
Fourth Special Report of Session 2014–15

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Treasury Committee

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The Government Response is in plain text and the Committee’s conclusions and recommendations are in bold text. It is attached as an appendix.

Appendix: Government Response

Accounting and budgetary incentives

1. In its previous Report, the Committee concluded that the accounting treatment of PFI debt was encouraging the use of private finance for reasons other than value for money. The production of National Accounts according to the European System of Accounts (ESA) leaves PFI debt off balance sheet. The Government’s headline debt statistic, Public Sector Net Debt (PSND), which is calculated using the National Accounts balance sheet, therefore excludes PFI debt. This acts as an incentive to pursue PFI as it does not add to the headline measure of national indebtedness. Departmental capital budgets also follow the definitions used by the ESA. When a department does not have a capital budget large enough to finance an investment project under conventional procurement, PFI can be used to leverage its capital budget to proceed with the investment. (Paragraph 33)

The fiscal aggregates, on which the Government assesses its fiscal mandate, are measured using components derived from the UK National Accounts using the European System of Accounts 1995 (ESA95 and, from September 2014, ESA2010) framework. This approach has been followed in the UK since 1998. Departmental budgets reconcile with the National Accounts in order to allow the effective control of spending so the Government can meet its fiscal targets. Departmental Accounts are based on the International Financial Reporting Standards (IFRS), which are in the main aligned with departmental budgets. In certain cases, ESA95 and IFRS for the public sector are not aligned and this is the case for PFI. As part of the implementation of ESA 10 Eurostat are currently reviewing the guidance on the treatment of PPPs.

The Treasury believes firmly that value for money is of primary importance and has always been clear in guidance to Departments that it is value for money and not the accounting treatment, which is the key determinant of whether a PFI scheme should go ahead. A strict scrutiny process has been applied by the Treasury to PFI projects with the aim of ensuring that a decision to use PFI is only made where it can be demonstrated to provide value for money over conventionally procured alternatives. In April 2011, the Treasury revised its project assurance and approval processes as part of a wider programme of strengthened
spending control. All major projects outside of a department’s delegated authority, regardless of procurement method, now need to go through the Treasury Approval Point process to confirm that the project will demonstrate value for money.

2. One of the PF2 innovations is the introduction of a control total. This will limit the payments under PFI and PF2 contracts to £70 billion over the five years from 2015–16 onwards, allowing about £1 billion of new PF2 projects a year. However, an aggregate control total would not remove the budgetary incentive for individual Departments to choose PF2 over traditional procurements: until the £70 billion upper limit is reached, it would remain. Indeed, the control total will create an incentive for departments to bring forward investment decisions under PF2 as soon as possible in order to include the projects within the £70 billion cap. This is likely to reduce the quality of decision making within government on investment projects, with less consideration given as to whether PF2 offers the best value for money. The Committee remains concerned that the control total will fail to address the budgetary incentives to use private finance. (Paragraph 34)

Any incentive effect on departments will depend on the exact operation and design of the control total framework that will be detailed ahead of implementation in 2015-16. To date, the Treasury has seen no evidence that the control total has influenced departments to bring forward decisions on investment projects. Indeed a number of departments have revised plans to undertake PF2 projects and currently there are only the Priority Schools Building Programme (PSBP) and Midland Metropolitan Hospital projects in procurement. Regardless of the operation of the framework, departmental Accounting Officers will continue to have a duty to ensure value for money for the taxpayer in their investment decisions, as set out in Managing Public Money.

The appraisal methodology is not a decision making algorithm, it is an approach to provide objective, transparent support for the decision making process and the choice of financial model is appraised in the round. The Treasury approvals process is based on the Better Business Cases methodology and the Treasury Five Case Model which is much more complex than reliance on a single decision criteria. Transparency and a requirement for all quantification and other factual statements to have a verifiable objective basis supports the constructive challenge of all spending proposals.

Value for money

3. There was agreement among our witnesses that increasing the equity proportion under PF2 is likely to increase the cost of capital compared to conventional PFI. The Government claims, however, that a higher proportion of equity will offset the increased cost of finance, in whole or in part, for two reasons. First, a higher proportion of equity will reduce the risk borne by lenders and should therefore help to attract long-term institutional investors such as pension funds. Given the reduction in availability and increased cost of long-term bank debt following the financial crisis, this alternative source of funding will, the Government argues, lower the cost of finance. Second, the cost of the higher equity share will be offset by the returns on the public sector minority
investment. However, there is a risk that these returns may not be realised in practice. For example, any return on the minority investment is subject to appropriate management of project risks. Failure to manage these risks will result in a lower return. This means that the Government’s equity share is exposed to the same risks as that of any other private sector equity holder—there is no guaranteed return on its investment. (Paragraph 49)

The Treasury accepts that returns on its equity investment in PF2 projects are not guaranteed and it would be inappropriate to require them to be guaranteed. It is an underlying principle of privately financed projects that the capital is at risk for the large majority of the contract term. However, public sector investments in PF2 projects will be managed professionally and on a commercial basis by a specialist delivery unit within Treasury staffed by individuals experienced in privately financed schemes.

4. The Committee would also be concerned if the Treasury did not consider the opportunity cost of the equity investments when assessing the value for money of PF2 projects. Investing a minority stake in the private finance project under PF2 will mean that the money cannot be allocated elsewhere across government. There is an opportunity cost if the alternative allocation would yield a better return for the taxpayer: for example, paying off public sector debt. In such a case PF2 would represent lower value for money. The Treasury must take account of the estimated opportunity cost of the public sector equity when assessing whether the PF2 procurement approach represents the best value for money for a project. (Paragraph 50)

The driver for all public sector spending is, as recognised in the Treasury Five Case Model, the public value generated by the proposal, not the generation of financial profit for the exchequer. Profits returned by a PF2 project will be counted as negative public spending and, as part of exchequer’s costs, will contribute to the financial case under the Five Case Model and will therefore be expressed through the budget constraint. On this basis the value for money of these investments in PF2, including the opportunity cost, is carefully considered by the Accounting Officer of the sponsoring department that provides the funding for the investment. The Treasury PF2 Investment Unit only manages the equity investment on behalf of the sponsoring department. All profits made by the investment are returned to the sponsoring department.

5. All potential PFI projects are appraised in line with the Government’s central appraisal process set out in the Green Book. The timing of cash flows and the discount rate follow this standardised approach. The appropriateness of the Green Book falls outside the scope of this report, but the Committee may seek to address this area in a future inquiry. (Paragraph 65)

Treasury notes the Committee’s comments.

6. The NAO report highlights that both the quantitative and qualitative elements of PFI assessment have lacked reference to supporting evidence. Failure to base assumptions on empirical evidence will reduce the value of the VFM comparison. (Paragraph 70)
This matter is not specifically a PF2 issue and would apply to any VfM analysis. The Green Book requires departments to base their appraisal of value, costs, benefits and risks on empirical evidence and, for example, using data from past projects or similar projects elsewhere to calculate optimism bias estimates for use during the proposal’s development process. Supplementary Green Book guidance provides cross-departmental guidance for generic project categories which can be used in the absence of more specific evidence.

In the case of the PSBP, Treasury has made it a specific condition of its approval that the Department for Education uses the opportunity of a programme that is funded through both traditional capital and private finance to collect comparative VfM evidence.

7. The Government withdrew the Value for Money Assessment Quantitative Assessment Tool for comparing private finance and conventional procurement options in December 2012. The Treasury is still in the process of developing its updated and extended value for money guidance for PF2. In the meantime, procuring authorities are still required to use the qualitative assessment when appraising whether projects should be funded by private finance. (Paragraph 71)

The Treasury agrees that a qualitative assessment of the suitability of a scheme for private finance remains an important part of the VfM assessment and will provide guidance in due course.

8. The Committee recognises that the qualitative element of the process is important, but believes that it should only be considered a supportive tool and in conjunction with a quantitative component. It is the quantitative assessment that provides the best basis for direct comparisons between PFI and government borrowing. The Committee recommends that the new value for money guidance for PF2 should consist of both quantitative and qualitative components. (Paragraph 72)

The Government’s approach to appraisal is set out in the Green Book. It provides a common, standard method for comparing all public spending decisions that use central government funding; the approach to appraising potential PF2 projects is consistent with this central guidance. The opportunity cost of alternative spending is the Government’s approach to comparing the relative public value of all spending proposals. At the individual project level, the appraisal informs the choice of options for implementation of individual spending and applies only as a choice between project options or between projects and programmes in the portfolio. There are decisions about resource allocations within the pre-determined spending budget, they do not and cannot reflect on the overall level of public spending or borrowing which is determined separately by ministers.

The standard Green Book approach uses a common discount rate, known as the social time preference rate. This is used simply as a means to adjust alternative options with different patterns of future costs and benefits to allow for social time preference and thereby facilitate their comparison. The discount rate used attempts to reflect pure preferences for benefits now over benefits postponed. Projects specific risk is, as far as possible, built in to the costs of the proposal and therefore excluded from the social time preference discount rate to avoid double counting.
Long-term forecasting requires assumptions to be made about the future and this applies equally to conventional or PFI procurement. This necessarily means that the quantitative assessment will have a degree of uncertainty which increases the further into the future the projection looks and for privately financed projects this can be thirty years. The Green Book is clear that the quantitative assessment provides support for making an overall assessment that also considers qualitative factors, risks, affordability and deliverability. All of this is made clear in the Better Business Cases methodology. Private finance is considered alongside all of these factors, as are all elements of the decision.

9. The Treasury should seek to ensure that under the new value for money guidance for PF2, quantitative assumptions, particularly for the optimism bias and the tax adjustments, are supported by robust evidence which can be subject to scrutiny. The Treasury should also ensure that Department’s responses to the questions posed in the qualitative assessment are also accompanied by evidence. (Paragraph 73)

The Treasury agrees this recommendation. The Green Book requires departments to base their optimism bias adjustments on empirical evidence, for example using data from past projects or similar projects elsewhere.

10. Decisions are nevertheless being taken, without such a quantitative assessment tool, on whether or not to use PF2 for infrastructure projects such as the Priority Schools Building Programme. The absence of robust updated guidance for assessing whether PF2 offers the best value for money for a particular project is highly unsatisfactory. The Treasury must consider carefully whether it should permit PF2 projects to proceed in the absence of such guidance, and should set a date for issuing new guidance. (Paragraph 74)

The approach that was adopted by the Department for Education to determine the VfM of the PSBP included a detailed quantitative analysis.

The Treasury agrees that a quantitative appraisal is an important part of the overall consideration of how to deliver a project. Each option should be costed as accurately as possible using outturn data. Where there is uncertainty about inputs, or outputs are highly sensitive to the input variables, it is important to improve the level of confidence wherever possible, but it is also important to undertake appropriate sensitivity and scenario analysis. Procuring authorities should continue to undertake appropriate quantitative assessment, in accordance with the principles set out in the Green Book.

11. The Committee welcomes the Government’s commitment to publish an annual report providing detailed financial information on all projects where the Government is a shareholder. We also support the requirement for private sector investors to provide actual and forecast equity return information to the Treasury for publication. The Treasury must clearly define the basis of the calculation of such information to ensure consistency over time and comparability between projects, and to minimise the risk of manipulation of the figures. The Treasury must demonstrate that the requirements will be sufficient to capture the returns of equity investors involved in subsequent refinancing or sales of equity. (Paragraph 77)
The new standard form equity documentation requires disclosure of both the actual cumulative equity internal rate of return and the forecast return (up to the expiry date of the relevant PF2 project) every 6 months. In each case the return will be determined in accordance with the relevant project specific financial model. Treasury will review the basis of each calculation so that projects may be fairly compared in the annual report.

Annual reports will be published after equity investments have been made. It expected that the first PF2 equity investments will be in the PSBP.

12. The Committee supports the principle of building greater flexibility into Private Finance contracts. The Treasury should seek to ensure that any benefits from the splitting out of ‘soft services’ from PF2 contracts are not negated by any increased complexity, and potentially cost, that coordinating and managing multiple contracts may bring. (Paragraph 83)

To improve the flexibility of service provision, soft services will now be excluded from contracts going forward and instead will be provided via short term contracts with the private sector or by the public sector directly. However, The Treasury agrees that this must be a VfM judgement for the procuring authority and it may not be appropriate where there are significant integration and interface benefits from procuring all services as a single contract. If procuring authorities consider that the inclusion of soft services is integral to the delivery of a project, a clear value for money case must be demonstrated and approved by the Treasury. The Treasury believes that strong and effective contract management is vital for the efficient operation of public services.

In the Department for Education’s Priority School Building Programme, the schools can either enter into separate contracts or self-provide soft services. They agree the interface (i.e. which services sit on the hard and soft ‘sides’ of the line) and are free to contract for soft services as they wish. DfE has avoided any need for the schools to contract for ‘gold-plated’ services by ensuring that PF2 contractors cannot place any requirements on the schools’ soft services providers other than the minimum requirement that they must follow manufacturers’ instructions as advised to them - this protects against damage to building fabric through use, for example, of harsh cleaning products or methods. In addition, school premises teams continue to provide some ‘first line’ maintenance, such as cleaning out drain traps and replacing light bulbs from a stock provided by the contractor. A common-sense approach has been taken that fits with the schools’ visions of a sensible split of work.

**Securing private investment**

13. Even if a value for money case could be demonstrated for the PF2 approach, institutional investors would need to enter the market in sufficient numbers to create the kind of competition that could lead to the cheaper equity pricing that the government is seeking. Investors have indicated that this is only likely to happen if there is a clear pipeline of PF2 projects and a flow of deals. Such a deal flow has yet to materialise, and some of the projects that the Government initially planned to procure
using PF2 have either scaled back their use of the approach or have abandoned it altogether. (Paragraph 97)

Treasury notes the Committee’s comments.

14. It is unclear how the new aggregator model which the Government intends to use to fund the privately financed element of the Priority Schools Building Programme will operate. We are concerned that, if this involves grouping schools into batches, the advantages of involving private investors at the individual project level may be lost and the approach will be driven by accounting and budgetary incentives rather than value for money. The Treasury should set out, in detail, how this model will operate and how it believes the approach will offer value for money compared with direct capital investment. (Paragraph 98)

The privately financed element of the Priority School Building Programme involves grouping schools into batches, as was the case in Building Schools for the Future and earlier private finance programmes. This is far more efficient than procuring schools individually. The aggregator model aggregates the funding requirements of the five PSBP private finance batches so as to enable a more competitive approach to funding which has traditionally been driven by the availability of commercial bank debt. The model drives further efficiencies in due diligence. While it remains as detailed as if it were to be done at batch level, the due diligence in the PSBP can, to a large extent, also be “aggregated” at a programme level as each batch project agreement is essentially identical. This approach has been instrumental in attracting finance from the European Investment Bank who would otherwise consider individual batches too small to warrant the resource requirements for due diligence.

Neither the batching of schools nor the use of the aggregator funding model has any effect on the involvement of private sector investors at project level—such investors remain an integral part of the private finance deal.