme which, appraised against remaining alternatives, represents “best” VFM. In this context, “best” needs to be understood as “best available” VFM.

Figure 2 examines certain dimensions of the decision; others are considered later. In Figure 2, the PFI is compared with the PSC and the FBP. It is presumed that the FBP is superior to the “do nothing” SQ. The analysis can easily be extended to cover the situation when this is not the case, but this complicates diagrammatic exposition[17].

Alternative schemes are assessed in terms of their present-valued cost (PVC), with the scheme with the lowest PVC, *ceteris paribus*, constituting the best VFM. This is a more intuitive terminology than “net present value” (NPV), the term used in much PFI documentation to denote PVC. In much PFI documentation, one is looking for the lowest (what is described as) NPV. In the academic literature, NPV is the discounted value of benefits minus costs; one is



Key and Interpretation:

FBP: Fall Back Position
PFI: Private Finance Initiative
PSC: Public Sector Comparator
PVC: Present-Valued Cost

Above the horizontal line, PFI is preferred to PSC. To the right of the vertical line, PFI is preferred to FBP

Figure 2.
The purchaser's
evaluation of VFM

therefore looking for positive values and, *ceteris paribus*, a scheme with a higher NPV is better than a scheme with a lower NPV.

In Figure 2, the horizontal line represents the position when $PVC_{PSC} = PVC_{PFI}$: the PVC differential between PFI and the PSC is zero. Above the line, $PVC_{PFI} < PVC_{PSC}$, with the reverse below. Above the horizontal line, PFI is preferred to PSC. The vertical line represents the position when $PVC_{FBP} = PVC_{PFI}$: the PVC differential between the PFI and the FBP is zero. To the right of the vertical line, $PVC_{PFI} < PVC_{FBP}$, with the reverse to the left. To the right of the vertical line, PFI is preferred to FBP.

Disregarding points on the lines, the analysis can proceed by examining four numbered quadrants. Quadrant 1 represents the position where the PFI is superior to both PSC and FBP. Quadrant 3 denotes situations where the PFI is inferior to both PSC and FBP. In quadrant 2, the PFI is preferable to the FBP but not to the PSC. In quadrant 4, the PFI is superior to the PSC but inferior to the FBP: in this quadrant the FBP is superior to all alternatives, whereas in quadrant 3 it is superior to all available alternatives (the PSC not being fundable).

Quadrant 1 is unproblematic from a VFM perspective: the PFI is best. However, there may be other circumstances in which the PFI is adopted when it is not the best option. In quadrant 2, the PSC should be chosen, but it is only hypothetical, with the PFI judged preferable to the FBP. Consequently, there may be implicit pressure not to produce a result that $PVC_{PSC} < PVC_{PFI}$. In quadrant 4, the FBP is the best option. As the FBP is feasible, the PFI should be rejected. In quadrant 3, the PFI is inferior to both the infeasible PSC and the feasible FBP. Consequently, the PFI should be rejected.

Figure 2 therefore highlights concerns about quadrants 2, 3 and 4[18], those quadrants in which the PFI is not the best option. The formal assessment of VFM is taking place in relation to a hypothetical PSC, which it is known would not be funded if it were found to be superior to both the PFI and the FBP. A PFI might be good VFM relative to the FBP, but poor VFM relative to the PSC. Care should therefore be taken, when making statements about VFM, as to the standard of comparison adopted.

Attention now turns to other VFM issues. First, Figure 2 has been drawn on the assumption that the calculation of PVC is unproblematic. It is well established in the project appraisal literature that estimating benefits and costs is difficult and vulnerable to manipulation (Mackie and Preston, 1998)[19]. The Treasury Taskforce guidance (1999a, para. 5.14) explicitly instructs the use of a real discount rate of 6 per cent. This follows the rate prescribed by the Treasury for use in a wide range of public sector contexts, as set out in its standard investment appraisal guidance (Treasury, 1997), known as the Green Book[20]. The impact on PVC of demand risk and residual value risk will be lower at 6 per cent than with a lower real discount rate; this is important if these end-loaded risks are large and remain with the purchaser.

Second, VFM analysis appears to be done primarily in terms of benefits and costs to the purchasing public body, without regard to costs imposed on other

public bodies. This is the question “VFM for whom?” Within the context of public sector fragmentation, the affordability of a project to a particular purchaser may differ from VFM for the public sector taken as a whole. The project could be a “good deal” for the public body but a “bad deal” for the UK Exchequer, if others are bearing a significant amount of costs. In the case of schools’ PFIs, the undertaking by the central government department to pay “level playing field support” (which is only available for off-balance sheet PFI) is treated as a reduction in the net cost to the local authority[21]. The temptation for local authorities to focus upon VFM for themselves is perhaps understandable, but an overall assessment needs to address VFM for the UK Exchequer and for the UK taxpayer. PFI documentation combines some aspects of cost-benefit methodology in what is primarily a financial appraisal.

Third, the VFM analysis should be concerned with total risk, and specifically with the amount of risk borne by the purchaser. It is not just the sharing of risk (relevant to the accounting treatment) but its total amount that has to be identified and managed. New procurement methods such as the PFI may reduce or increase the total amount of risk and this requires careful analysis. For example, a plausible argument can be mounted that the PFI reduces construction risk, using a game theory argument about the behaviour within consortia of construction firms and finance providers[22]. Conversely, the PFI may increase demand risk, as the purchaser may, for instance, in the context of schools, pay for unwanted serviced school places many years ahead, unable to secure a contract revision, whether for commercial or political face-saving reasons. This raises the fundamental question as to whether the PFI “evaporates” or magnifies the total amount of risk, or simply parks the same amount of risk elsewhere. The logic of insurance is that risk pools behave predictably even when individual cases are subject to a large dispersion of possible outcomes. Similarly, the influential Capital Asset Pricing Model emphasises that a well-diversified portfolio investor should concentrate on systematic risk (i.e. that component of total risk that is correlated with the market index); unsystematic risk is diversified away. Genuine reductions in the total amount of risk, or in the cost of bearing that risk, are clearly a potential economic benefit from the PFI, but there needs to be clear evidence that risks have been reduced (e.g. because they are now handled by economic agents better equipped to deal with them), not just parked out of sight.

Fourth, Figure 3 addresses the question of whether the purchaser and operator are “content” or “discontent” with the PFI project, viewed over the full life of the concession. Initially, “content” may be thought of for the private sector as the project yielding a risk-adjusted rate of return above the firm’s cost of capital and comparable to that available on other projects. Also, the purchaser has secured access to the productive capability of the asset at a cost not greater than that of the available alternatives. Attention subsequently returns to this question, once the assumption is removed that the identity of the contracting parties remains constant over the full length of the concession.

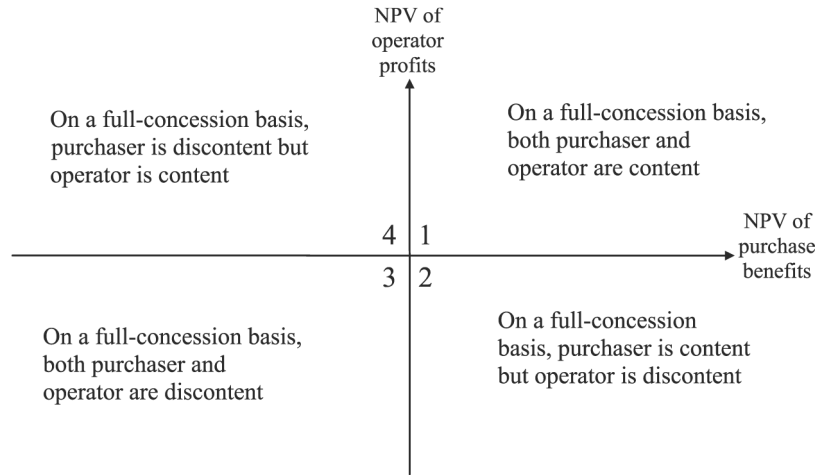


Figure 3.
Analysis of purchaser
and operator
contentment

In Figure 3, it is assumed that the operator conceives of the PFI scheme in terms of the NPV of operator profits, the discounting being done at private sector rates; and that the purchaser is concerned with the NPV of purchaser benefits discounted at public sector rates. Operator profits are measured vertically and purchaser benefits horizontally. In quadrant 1, both purchaser and operator are content, viewing the PFI scheme over its full concession life. This is clearly the quadrant policy makers hope can be reached. However, as will be discussed below, contentment over the full life of the concession does not guarantee contentment at all points during the life of the concession.

In quadrants 2, 3 and 4, at least one of the parties is discontent. The case of quadrant 3 (both discontent) is of less interest to the present analysis; mutual discontent might even provide a basis for concession modification to mutual benefit. Quadrants 2 (operator discontent) and 4 (purchaser discontent) raise important issues, notably whether they are symmetrical. If so, with a sufficiently large portfolio of PFI schemes, it is a matter of taking the rough with the smooth, though that may be uncomfortable for a purchaser dependent on a single PFI scheme.

However, there are good theoretical grounds for questioning this symmetry. In the case of a quadrant 2 outcome, the discontented operator may not be willing to remain so for the full life of the concession. In quadrant 2, the private sector principals behind the special purpose vehicle (SPV) operator will wish to renege, not least because existing managements bound by their word would be vulnerable to takeover via the capital market. In extreme circumstances, administration or bankruptcy is a clear option[23]. Since there are matters of reputation at stake, the private principals may tolerate an occasional bad scheme for the purpose of protecting and developing their portfolio of PFI schemes. Nevertheless, the purchaser may find it hard to hold on to its gains in quadrant 2 unless it feels able to quickly secure control of the assets and re-let the concession without disruption[24].

In quadrant 4, the discontented purchaser may find itself locked in over the full concession. The purchaser will usually not have a portfolio of projects (even when the public sector does) and the bankruptcy option is excluded (two Acts of Parliament have transferred risk to the Secretary of State in the case of failure of a particular NHS Trust (National Health Service (Private Finance) Act 1997, National Health Service (Residual Liabilities) Act 1996)). Moreover, confidential documents purporting not to be letters of comfort written on behalf of the relevant minister appear to be a common feature of PFI schemes. On the other hand, there might be tactical reasons for an operator to ease the purchaser's position, for example if this is only one of the operator's portfolio of PFI projects.

Thus far, the analysis has proceeded on the assumption that both purchaser and operator focus only on present values over the full life of the concession. However, 30 years is a long time[25] and the position may change over that period. A project in quadrant 1 may generate operator profits on a front-loaded basis, with the result that, some years into the concession, the NPV of operator profits still to be received becomes negative. This time-profiling issue extends to the other three quadrants. Moreover, such time profiling, plausible when construction forms a large part of total contract value, is not the only potential source of such quadrant switches. For example, an increase in the private sector discount rate might cause such a switch, as might a refinancing scheme.

More fundamentally, the above discussion implicitly assumes a constant composition of the PFI consortium over the full concession life, and this assumption may not hold. The interests of the construction firm and finance providers may diverge, especially after the project has reached the operation stage, and this may lead to a change in composition. On the purchaser side, a new political administration may feel locked into a web of inherited PFI contracts, and may feel resentment about the loss of operational flexibility and policy choice.

PFI accounting in theory

Concerns within the accountancy profession about PFI accounting have been reported in the media:

Andy Simmonds, technical partner at Deloitte & Touche, told the *Independent on Sunday* that many PFI contracts were being awarded for "accounting not financial reasons" and could prove to be "poorer value for money". These [PFI] deals were being signed because they allowed government bodies to take the liabilities for the deal off their balance sheet, so it would not appear in public debt calculations. "In reality, what we are seeing is that if the thing is on the balance sheet it is not going to happen", said Mr Simmonds. "*The authorities could beat up the auditors to get a different accounting treatment or renegotiate the deal to get it off the balance sheet. This could mean poorer value for money*" (Nisse, 2000, italics added).

The injunction that accounting should not damage VFM had earlier been made by Treasury Taskforce guidance on PFI accounting, which specifically warned against sacrificing VFM to secure off-balance sheet accounting treatment:

The objective of PFI procurement is to provide high quality public services that represent value for money for the taxpayer. It is therefore value for money, and not the accounting treatment, which is the key determinant of whether a project should go ahead or not. Purchasers should focus on how procurement can achieve risk transfer in a way that optimises value for money and **must not** transfer risks to the operator at the expense of value for money (Treasury Taskforce, 1999a, para. 1.8, bold in original).

Notwithstanding this official pronouncement, there is clearly a tension between protecting VFM and the widespread awareness that an on-balance sheet decision would lead to the rejection of the PFI and recourse to an inferior option.

The Treasury Taskforce (1999a) guidance on PFI accounting contains some differences of emphasis[26] from the specific PFI guidance of the Accounting Standards Board (ASB) in FRS 5A (ASB, 1998)[27]. The former guidance is mandatory for central government departments and many other bodies sponsored or controlled by departments and whose Accounts Direction is issued by the Treasury. However, “it is a matter for CIPFA/LASAAC Joint Committee to determine the status of this guidance for local authorities” (Treasury Taskforce, 1999a). CIPFA (1999) specifically stated that “Application note F requirements are therefore applicable to the local authority Statement of Accounts”. The same source describes the Treasury Taskforce guidance as “influential but not mandatory”. Supplementary to the Taskforce guidance is another layer of advice, known as the “method statement” (Treasury Taskforce, 1999b).

The accounting question[28] is whether the PFI project appears as an asset on the balance sheet of the client, of the operator, of both client and operator, or of neither. Symmetry is not required by UK GAAP, as both sets of management have to make their own decisions. However, there is information content in asymmetry, where managements in a long-term relationship report different understandings to their own shareholders and/or stakeholders, especially if the asset is on neither balance sheet[29].

The pivotal issue with regard to accounting treatment concerns where the risks lie. Judgements about the relative importance of different kinds of risk are likely to be crucial, for example the balance between construction risk, design risk, demand risk and residual value risk. The Treasury Taskforce emphasised the importance of demand risk and residual value risk:

The AN [i.e. FRS 5A] also provides that: where demand risk is significant, it will normally give the **clearest** evidence of who should record an asset of the property, and where it is significant, residual value risk will normally give **clear** evidence. However, it will not always be the case that demand and residual value risks are significant and therefore, where they are not significant, these risks will not necessarily give the clearest (or clear) evidence of who should record an asset of the property (Treasury Taskforce, 1999a, para 4.10, bold in original).

The publication of FRS 5 (ASB, 1995) was, in part, motivated by the practice in the private sector of positioning leases just on the “right” side of the 90 per cent rule, in order to secure off-balance sheet treatment for the lessor under SSAP 21[30]. The subsequent publication of FRS 5A (ASB, 1998) reflected the ASB’s

concern to regulate the accounting of PFI schemes, to avoid off-balance sheet finance making a comeback. ASB (1999) has now launched a fundamental review of lease accounting, which may in turn have implications for PFI accounting.

A specific accounting issue that has arisen in the context of the PFI is whether a transaction should be accounted for under SSAP 21 (interpreted in the light of FRS 5 and 5A) or directly under FRS 5 (interpreted in the light of FRS 5A)[31]. The test in FRS 5 is that the majority of the risks and rewards of property ownership should be transferred to the operator; this would justify off-balance sheet treatment for the purchaser. The separability test provides for non-property-related services to be stripped out of the PFI contract, leaving the decision on accounting treatment of the property to be determined on the basis of the stripped-down contract. There seems to have been some disagreement as to whether the stripped-down contract should then be accounted for on the basis of SSAP 21 or FRS 5, under which the tests are different. Where a considerable amount of property-related services (e.g. maintenance) remains within the stripped-down contract, then what is described as an FRS 5 treatment is implemented. An authoritative exposition of UK GAAP (Wilson *et al.*, 2001, p. 1296) expects most PFI contracts to fall within FRS 5 because “the ‘availability’ of the payment may vary if services are not performed to the agreed standard”. However, the history of problems with the application of SSAP 21, notably the manipulation of calculations to fall on the “right” side of a dividing line, is relevant background to the application of FRS 5 to PFI schemes.

The Treasury Taskforce guidance recognises that a property should be the asset of some party:

Determining the substance of transactions is a matter of professional judgement, which involves weighing up all the relevant indicators (both qualitative and quantitative) of *which party has an asset of the property* (Treasury Taskforce, 1999a, para. 4.3, italics added).

There is no suggestion that asymmetry should be expected.

PFI accounting in practice

Responsibility for decision making

On the advice of their professional advisers and with the concurrence of their auditors, many public bodies have decided that their PFIs will be off-balance sheet to themselves as purchasers. Although PFI documentation provides no information on this point, it seems likely that the PFI will often be off-balance sheet to the SPV. Although judgements of management might differ in marginal cases, there is a credibility gap when a pattern develops of both purchaser and operator confidently claiming that the majority of risks fall elsewhere.

Professional advisers stick closely to the Treasury Taskforce guidance, sometimes as elaborated in its “method statement”, often advising that the PFI should be accounted for under FRS 5:

The accounting treatment of PFI transactions, as determined immediately prior to contract signature, will *normally* apply throughout the life of the contract and should not be revisited each year as the risks crystallise after contract signature. The accounting treatment, however, would need to be reviewed if there was a substantive change to the contract (i.e. a re-negotiation), *a change in the accounting standards* covering the transaction or other grounds for questioning the accuracy of the original accounting treatment (e.g. a fundamental error in the original analysis) (Treasury Taskforce, 1999b, para 2.2, italics added).

There is only limited assurance here, as highlighted in the italicised phrases:

- “normally” is a strong qualifier; and
- “a change in the accounting standards” might be spurred by events unrelated to PFI schemes in the UK, for example by the association of the bankruptcy of Enron with off-balance sheet SPVs or by UK firms encountering financial difficulties because of PFI contracts elsewhere in the world.

Accounting firms providing such financial advice emphasise that “primary responsibility” for accounting treatment rests with the management of the purchasing body. Such advice would be more reassuring if there was confidence that the operator’s financial advisers were taking the same view as to where risks lay. Non-accountants are less easily persuaded than accountants that certain property may belong to no balance sheet.

Have accounting standards been followed?

There is evidence with certain PFI schemes that a large proportion of construction risk has been transferred to the operator. Given infamous examples of cost and time overruns on major public projects, this is an important driver in terms of VFM analysis (National Audit Office, 2003). However, FRS 5A (ASB, 1998) is clear that construction risk is unlikely to play an important role in determining accounting treatment.

Advice on accounting treatment to many individual purchasers is following a template, the “method statement” published by the Treasury Taskforce (1999b). This supplemented the Treasury Taskforce (1999a) main guidance, which was developed as a way of proceeding after the widely reported clash between the Treasury and the ASB over FRS 5A[32]. This allowed the ASB to emphasise the primacy of accounting standards and enabled the Treasury to get PFI contracts signed (Broadbent and Laughlin, 2002). The danger is that, when so much depends on the purchaser having an expert opinion supporting off-balance sheet treatment on which it can then proceed to signature, the resulting numbers may lack credibility. A purchaser will derive reassurance from the prescribed process having been carefully followed by its professional advisers; this legitimates the decision and is thought to afford some protection from later criticism (Broadbent and Laughlin, 2002). The concerns of this article about accounting treatment are not only to do with process, but also with the underlying assessments of risk and the relative weights placed upon different types of risk.

Part A of Table I provides a hypothetical example of the quantitative analysis of property risks, following the Treasury Taskforce (1999b) “method statement”. This appears to have been used extensively in actual PFI schemes. For reasons of practicality, especially in large schemes with physically separate properties, a grouping procedure is undertaken. The quantitative analysis might be conducted by component, for example, new build structure, and refurbishment and extension of existing buildings. Of the eight categories of risk identified, three are judged in this example not to be numerically important: third-party revenues[33]; penalties for underperformance[34]; and obsolescence.

The number entered in each cell of Part A of Table I is the range between the 5 per cent lower limit and the 95 per cent upper limit of the NPVs of potential variations in property profits/losses. For example, £20,000,000 is the range for design risk, entirely attributed to the operator, for component 1. Entries have also been made for the other four risks that have been quantified:

- (1) demand risk (purchaser);
- (2) penalties for non-availability (operator);
- (3) potential changes in relevant costs (operator); and
- (4) residual value (purchaser).

It should be remembered that these numbers have been invented for expository purposes.

In the third column of the component 1 entries, the percentage contribution of each category of risk to the “sum of ranges” is shown. In this case, the division into components is decisive: component 1 is off-balance sheet; component 2 is on-balance sheet; and, if taken as a whole, the entire project would be off-balance sheet. The principal risk is design risk: 47 per cent and 33 per cent, for the two components respectively. Next in importance is residual value risk (32 per cent and 44 per cent), followed by potential changes in relevant costs (14 per cent and 11 per cent) and demand risk (6 per cent and 11 per cent). Penalties for non-availability account for a very small proportion (1 per cent) of total risk.

The accounting test applies in the following way. Those risks allocated to the operator are summed together to calculate a range of total risk relevant to the operator. Table I reports this as £21,000,000 for component 1, a different number from the sum of the range of each separately identified risk discussed above (£26,500,000)[35]. A similar calculation is done for the purchaser, producing a figure of £14,000,000 for the range of total risk for component 1. Therefore, the allocation of risk is 60 per cent to the operator and 40 per cent to the purchaser, meaning that the accounting treatment is off-balance sheet to the purchaser because the test refers to “majority”. Exactly the same process is undertaken for component 2, which shows the opposite result.

It should be noted that both demand risk and residual value risk have been allocated entirely to the purchaser. Demand risk is judged to be relatively

Table I.
Quantitative analysis
of property risks

Category of risk	£000s			£000s			£000s		
	Operator	Purchaser	%	Operator	Purchaser	%	Operator	Purchaser	%
<i>A: Risks relevant to accounting treatment</i>									
Demand risk		2,500	6		1,500	11		4,000	7
Third-party revenues									
Design risk	20,000		47	4,500		33	24,500		44
Penalties for underperformance	500		1	200		1	700		1
Penalties for non-availability	6,000		14	1,500		11	7,500		13
Potential changes in relevant costs									
Obsolescence		13,500	32		6,000	44		19,500	35
Residual value									
Sum of range of risks (£000)	26,500	16,000		6,200	7,500		32,700	23,500	
Range of total risk (£000)	21,000	14,000		5,400	6,600		26,400	20,600	
Allocation of risk (per cent)	60.00%	40.00%		45.00%	55.00%		56.17%	43.83%	
<i>B: All risks relevant to VFM analysis</i>									
Construction risk			41	15,000		52	45,000		44
Demand risk	30,000	2,500	3		1,500	5		4,000	4
Third-party revenues									
Design risk	20,000		28	4,500		16	24,500		24
Penalties for underperformance									
Penalties for non-availability	500		1	200		1	700		1
Potential changes in relevant costs	6,000		8	1,500		5	7,500		7
Obsolescence									
Residual value		13,500	19		6,000	21		19,500	19
Sum of range of risks (£000)	56,500	16,000		21,200	7,500		77,700	23,500	
Range of total risk (£000)	42,500	14,000		17,000	6,600		59,500	20,600	
Allocation of risk (per cent)	75.22%	24.78%		72.03	27.97%		74.28%	25.72%	

Notes: The numbers in this table are entirely fictitious, invented by the author for expositional purposes. However, the form of analysis in Part A mirrors that of unpublished PFI documents. In actual calculations, the entries for "range of risk" for each component are derived using Monte Carlo simulations. The sum of range of risks is simply the addition of the range of risks for each component of risk. This is different from the range of total risk, itself also generated by Monte Carlo simulation. Whereas, in Table 1, £26,500,000 is calculated as the sum of individual risks, the range of total risk (£21,000,000) is an invented figure. The range of total risk is less than the sum of the range of risks because there is some self-cancelling

small. A lot of residual value risk derives from demand risk and obsolescence, less from the relationship between depreciated replacement cost and zero reversion cost at the end of the concession period, which is what the Method Statement emphasises. For example, demand risk originates from demographic trends and cohort participation rates in purchaser facilities (e.g. exit to the private sector or to facilities offered by neighbouring purchasers). This could drastically affect the value of buildings at the end of the concession period, when there may still be 30 years of residual asset life. Given that it is difficult to forecast the organisation of service provision so far ahead, the question of obsolescence risk may be closely related to design risk. More importantly, classification matters, most specifically the line drawn between first, obsolescence and design risks (relevant to the accounting decision), and second, construction risk (not relevant to the accounting decision). Discretion over this distinction, notably including in design risk items that belong in construction risk, would make it easier to justify off-balance sheet treatment.

A local authority (NHS Trust) with all of its schools (hospitals) provided through a single PFI may effectively be a “hostage” client for 30 years, therefore fundamentally affecting the bargaining position between the purchaser and operator. This is a different context from one in which, say, a Prison Service has in-house prisons and also concession prisons from several different operators.

In FRS 5A (ASB, 1998), great emphasis is placed upon demand risk. In the light of paragraphs F24-F31, it would seem that demand risk is much more important than the implementation of the Treasury Taskforce (1999b) Method Statement allows, for example the length of the contract period (F26) and the obligation of the purchaser to pay for places. Similarly, the residual life (F44) and the zero reversion cost (F47) suggest that residual value risk is important. Together with the absence of third-party revenues (F34), these are strong pointers that the property is an asset of the purchaser. The nature of the property (F35) has been influenced by the operator, though it seems unlikely that the operator can effectively be held responsible for that part of design risk that shades into obsolescence.

Conviction that relevant risk transfer has taken place would be strengthened if:

- the management of SPVs, in discussion with their auditors, made symmetric decisions to those of purchasers, in association with their auditors, except in a few marginal cases; and
- the parent companies behind the SPVs accounted on-balance sheet for these risks and rewards.

The three-way plus splitting on the operator side (e.g. construction firm, service operator and finance provider) is a further complication. Although operator accounting is primarily a private sector matter, the collapse of a major principal behind an SPV, perhaps as a result of entirely unrelated transactions, might

compromise VFM in UK PFI schemes. The worldwide boom in PFI may lead to large off-balance sheet financing on the operator side[36].

Off-balance sheet treatment seems to be based on the relative importance of risks other than demand risk and residual value risk. For example, the range of pupil numbers in the case of schools' PFI may be unduly narrow, especially in the context of parental choice; responsibility for these estimates rests with the purchaser. If actual pupil numbers were to turn out much lower, the purchaser would still have unitary payment commitments for 30 years on the contracted level of serviced school places. Moreover, an excessively large stock of schools, all with the same residual life, would revert at the end of the concession. An examination of the physical estate of public services such as hospitals, prisons and schools shows evidence of vintage effects, for example in relation to number of storeys and physical layout. This was particularly well documented in a report by the National Audit Office (1994), which carefully explained changes in prison design over a long period. A public service provider whose assets are all of the same vintage may be either at a competitive advantage (the designs of that decade have worn well) or disadvantage (they have worn badly), compared with providers with assets of mixed vintage.

In summary, though substantial property risk may be transferred, this may be primarily of a kind that is irrelevant to the accounting treatment decision. There are complex questions as to whether the existence of the PFI increases or reduces the total amount of demand risk, as opposed to its allocation. For example, it might become easier or more difficult to reconfigure facilities to meet variations in the level and location of demand. It might be that the accounting tests have been regarded as so non-onerous that there has been less motivation to make them easier to meet by bundling transactions together. If so, this would reduce concern about one specific source of VFM loss, but increase concern about accounting treatment.

VFM from PFI schemes in practice

An addition to the NPV (i.e. PVC) of the PSC is often decisive at the decision-taking stage[37]. This adjustment for risks transferred to the private sector often takes the NPV of the PSC from below 100 per cent to above 100 per cent of the NPV of the PFI. Whether or not a convincing VFM case could be made for the PFI scheme, the analysis on which the decisions are made is not necessarily convincing.

First, at least in some cases, there is a surprising disconnection between the VFM analysis and the accounting treatment analysis[38]. For the latter, the proportions of the allocation of risk are crucial, meaning that all relevant risks have to be quantified, even if they do not vary by procurement method. In Part A of Table I, the accounting analysis takes as its starting point that demand risk and residual value risk are comparatively small. The assumption is made that the form of contractual relationship between the purchaser and the private sector does not affect the total amount of such risks. A thorough VFM analysis would not necessarily reach the same conclusion.

Part B of Table I adds entries for construction risk, in order to focus on all risks relevant to VFM analysis. On the invented numbers, construction risk accounts for 41 per cent of the range of total risk (component 1), 52 per cent (component 2), and 44 per cent (total). This demonstrates that the appropriate calculations of risk transfer in the VFM analysis might differ considerably from those in the accounting treatment analysis.

Second, there are conceptual problems about what constitutes the PSC. The infeasible nature of the PSC is often explained in full business cases. The fact that there is no possibility of implementing the PSC because funding or borrowing approvals are not available may lead to a subconscious psychological bias. This infeasibility is a different point from the fact that the PSC is hypothetical. The PSC may be based on what the purchaser originally expected the private sector to offer, rather than what it did offer and what was then selected. A case can be made for giving credit to this procurement method for coming up with new ideas, but it is necessary to separate out this benefit and demonstrate that it could not have been achieved by other means[39]. An element of the final advantage of the PFI may arise from economies of scale in construction and in project-related expenses, not available to the PSC because of its different configuration. There are obvious problems of comparison when the PSC “lags” the PFI: like is not being compared with like.

Third, in terms of the context within which decisions have to be taken, there might be a good VFM case to be made for the PFI, though the analysis would be differently structured. This would involve showing that the PFI is superior to FBP. There would have to be an argument to the effect that, even were funding available for the PSC, there could be no confidence that the purchaser would find the managerial expertise and political will to deliver the PSC within the margin afforded by the higher cost (if that were indeed the case) of the PFI. The condition of the existing assets may reflect no credit either upon the sponsoring government department (which had imposed capital starvation) or upon purchasers (which had mismanaged the asset base). This argument would be strengthened if the construction phase of the PFI were successfully delivered, in part because it is protected from the continuous redesign which often blights conventional procurement and because PFI consortium members purge the “claims culture”[40] to which construction companies are accustomed. Moreover, there might be evidence that the process of engagement in the PFI has energised purchasers to clarify their requirements. Such a justification would have been difficult to mount *ex ante* in support of the PFI option, but this is clearly relevant to the assessment of *ex post* VFM.

Fourth, purchasers may be locked into an indexed unitary charge for 30 years, imposing the risk of paying for unwanted serviced places, not just unwanted buildings. The impact on cost per client could be dramatic. Methodologically, the assessment of risk from a VFM perspective needs to cover the 60-year life of the buildings, not just the 30-year concession. The zero reversion cost at, say, year 30 should not disguise the fact that the purchaser is buying 30 years’ post-concession life during the concession period. Although

the accounting treatment decision proceeds after stripping out separable elements, the VFM analysis of a particular contract needs to take account of all services bundled within the unitary payment[41].

Fifth, there is the question of how public expenditure scoring in future may affect VFM. A retrospective shift on-balance sheet might lead to retrospective public expenditure scoring[42], thus imposing an opportunity cost by displacing projects that would otherwise have gone ahead.

Assessment

Broadbent and Laughlin (1999) cautioned researchers that the discourse concerning the PFI was complex and multi-level. This article has confirmed that judgement. It is beyond the scope of this article to be definitive about whether particular PFI schemes offer better VFM than conventional procurement and whether they should be on- or off-balance sheet. The former will have to await the evolution of experience and the latter requires large-scale access to documents treated as commercial-in-confidence, together with the freedom to publish results. Nevertheless, certain key issues can now be highlighted.

First, there is the question of how certain decision techniques fit into the “reality of the policy making milieu” (Carley, 1980, p. 63). The formalisation of the decision problem in Figure 2 is an example of “analytic rationality”, a process of orderly systematic problem solving. However, there is a hollowness to the surface rationality of the PFI decision-making process because the formal process is situated within the broader context portrayed by Figure 1. Instead of policy choice being synoptic, key options are foreclosed, with varying degrees of explicitness. Hogwood and Gunn (1984, p. 172) considered the possibility that certain options would be deliberately suppressed or incidentally foreclosed (Hogwood and Gunn, 1984, pp. 96-7). Whilst rejecting synoptic rationality as infeasible, they warned of the damage to policy analysis that suppression and foreclosure can bring. This is partly a matter of the assumptive worlds (Young, 1977) of policy makers, and of the way problems are defined and policies framed or misframed (Hogwood and Gunn, 1984). It is also a question of portrayal; a political choice is disguised as a technical decision, whether for ideological purposes (the private sector is believed superior to the public sector, or vice versa) or instrumental reasons (gaming against externally imposed constraints).

Quite apart from the possibility of confusion generating poor results, such misuse is likely to discredit rational techniques, which will be tarnished by the systematic suppression or foreclosure of options, allowing opponents of the actual decision to portray that as a fix. In turn, this can do significant damage to the legitimacy of public policy choices. Although symmetric accounting treatment cannot be imposed upon purchaser and operator, recourse to disclosure would be a useful policing device[43]. This would counteract the typical argument that a particular PFI scheme can be off-balance sheet because that is how comparable schemes have been treated. It is clear that an

accountancy firm, regularly advising that prospective PFI projects should be on-balance sheet when their client has no alternatives, would be short of such work. A requirement for the purchaser to disclose in the notes to its accounts whether the property is on the balance sheet of the SPV, and the names of the professional advisers to both the purchaser and the SPV, would be salutary.

Second, though quantitative techniques are used in both the VFM assessment (Figure 2) and the accounting treatment decision (Table I), these are “soft” numbers. Much depends upon professional judgement on matters such as the differential risk of construction cost overruns and the robustness of risk transfer to the private sector. Even disinterested policy analysts, operating with different assumptive worlds about public versus private performance, are likely to generate different numerical answers. Another part of the problem derives from the location of analysts within the decision-making system; they are not neutral referees but interested players. There should be anxiety whenever so much of substance (“decent buildings in which to raise standards”) hangs upon a technical professional judgement involving soft numbers. This applies to both VFM analysis (e.g. construction and analysis of PSCs and of the value of risk transfer) and accounting treatment (proportioning the various kinds of risk in Table I). In the present context, one obvious feature is that much *ex ante* appraisal is contracted out to consulting firms, hired by one of the involved public agencies. At its worst, this becomes policy advocacy on a deniable basis[44]. A downside of this “market for advice” is that, whatever the technical competence of the work, its commissioning provokes a cynical response from commentators[45]. The corrosive properties of such an environment are most worrying, and senior finance officials in purchasers must alternate between pleasure at doing good by stealth (ending years of capital starvation) and a sense of vulnerability (professional and political support will evaporate if projects encounter problems).

Third, the analysis in this article rekindles unease about the methodological basis of VFM work, which must, in the UK context, be framed so as not to question “policy”. This is not a pedantic point as it has substantive implications (Marshall, 1999). The 1979-1997 Conservative government adopted privatisation as a policy *per se*, without resting that case specifically on VFM. This constrained NAO VFM studies, which therefore concentrated on matters of implementation of privatisation. In contrast, the Conservative government, from the launch of the PFI in 1992, and the Labour government, from taking office in 1997, have both emphasised that the objective of PFI is VFM. Accordingly, the PFI can be tested for VFM without questioning policy. In practice, however, the UK government increasingly behaves as if PFI were the policy[46], with the rationale for the exclusion of alternatives in Figure 1 becoming a policy matter. In their efforts to improve implementation, VFM auditors may become implicated in a concealed yet deliberate narrowing of policy choice[47].

In terms of the conduct of individual VFM studies, it is essential to differentiate two levels of analysis: whether the PFI project constitutes good

VFM relative to the full range of alternatives (i.e. no arbitrary exclusion of options); and whether purchasers, operating within constraints binding on their freedom of action, have vigorously sought best-available VFM. The scope for different judgements about potential outcomes is just as much a difficulty for *ex post* VFM evaluation as it is for *ex ante* appraisal. Unsystematic processes are easier to identify than “correct” numbers.

Attention therefore needs to focus on how the decision problem was formulated, without necessarily accepting that formulation. The “moment of choice” (Hogwood and Gunn, 1984, p. 19) must be identified and linked to decision steps both preceding and following that “crucial episode”. Decisions are made at the “moment of choice”, with subsequent decisions taken as the consequences of the former flow through. In this way, those technical analyses that exemplify analytical rationality can be distinguished from those that camouflage the underlying decision process. One of the pieces of evidence for camouflage in the PFI process is the presence of inconsistencies, which would be less likely to be tolerated if the process was decisive. For example, there is a disconnection between the VFM and accounting treatment decisions: these are distinct but should be undertaken using a single framework and a common set of numbers.

Inevitably, assessments of full-life VFM must be provisional, given the front-loading of construction risk and the end-loading of residual value risk and policy risk. If the PFI exhibits better control of construction costs, an additional dimension of the PFI package should be the lessons that can be drawn for conventional procurement. Such improvements would then feed through into a lower PVC for the PSC, thus stiffening the test for the PFI project whenever $PVC_{PSC} < PVC_{FBP}$. VFM analysis has to get to grips with both context and the full range of alternative means, otherwise it will either become complicit in the obfuscation or render itself easily disregarded. Even at the high water mark of “rational” economic methods in UK government in the 1970s (Colvin, 1985), there were the inevitable tensions between efficiency and equity, and between systematic considerations of benefits and costs and the “politics” of decisions. Efficiency in government is a complex idea, whether conceptualised in terms of economy/efficiency/effectiveness or of productive and allocative efficiency. Moreover, it is deeply situated in context (Hopwood, 1984).

Fourth, there are two separate interfaces between VFM and accounting in its broader sense. Public expenditure scoring rules, largely within the control of the Treasury, play a crucial role in the delineation of alternatives in Figure 1. Then, on the basis of accounting standards, on-balance sheet PFI will not go ahead in many cases. A widely voiced concern has been that VFM might be compromised, for example, by cost-ineffective bundling, in efforts to keep PFI projects off-balance sheet. It is possible that this concern may not have materialised, because of the ease with which the analytical framework of Table I can be used to demonstrate that the majority of the risks have been transferred to the operator. Whilst the Treasury has policed its public

expenditure scoring rules, it has tolerated laxity in accounting treatment, with long-term implications for the total amount of public expenditure commitments.

Conclusion

By examining the detailed process of implementation of the PFI in the United Kingdom, this article has demonstrated the complexity of the accounting treatment and VFM issues. These have been shown to be distinct, though related. In particular, VFM analysis needs to pay attention to total risks, which may be sensitive to the choice of service delivery mechanism, whereas the rules for accounting treatment have focused attention upon risk transfer (i.e. the sharing of risk). The analysis has emphasised the potential VFM gains from PFI, in terms of improved management of construction contracts, but has highlighted the potential problems arising from the discrediting of the appraisal process if that becomes associated with excessive gaming. Boundaries and lines are necessary and important in the management and statistical mapping of public sectors, but too much gaming about them is destructive and diverts effort; the impact of tolerated gaming on general respect for the process should not be underestimated. Indeed, there are grounds for alarm in the way that analytical techniques, often themselves of merit, are used to sanction decisions made at a previous stage in the decision process. In particular, the exclusion of certain alternatives from the options available has resulted in “best VFM” becoming a code that has to be deciphered.

This article has developed a framework for logical thinking about what is meant by “best VFM”, in the context of PFI projects. Moreover, it has shown the relationship between VFM tests and decisions on accounting treatment. Specifically, a reduction in construction risk may be a powerful source of VFM gains, but, under UK accounting regulation, it should not influence the accounting treatment decision. New complications about how VFM should be interpreted arise directly from the process of public sector fragmentation associated with new public management: affordability to the client is not necessarily the same as VFM for the public sector as a whole.

Although the specifics will differ from country to country, it is expected that the analytical issues will be remarkably similar and are likely to recur in other jurisdictions. What is unquestionably needed is good empirical evidence for a sufficiently large number of PFI projects for the results to be regarded as representative. Such access, on the basis that the results can be published, will never be gained by academic researchers in the UK. Only public auditors, such as the NAO and the Audit Commission, can gain access on the terms and conditions necessary for a comprehensive assessment. It is essential that the work of public auditors in this field be developed within a theoretical framework, such as the one developed in this article. Otherwise, findings on the PFI are likely to be ambiguous and hence vulnerable to rebuttal by governments.

Notes

1. Treasury (2000) explained that the PFI is one type of PPP: others include the various models for public enterprises, such as the partial privatisation of National Air Traffic Services; the wider markets initiative; and contracting for local education or health services on five- to seven-year contracts.
2. On lessons which other countries might draw from the UK experience of the PFI, see Spackman (2002).
3. The Treasury Taskforce, a company limited by guarantee, was set up in 1997 following the recommendations of the Bates Review on the PFI (Bates, 1997). Its aim was to improve the quality and viability of PFI schemes by the provision of practical guidance on key technical issues. The Bates Review suggested that the Taskforce have a limited life span of two years, highlighting that by such time there ought to be sufficient PFI expertise within government to do without a central co-ordinating capability. In practice this was felt not to be the case, and so, in June 2000, a new PPP, Partnerships UK, was established under the Government Resources and Accounts Act 2000. There is now a separation of the regulatory role (the Office of Government Commerce, an independent Office of the Treasury, with a broad procurement remit) and the promoter role (Partnerships UK), with the intention being to remove any perceived conflict of interest.
4. These include: relevant accounting standards (ASB, 1998, Wilson *et al.*, 2001); Treasury guidance on project appraisal (Treasury, 1997); the Treasury Taskforce (1999a) guidance on PFI accounting and its largely identical local authority variant (CIPFA, 1999); the Treasury Taskforce (1999b) "method statement"; and a report on VFM drivers (Arthur Andersen and Enterprise LSE, 2000), both commissioned by the Treasury Taskforce. Use has also been made of VFM reports on PFI projects published by the National Audit Office (2001), and on schools' PFI projects in Scotland by the Accounts Commission (2002) and in England and Wales by the Audit Commission (2003b).
5. See, for example, the discussion in Spackman (1991, 2001). In the context of investment in London Underground, Kiley (2002) viewed the lower borrowing rate of public bodies as a cost saving, a view denounced by Currie (2000).
6. The substance of the Ryrie Rules was summarised by the Treasury as follows: "(i) decisions to provide funds for investment should be taken under conditions of fair competition with private sector borrowers; any links with the rest of the public sector, government guarantees or commitments, or monopoly power should not result in the schemes offering investors a degree of security significantly greater than that available on private sector projects; and (ii) such projects should yield benefits in terms of improved efficiency and profit from the additional investment commensurate with the cost of raising risk capital from financial markets" (Treasury, 1988, Annex). There was a strong Treasury presumption against additionality. The change in the Treasury's position during the 1980s and early 1990s from alleged strangler at birth (Willets, 1993) to midwife of private finance in the public sector has attracted comment: "Rather than simply being the watchdog of financial probity and fiscal rectitude, HM Treasury has . . . been playing . . . a number of potentially conflicting roles" (Mayston, 1999, p. 264).
7. This includes £16.080 billion representing the estimated capital value of the London Underground Ltd PPP contracts.
8. No separation between on-balance and off-balance sheet PFI was provided by Treasury (2002a).
9. For an analysis of the post-1998 system of UK public expenditure control (see Heald and McLeod, 2002, para. 489-92).
10. Strictly, the "merits of policy objectives" cannot be questioned. The power in the National Audit Act 1983 (c 44), s 6(1) ("may carry out examinations into the economy, efficiency and effectiveness with which any department, authority or other body to which this section

- applies has used its resources in discharging its functions”) is qualified by s 6(2) (“[the power] shall not be construed as entitling the Comptroller and Auditor General to question the merits of the policy objectives of any department, authority or body in respect of which an examination is carried out”) (Heald and McLeod, 2002, para. 519-20).
11. The context of the present discussion is that of a project whose services are delivered free to users, or where user charges will go to the public purchaser. The framework can, however, be extended to the case where, like the Severn Bridge, a concession is let allowing the operator to levy user charges in return for the provision of the service.
 12. Darker shading is attached to the two bond-financed segments as these are categorically ruled out. Lighter shading is attached to the Exchequer-financed PSC (often understood not to be fundable) and to the on-balance sheet PFI (often understood not to be available).
 13. The non-availability of Exchequer finance raises issues of capital rationing beyond the scope of this article. If public borrowing is ruled out in a particular year by macroeconomic considerations, then Exchequer finance in that year has an implicit shadow price in excess of both the costs of government borrowing and the Treasury’s prescribed 6 per cent real discount rate. Although the Treasury has subsequently shifted its position, towards a social time preference rationale for the public sector discount rate, it argued for many years for using a discount rate based on opportunity cost. Given that departments have capital budgets, the question arises as to why Exchequer finance is available for some projects but not for others, apparently irrespective of project returns.
 14. Mayston (1993) expressed concern that the PFI reinforces the public sector bias towards new build rather than pro-active management of existing asset portfolios.
 15. “All [NHS] Trusts claim that ‘do nothing’ is not an option” (Froud and Shaoul, 2001, p. 256).
 16. “Speaking to Labour’s spring conference last Sunday, Tony Blair said: ‘Our strategy is to build up the public services. Theirs is to knock them down. Reformers versus wreckers’” (*Guardian*, 2002).
 17. For convenience of exposition, Figure 2 is drawn on the basis that the same benefits can be achieved via different schemes, with only costs varying. In practice, alternative schemes are likely to vary in terms of benefits as well as costs. If this point was taken on board, it would complicate the diagrammatic exposition, without the complications affecting the conclusions of the analysis.
 18. In quadrants 3 and 4, the FBP will be chosen ahead of the PFI, provided that decisions are taken on the basis of PVCs. In practice, there may be other considerations: for example, clients expecting public expenditure cuts might be enthusiastic to sign a contractually binding PFI, rather than staging investment under the FBP.
 19. Flyvbjerg *et al.* (2002) discussed the evidence on “strategic misrepresentation” (which they subtext as lying) in cost estimates for public works projects.
 20. At the time of writing, the Treasury has been consulting on a new Green Book (Treasury, 2002b). In the draft version, the Treasury now recommends 3.5 per cent for time preference, plus appraisal methods designed to counter optimism bias. There is extensive discussion of problems of poor construction performance, on which a report was commissioned (Mott MacDonald, 2002). If these proposals go ahead, the implications for PFI appraisal will be more complicated than a simple reduction in the discount rate from 6 per cent to 3.5 per cent.
 21. There is much discussion in the United Kingdom, in the context of new public management (NPM) reforms, of establishing level playing fields among different public sector providers, and sometimes with private sector providers. This particular usage of “level playing field support” relates to those local authorities with PFI schemes receiving special assistance, top-sliced from public funds available for distribution, in recognition of the fact that, if the project were undertaken from public funds, a very substantial proportion of the loan charges would be met by central government grant.

22. The existence of a PFI consortium creates a new set of incentives. The finance providers may impose stricter *ex ante* controls on the construction stage, thus ensuring that the project is fully costed and that the contractor does not anticipate that claims for additional work will meet a soft budget constraint.
23. A case entirely unconnected with the PFI has reinforced this point. The two main Independent Television franchisees in the United Kingdom, Granada and Carlton, set up a joint venture (ITV Digital) to run subscription services. Having invested heavily in football coverage of an inferior quality (i.e. Nationwide League as opposed to the Premiership), ITV Digital was unable to recover its outlay through subscriptions and, after an unsuccessful period of administration, rescinded its licence to broadcast and was wound up, leaving large sums (£178.5 million) unpaid on the Football League deal. Explicit contracts involving parental guarantees of ITV Digital never having been signed, Mr Justice Langley concluded that the initial bid agreement to such guarantees was a subject-to-contract proposal and could not be accepted by conduct, meaning that Carlton and Granada were not severally liable for the Football League's outstanding claim (*Carlton Communications plc and Granada Media plc v. The Football League* [2002]).
24. It is clearly easier to dismiss the holder of a catering concession than the operator of the purchaser's entire stock of schools or hospitals.
25. Moreover, asset life may be 60 years, even when the concession is for 30 years. Expectations of residual value at the end of the concession will be influenced by changing perceptions of the usefulness of these assets beyond the concession period.
26. For example, the Treasury Taskforce (1999a) guidance produces arguments as to why demand risk might be shared between purchaser and operator in cases where it might at first appear that this all falls on the purchaser.
27. This document is sometimes called "Application Note F", because its practical effect is to add a sixth Application Note to FRS 5.
28. This has been extensively discussed in the PFI literature and therefore treatment here is strictly limited (see Broadbent and Laughlin, 1999; Froud and Shaoul, 2001; Hodges and Mellett, 1999; Mayston, 1999).
29. Such a case would involve the purchaser being determined as having a contract only for services (not an asset of the property used to provide the contracted services together with a corresponding liability to pay the operator for it) and the operator being determined as having a financial asset being a debt due from the purchaser (not an asset of the property used to provide the contracted service) (Wilson *et al.*, 2001, p. 1295).
30. In the context of the PFI, care is required in exposition. In terms of SSAP 21 (ASC, 1984), an operating lease occurs when sufficient risk has not been transferred from the lessor to the lessee. References by the Treasury to risks being transferred should be read to mean that the private sector lessor has *not* transferred risk to the public sector lessee. The 90 per cent rule relates to a view that, as a rule of thumb, any lease will be a "finance" rather than an "operating" lease if the present value of the minimum lease payments amounts to 90 per cent or more of the "fair value" of the leased asset.
31. This issue is explicitly covered in the flow chart attached to FRS 5A (ASB, 1998, p. 28).
32. The political and economic circumstances surrounding the PFI have "led the Treasury to take a particular interest in the development of this guidance, that has not always appeared to be benign. This culminated in June 1999 in the issue of the Treasury's own guidance on how the public sector should interpret the Application Note [FRS 5A], and although the ASB has not demurred, *the two documents do not seem to be in complete harmony*. The consequence is that this remains an area of some confusion, but we believe that Application Note F is the more reliable source of reference and that PFI transactions should be carefully analysed according to its approach" (Wilson *et al.*, 2001, p. 1296, italics added).

33. Third-party revenues are generally unimportant in PFI projects for schools, hospitals and prisons. However, they can be very important in student accommodation projects, when there is dual use: 30 weeks for student use guaranteed at a certain occupancy rate by the university; and conference and tourism use for the rest of the year. Unforeseen events, such as those on 11 September 2001, can significantly affect tourism revenue.
34. The deliberate arson by detainees of the Yarl's Wood immigration removal centre on 15 February 2002 shows that underperformance, with regard to properties, can be significant (Travis, 2002). According to Morris (2002): "Bafflingly, the centre had no sprinkler system, although the fire service had recommended that one should be installed". According to a newspaper report (Burrell, 2002), "Bedfordshire Fire Service recommended the installation of a sprinkler system when the centre was built but was ignored by the Home Office. In the House of Commons yesterday [25 February 2002], Mr Blunkett [Home Secretary] said the decision not to fit sprinklers was 'informed by advice from a number of different expert sources' but events had shown that such 'precautionary measures' were now necessary. He said he had therefore decided to install sprinklers in all removal centres". According to BBC News Online (2002), Capita McLaren, loss adjusters for the private operator's (Group 4) insurers, informed Bedfordshire Police Authority that they intend to sue it for £38 million under the Riot Damages Act 1866: "A spokeswoman for Group 4 said that the company had no involvement in the legal action . . . Alistair Burt, the Conservative MP for North East Bedfordshire, said his constituents would be 'astonished' by the move. 'If this is the law of insurance, then I am a banana'". Quite apart from the rebuilding cost, providing replacement facilities also imposes costs upon both the government's deportation policy (detainees at Yarl's Wood were awaiting deportation) and its prisons' policy (the construction of this facility was in part to ease overcrowding in prisons).
35. The entries in Table I are fictitious. For an explanation of the entries, see the note attached to the table.
36. The publication on 6 December 2001 by the ASB's Urgent Issues Task Force (2001) of an Information Sheet on accounting for PFI pre-contract costs, and then prescriptive guidance on 21 May 2002 (Urgent Issues Task Force, 2002), indicates that more attention is now being paid to operator accounting. After the present article was written, some firms that are important in PFI consortia restated their profits and/or suffered a dramatic reduction in their share price.
37. "But the much vaunted private contractors pitched their bids 4 per cent higher than the public sector estimated its costs to do the same job. The only way the PPP could be justified was after the accountants and consultants estimated that if [London Underground Ltd] stayed in charge the bill would be a cool £4.3bn higher in cost overruns" (Hutton, 2002).
38. If certain risks are identical for both the PFI and PSC (or FBP), they can be ignored in the VFM analysis, which is conducted in terms of levels of NPV. However, such risks should not be ignored in the analysis for the accounting decision because their existence will affect the proportions of risk retained by the client and transferred to the operator.
39. For example, by means of an invitation to tender for a contract to design a reconfiguration of the asset base.
40. For example, win the contract by bidding low and then secure additional payments.
41. Consequently, Table I is incomplete. Rather than the only difference between the accounting treatment decision (A) and the VFM analysis (B) being the introduction of construction risk into the latter, all the risks attributable to the stripped-out separable elements should be reintroduced into (B). The bundling of various elements into the PFI contract, including those normally tendered over much shorter periods, adds to purchaser-borne risks.

42. Thus far, the Treasury has not retrospectively scored those PFI projects that, contrary to initial expectations, are on departmental balance sheets.
43. "The practical examples in this paper, drawn from the accounts of entities [NHS Trusts] in the throes of developing PFI projects, indicate a trend of increasing narrative description of the beneficial impact of PFI schemes accompanied by an absence of financial disclosure, particularly in the summarised accounts. This suggests a failure of voluntary disclosure and that a tighter description of requirements in 'Trusts' annual reports and summarised accounts is needed" (Hodges and Mellett, 1999, p. 289).
44. "The risk assessment is typically drawn up by external consultants for the purpose of demonstrating risk transfer and at best describes an a priori division of risk. But, without analysing and cross-checking the legal documents against the risk assessment, it is impossible to know whether risk has in fact been contractually transferred as outlined in the risk assessment . . ." (Froud and Shaoul, 2001, p. 258).
45. "Mr Livingstone questioned the independence of the 'value for money' report from Ernst & Young (2002), saying the company was the auditor for key firms in two of the successful PPP consortiums . . ." (Harper, 2002). The economic journalist Alf Young noted: "Accountants are also both the midwives and undertakers of the corporate life cycle. In their other contemporary guise, as consultants, there is scarcely an issue they don't claim to know more about than the rest of us put together. If Ken Livingstone and Tony Blair can't agree about what to do with the London Tube, they call in Deloitte and Touche, PwC and eventually Ernst & Young to back their side of the argument. Accountants can, and do, pontificate on everything" (Young, 2002).
46. For example: "Mr Brown said he wanted to send a 'strong message that the wealth-creating agenda and support for public-private partnerships [and] the encouragement of small business [are] central to everything we as a government will do'" (Groom and Crooks, 2002).
47. The extent to which the PFI is beginning to resemble a government policy, rather than a means to achieve policy, inevitably complicates the NAO's work in this area, as the National Audit Act 1983 (c 44) prohibits it from examining the "merits of policy objectives" (Heald and McLeod, 2002, para. 520). There is also the question of how governments respond to published VFM reports. Two examples illustrate this point. First, what the Prime Minister Tony Blair wrote at the time of the September 2002 Labour Party Conference is not an accurate representation of the content or conclusions of National Audit Office reports on the PFI. In a Fabian pamphlet, of which an extract appeared in the *Guardian* on 27 September 2002, he wrote: "The National Audit Office has examined existing PFI schemes and found they will *all* deliver value for money and this continues to get better" (Blair, 2002, p. 15, italics added). Second, when the Audit Commission press released (Audit Commission, 2003a) its report on schools' PFI, the Schools Minister (David Miliband MP) is reported to have dismissed the findings as "old news" (Perkins, 2003).

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