AFFORDABILITY, ACCOUNTABILITY AND THE TWO-TIER WORKFORCE

PUBLIC SERVICES PRIVATE FINANCE

UNISON

Public Services, Private Finance

Accountability, affordability and the two-tier workforce

Report for UNISON by:

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February 2001

Websites:

http://www.ucl.ac.uk/spp/about/health.htm

http://www.unison.org.uk/pfi

Printed and published by UNISON, 1 Mabledon Place, London WC1H 9AJ.

http://www.unison.org.uk CU/............ stock no. ,.,.,.,.,., Printer's ref:

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Abbreviations

DETR	Department of Environment, Transport and the Regions
DfEE	Department for Education and Employment
DLO	Direct Labour Organisation
DSO	Direct Service Organisation
FBC	Full Business Case
FM	Facilities Management
LEA	Local Education Authority
NPC	Net Present Cost
NPV	Net Present Value
OBC	Outline Business Case
PFI	Private Finance Initiative
PPP	Public Private Partnership
PSC	Public Sector Comparator
SSA	Standard Spending Assessment
VFM	Value for Money

Preface

Public services, private finance

This report on the government's Private Finance Initiative (PFI) was commissioned by UNISON. It draws on the procurement documents for a number of PFI schemes currently in progress in the local authority sector and on government policy statements and guidance. Where relevant parallels with, and departures from, previous experience with the PFI in the National Health Service arise (the subject of previous reports commissioned by UNISON), these are pointed out.

Thanks to the obligation on Local Education Authorities to consult with governors of schools about proposed changes, there has been much greater public availability of documents on school PFI schemes than on other local authority schemes. However, there is in general a regrettable lack of publicly available information on PFI schemes in local government. This is in contrast with the health sector, where there are departmental guidelines on the disclosure of PFI documents at each stage of the procurement process.

Summary conclusions

- Despite changes to accounting practice which should in principle remove the incentive to seek 'off-balance sheet' deals, government departments are continuing to make approval for Private Finance Initiative (PFI) schemes conditional on 'off-balance sheet' accounting treatment. Capital for publicly funded schemes remains limited, and PFI remains government's preferred procurement method.

- The pursuit of 'off-balance sheet' deals demands dividing services into 'core' and 'non-core' functions, making the PFI a driving force in the reconfiguration of public services and the transfer of public sector staff to the private sector.

- The transfer of services and staff from the public to the private sector in PFI schemes appears to be motivated by the pursuit of 'off-balance sheet' accounting treatment rather than genuine value for money.

- Results of economic appraisal of PFI schemes are largely determined by the discount rate used and the costing of risk transfer. The savings claimed for PFI schemes are largely dependent on these subjective elements in the appraisal of projects.

- The system for revenue support for local authority PFI schemes does not meet the full additional costs of schemes to authorities, making it necessary to divert funding intended for other uses.

- Liability for the debts of PFI/Public Private Partnership (PPP) companies rests with commissioning authorities. It is very unlikely that authorities will now be able to extricate themselves from PFI contracts in the event of poor performance by contractors, given the financial consequences of early termination. In practice, many risks will be retained by the public sector.

- There is evidence that the cost of Public Sector Comparators (PSCs) has been increased in the course of PFI procurement. The PSCs we have examined do not provide a reasonable benchmark for the comparison of publicly- and privately-financed projects .

- The PFI has enormous implications for the future provision of publicly-funded services. We are concerned that the motivations for the policy remain unclear and that there is no clear line of accountability linking local initiatives to national policy.

Scope of this report

The purpose of this report is to describe the operation of the PFI in local government across the UK. The report draws on several projects currently underway to illustrate some of the principles at work. It does not attempt to evaluate any of the projects; although it does in some cases comment on the way in which purchasing authorities and government departments have evaluated them.

The projects discussed are:

- A scheme proposed by Glasgow City Council for the building of 11 new secondary schools and one new primary school, extensions to seven secondary schools and the refurbishment of 17 secondary schools.

- A scheme proposed by Cheshire Police Authority for a new building to house Cheshire Constabulary's headquarters and forces training centre on a single site. It was selected by the previous government in 1996 as one of 14 'Pathfinder' Home Office PFI projects.

- A scheme proposed by the London Borough of Haringey to provide accommodation for ten local schools.

- A bundled schools project proposed by Tameside Metropolitan Borough Council, involving most secondary and primary schools in the Hattersley area, seven miles east of Manchester.

- A bundled schools project in East Leake, proposed by Nottinghamshire County Council for the redevelopment of seven schools.

- A bundled schools project, involving most secondary and primary schools in Stoke on Trent. One hundred and twenty-two schools are involved in all, of which 22 are voluntary aided and two are grant maintained. The scheme aims to reduce the number of schools to 102 sites. This scheme is noteworthy as most support services and staff remain in the public sector and are not transferred to the PFI contractors.

- A scheme proposed by Brighton and Hove Council to renovate or rebuild four local schools.

- A bundled schools scheme in the London borough of Merton.

1. Off-Balance Sheet Financing

1. Commercial involvement in public services

The development of the PFI is part of a trend towards the greater involvement of commercial enterprises in the delivery of tax-funded public services. The notion of public private partnerships includes such initiatives as the privatisation of Local Education Authority (LEA) services; the construction, operation and maintenance of National Health Service (NHS) hospitals; the sale of contracts to provide educational services at publicly-funded schools; and the privatisation of infrastructure provision for the London Underground.

PFI projects have a number of features which distinguish them from other types of commercial involvement in public services:

- The public sector assumes the role of client and ensures a regular payment stream to the private sector providers of assets and services

- A distinction is drawn between 'core' and 'non-core' aspects of service delivery.This effectively redefines the role of the public sector

- Capital investment is overwhelmingly financed by debt raised by PFI companies though it continues to be funded in total by the public sector

- The structure of deals is strongly influenced by government's requirement that transactions should be accounted for 'off balance sheet'. This is usually interpreted by public sector bodies as meaning that 'non-core' staff should be transferred to the private sector.

- The shifts in the role of the public sector resulting from PFI deals are long-term. PFI contracts usually run for 25-30 years, with very limited scope for early termination. When a skilled workforce is transferred to the private sector as usually happens under PFI agreements, the public sector is likely to find that it would be extremely difficult to provide the service itself, even if it wished to do so. In other words, when a PFI contract is signed, there is often no going back to public sector provision.

For all these reasons, securing finance through the PFI depends on a redefinition of the nature of key public services, which is likely to have permanent effect.

2. Policy motivation

> *'The purchase of capital intensive services from a private sector partner for a long term contract would, before recent changes in the Capital Finance Regulations, have constituted a credit arrangement under the capital finance system. The full value of this expenditure would have scored against the authority's capital resources in the year that the contract began. The changes in the regulations permit local authorities to enter into such contracts and to receive revenue support'.*
> [London Borough of Haringey Schools PFI scheme; OBC, p.27]

In the debate about the PFI two quite different types of argument are used to explain both the policy and decisions to use private finance for particular schemes. The first is the claim that the PFI allows more investment in public services to take place than would otherwise be possible given constraints on public expenditure.

A second set of arguments concerns the claimed economic efficiency, or 'Value for Money' (VFM) of PFI as a procurement instrument. We address the latter in chapter three. In this section we are concerned with the first claim. This is how one local authority explained why it was seeking private finance for investment in its school stock:

> *'In recent years the current method of financing has severely restricted local*

authority expenditure. There is no indication that the capping rules for authorities or the SSA settlements are going to be relaxed or improved significantly for the foreseeable future. External sources of funding, in particular the PFI route which the Government is encouraging, seem to be the only way of bringing significant capital to bear on our deteriorating school stock.'
[Stoke on Trent City Council, PFI booklet (98) p.4]

Similarly, Brighton and Hove council states that:

'Insufficient resources are available to fund the projected expansion of secondary school pupil numbers. It is therefore believed that the only practical route for procuring the required school facilities is through PFI.'
[Brighton and Hove Council, Outline of Business Case]

For local authorities, whose access to capital is decided by central government, PFI can be seen as a solution to a lack of resources – if central government is refusing to make capital available. PFI, on this account, is a way of getting more funding into the system given government-imposed constraints on local authority expenditure. What makes less sense, however, is when the same argument is made, as it frequently is, by central government itself. For example, the former Health Secretary Frank Dobson, asked by the House of Commons Health Committee why PFI remained so central to government policy replied:

'Well, because it brings in more money, basically ... we believe that the contribution of PFI is very important because with the limits that are always going to be there on public capital, if we do not have private capital coming in, then we will not get as much done.'
[HoC Health committee minutes of evidence 22 July 1998, para 110]

The Department for Education and Employment (DfEE) has told school governors:

'PPP is in addition to what Local Education Authorities normally spend on capital maintenance, refurbishment and building programmes for schools. As with all public expenditure, there are limits to what is available and demand regularly outstrips supply.'
[Public private partnerships: a guide for school governors p.7]

Statements which imply that PFI is in some sense supplementary to public expenditure are highly inaccurate. The costs of borrowing by PFI companies have to be met by the public sector. Where a PFI company borrows in order to provide services ultimately paid for by taxpayers, the net effect on public expenditure is the same as if the government had borrowed the money itself except that government could have borrowed at a lower interest rate.

3. PFI and measures of government borrowing

How then can PFI be regarded as a solution to shortfalls in public expenditure? If it is necessary to borrow to finance investment then public sector borrowing is the obvious solution. However, PFI has one potential, but illusory, advantage over direct borrowing: the liabilities involved in PFI do not appear as public sector borrowing in annual financial statistics. This is because the loans are taken out by private sector companies (even though they are repaid from public funds). By contrast, when public sector bodies borrow for investment purposes, the full value of the capital raised counts towards the public sector borrowing requirement and other measures of government deficit.

PFI transactions offer the possibility of investment not counting towards measures of government deficit because borrowing is undertaken by private companies. This is known as 'off-balance sheet' financing, as the liability for debts is not recognised on the public sector balance sheet. Thus, where a government is concerned to control the standard measures of deficit, PFI allows more investment to take place. For this reason, PFI is often regarded as an accounting trick focused on measures of government deficit rather than on the underlying economic reality.

Using private finance in order to keep projects off the balance sheet does not create a benefit for taxpayers, as the costs of borrowing by PFI companies have to be met by public authorities just like the costs of government borrowing – and tend to be somewhat higher. Moreover, the liability for borrowing by PFI companies rests squarely with the public sector bodies which have commissioned the work, even if the PFI contractors fail to deliver on the contract [see below, chapter three]. Under these circumstances, PFI is effectively government borrowing through an intermediary.

Concerns that PFI was being used as an accounting trick led the Accounting Standards Board (ASB) to issue special guidance on accounting for PFI in 1999. This guidance introduced much more rigorous tests for whether assets should count as on- or off-balance sheet. Initially resisted by the Treasury, the ASB guidance has now been accepted by government.

However, while the new guidance makes it considerably more difficult for public sector bodies to keep deals off the balance sheet, the evidence suggests that rather than accepting that PFI schemes should be on the balance sheet, government is actively encouraging public sector bodies to structure deals so that they will be 'off-balance sheet' under the new criteria.

4. Government policy and the public sector balance sheet

In recent months some ministers have been at pains to argue that PFI is no longer used to disguise public borrowing.

In the words of the Chief Secretary to the Treasury,

> *'We use PFI in a very different way to the previous government. In the past PFI has been used as a way to hide public sector borrowing. Accounting reforms now mean PFI cannot be used to take projects off the public sector balance sheet. We do not use PFI to hide borrowing, we use it because it is often the best, the fastest and the most effective form of delivering publicly funded universal services.*
>
> *'This government is committed to using PFI only where it delivers better value than traditional procurement. Every proposed PFI is tested against traditional public sector procurement, not for cheapness but for value for money, not just for the initial procurement but over the whole life of the project.'*
>
> [Statement by the Right Hon. Andrew Smith MP read out to a meeting at the Radcliffe Infirmary, Oxford, 16 September 2000.]

On the face of it, this seems like a pretty clear statement of policy. Moreover, the state of the public finances should remove any incentive for government to seek off balance sheet deals, as the government's deficit has been negative for the last two financial years, meaning that government is paying off debt rather than borrowing.

The excess of the government surplus over planned investment under the PFI in all areas of the public sector means that all this investment could be financed through the Exchequer without pushing the government finances into deficit [table 1].

Table 1
UK General Government Net Borrowing and PFI expenditure, 1999-2002

	1999/0 (£m)	2000/01 (£m)	2001/02 (£m)
General government net borrowing	-5,100	-11,400	-5,000
PFI investment (all sectors)	1,432	2,971	2,829

Source: Financial statement and budget report 2000 tables C3 and C14 (Negative figures indicate a surplus)

However Mr Smith's statement, with its implication that PFI no longer has anything to do with the balance sheet is not supported by evidence from recent PFI procurement. If the accounting treatment is not an issue then one would expect revenue support to be forthcoming for schemes whether they were off balance sheet or not: public sector clients would behave as if they were neutral between PFI and 'on-balance sheet' schemes This is quite clearly not the case. For example, one London local authority states in its Outline Business Case (OBC), dated March 2000:

> *'It is assumed that securing PRG [i.e., central government] approval for PFI credits will be conditional on the deal being Off Balance Sheet.'* [Merton OBC, p. 36].

It is clear that local authorities believe that in order to receive approval and financial support from the relevant department, schemes have to be off balance sheet. All business cases we have examined have included a section on accounting treatment giving the reasons why authorities expect schemes to be accounted for in this way.

5. Strong incentive to make off-balance sheet deals

The reason for this apparent contradiction between government policy and practice lies in the way in which resources are allocated to government departments. Each government department is allocated a revenue and a capital budget in the annual public expenditure round. All publicly financed capital expenditure is scored in total against the capital budget. As long as the deal is off the balance sheet, PFI expenditure is scored against the revenue budget as payments become due.

Any investment, whether publicly or privately financed, which is on the balance sheet has to be scored in total against the departmental capital budget, which is reduced accordingly. There is therefore a very strong incentive for departments to encourage off balance sheet deals. The capital value of signed NHS PFI deals, for example, would absorb the entire NHS capital budget if they had to be placed on the balance sheet.

Thus Stoke on Trent City Council points out that:

> *'the [PFI] contract does not score against a Government department's annual expenditure total but is 'financed' by a credit approval by way of revenue support grant. For this accounting treatment to be possible, the procuring authority has to demonstrate that the risks and rewards associated with the asset procured are, on balance, transferred to the private sector'.*
> [Stoke on Trent City Council Full Business Case (FBC) p. 18]

Local authorities believe that the accounting treatment determines the availability of revenue support; that schemes need to be off-balance sheet and financed under the PFI, if they are to be supported by government departments. In the London Borough of Haringey school governors were requested to:

> *'confirm their wish to take part in the [PFI] scheme or noting the uncertainty of alternative funding indicate their wish to withdraw from the scheme.'*
> [Report of the director of Education Services, 1999 – preferred bidder stage]

If local authorities are assuming that only off-balance sheet PFI deals will be supported, they can hardly be blamed, as this is the message coming from government.

A draft consultation on the standardisation of PFI contracts for local authorities issued by the Public Private Partnership Programme (4Ps) in May 2000 states, inaccurately, that local authorities are *obliged* to structure deals so as to achieve off-balance sheet treatment.

> *'The new [capital finance] regulation 40 requires the Local Authority ... to structure deals such that a sufficient balance of risks are [sic] transferred to the Contractor [for instance, the PFI consortium] to enable the transaction to be treated off balance sheet the Local Authority'*
> [4Ps, Standardisation of Local Authority PFI Contracts, 2.8.1]

It seems therefore that government's stated policy on PFI is not being put into practice. Public sector bodies are continuing to structure deals to maximise the chance of securing off balance sheet treatment, and they are doing so because they have been advised by their departments that this is what is required if they are to receive revenue support. This reflects the position of government departments which would see their own capital budgets reduced if deals were recognised on the balance sheet.

Andy Simmonds of Deloitte and Touche, who act as auditors for many local authorities and NHS trusts, was recently quoted in the *Independent on Sunday* as saying:

> *'In reality what we are seeing is that if the thing is on the balance sheet it is not going to happen... This could mean poorer value for money'.*

In fact the question of value for money has been conflated with that of the accounting treatment, as the 4Ps' consultation document on the standardisation of PFI contracts for local authorities has made clear. While it is widely accepted that the issues of accounting treatment and value for money should be clearly distinguished the guidance asserts without evidence or argument that

> *'In general terms well structured Value For Money deals will involve sufficient transfer of risk to be off the Authority's balance sheet'*
> [GPs, Standardisation of Local Authority PFI contracts2.8.1]

John Hawksworth, head of macro-economics at PricewaterhouseCoopers (PwC), writing in a personal capacity for the IPPR, has recommended that government should,

> *'issue a policy statement making it absolutely clear that accounting tests of whether a PPP project is on or off the public sector balance sheet are not relevant to assessing whether or not such a project should go ahead'*
> [IPPR: The Private Finance Initiative – Saviour, Villain or Irrelevance (2000) p.21]

If government policy is that PFI should be used only where it represents better value for money, then the perverse incentives on government departments to pursue off-balance sheet PFI deals should be removed. The current situation means that not only is PFI likely to be used where it is inappropriate but that poorer quality PFI deals will be signed because they come with the required accounting treatment.

6. The balance sheet and the workforce

The issue of 'off-balance sheet' treatment is of particular importance to trade unionists because of the widespread perception that achieving 'off balance sheet treatment' depends on transfers of staff to the private sector – despite recent government policy changes in this area.

The following quotation, from Glasgow City Council, states clearly the perception on the part of local authorities as to the need to transfer staff:

> *For a project to qualify as a private finance initiative project, there has to be significant transfer (for instance, building maintenance, cleaning) to a private sector contractor. This would mean that in such a project, all the facilities management services would transfer to a private contractor. The employees likely to be affected by such a transfer are those involved in cleaning, catering, sanitation and maintenance ... There are major doubts about the legality of DLOs and DSOs being able to tender directly for the provision of services in a public/private partnership project.*
> [Glasgow City Council Education department Capital investment strategy p. 6]

The same authority also commented that:

> *'The lenders [to the PFI consortium] will insist that all of the risks associated with providing facilities management services be transferred to the facilities manager through the contract.'*

This implies that it is the interest of lenders which is served by staff transfers. While this may in some cases be true, we have seen that the transfer of risk, and thus of staff arises mainly from perverse incentives on government departments and local authorities. As the council points out, earlier DoE guidance had suggested that such a participation of a DSO in a PFI scheme would be inconsistent with the risk transfer required of PFI schemes.

In the summer of 1999, the government announced a number of changes to PFI policy, in response to concerns raised by trade unions and others. With regard to the transfer of public sector employees to PFI consortia, it was stated that this would only take place where it represents VFM.

This was in contrast to the previous position, where there was an assumption that all workers classed as 'non-core' would automatically be transferred. The new policy will remain without force as long as departments are encouraged to structure deals in accordance with accounting criteria.

7. A two-tier workforce?

There is therefore an incentive for public sector bodies to transfer staff under PFI schemes. The requirement that this should happen only if it represents value for money is a weak one given the ease with which VFM appraisals can be manipulated (see *UNISON 'Challenging the Private Finance Initiative'* for examples).

Moreover, the way in which PFI consortia can drive down labour costs needs to be considered. Despite government's commitment to protect the terms and conditions of staff transferring to the private sector, new staff taken on by PFI companies will have no such protection. Not only does this mean that some workers who would otherwise have been employed on public sector rates will be paid less: it also undermines the collective bargaining process by, for example, giving contractors the incentive to allocate overtime to lower-paid staff. Thus it is not the case that staff transferred under TUPE conditions have the same level of protection as if they had remained in the employ of the public sector. We must ask what 'value for money' means in this context.

Government policy is that staff transfers should only take place if they represent better value than keeping the service in-house. In order for the government's stated aim of protecting workers' terms and conditions to have effect, certain conditions would need to be met

(1) The transfer of staff would have to show value for money in its own right through a separate economic appraisal of the services component of each scheme, with a fair and agreed formula for assessing risk transfer;

(2) Cost savings should not be achieved through deterioration of the terms and conditions of current or future staff, or through the creation of a two-tier workforce;

(3) where a PFI option involves lower staffing levels than its public sector comparator, the comparator should be adjusted accordingly, to ensure a like-for-like comparison (for instance, there should be no presumption of greater efficiency savings under PFI).

8. Transfer of staff – is there an alternative?

Most of the schools schemes currently in progress involve the transfer of non-educational staff such as site managers and cleaners. Where schemes 'bundle' a number of schools together, as is increasingly the case, the numbers of staff affected can be significant, as the example below from Haringey illustrates. In some cases, such as the Merton scheme in south London, transfers are limited because services have already been contracted out.

Transfer of staff at Haringey Schools PFI scheme:

Site managers	10
Assistant site managers	18
Cleaners	93
Total	121

There is however one major schools scheme, at Stoke on Trent, where most non-educational staff will remain in the direct employ of the council. It provides an important example of how a local authority can approach the issue of support staff on the terms set down by government and still remain the employer.

The outcome of consultation with teachers and governors when the scheme was first proposed in 1997 was that:

- *The inclusion of soft services would not receive widespread support from a large proportion of governors and head teachers, with the potential that many schools would not participate.*

- *The contract services Direct Service Organisation (DSO) which provided a number of these services was perceived as being the provider of an efficient cost-effective service.*

As a result the OBC submitted to the DfEE in December 1997 did not include ancillary services.

Table 2
Stoke-on-Trent schools PFI: services under proposed PFI contract

Services		included	excluded	optional
Building related services	repair, replacement or refurbishment	X		
	maintenance	X		
	fixtures and fittings	X		
	minor internal repairs		X	
	insurance	X		
Utilities and services	utilities provision	X		
	mechanical and electrical installation	X		
Facilities management	security		X	
	cleaning			X
	caretaking			X
	catering			X
	grounds maintenance			X

Source: Stoke on Trent Schools PFI, FBC (9.1.00 draft) p.12

The DfEE demanded that the council undertake specially-commissioned work to demonstrate that excluding services would represent value for money. That a department should require this specific point to be demonstrated is indicative of the close association between value for money and privatisation of staff in government thinking.

We are not aware of a case in which government has requested that a public sector body demonstrate that transferring staff represented value for money in its own right. The Stoke on Trent business case suggests that if it had, there would be considerably fewer transfers under PFI. The work commissioned by the council 'confirmed to the DfEE that the exclusion of services, as a package, does represent value for money.

This precedent has already been imported into the NHS. At Blackburn Royal Infirmary, ancillary staff were excluded from the PFI OJEC notice following an evaluation which found that its services already provided above-average VFM.

The pressure to pursue 'off-balance sheet' deals has encouraged public sector bodies to transfer staff under PFI deals. However, as the Stoke on Trent and Blackburn examples show, where in-house services are properly evaluated, it is possible for purchasing authorities to demonstrate that retaining services in-house represents better value or money.

2. Affordability

1. Are PFI schemes revenue neutral?

In promoting their PFI schemes, local authorities tend to lay stress on the funding provided by central government, implying and at times stating that schemes are effectively 'revenue neutral': that is, that they involve no increased call on local authority budgets.

The distinction between the costs associated with assets and the cost of services is central to the way government allocates revenue support to local authorities for PFI schemes: the policy is that revenue support is available to cover the capital component of PFI payments, not the cost of services such as facilities management.

The logic is that the cost of services is already being met by local authorities (and by schools through their delegated budgets). The amount of revenue support to be provided is thus determined by what Department of Environment, Transport and the Regions (DETR) refers to as 'the capital component' of the PFI charge. Confusingly, this means that 'revenue support' is only available to meet 'capital' costs. Government support for PFI schemes for local authorities is normally allocated as 'PFI credits'.

Most of the OBCs examined for this report state that almost the entire cost of the PFI contract will be met through the existing budgets for services and PFI credits.

In its schools' OBC, Haringey Council states:

> *'In effect the contract will be paid for from two sources:*
>
> - *PFI credit: we will receive money from central government through the revenue support grant to fund the capital element of the scheme*
> - *Revenue: the revenue budgets which currently fund the services covered by the contract, both those delegated to schools and those retained by the council'.*
>
> [London Borough of Haringey, OBC p.27]

Similar claims of near revenue-neutrality can be found in other business cases, with financial projections showing that existing budgets and PFI credits will suffice to cover most of the costs.

Table three below shows the results of the initial affordability appraisals carried out for a number of local authority schemes which received initial approval in 1998. As can be seen, the difference between available funding and projected PFI charges on this basis is minimal.

Table 3
OBC affordability projections – schemes approved in 1998

Authority	*Haringey NPC (£m)*	*Hattersley NPC (£m)*	*East Leake NPC (£m)*
PFI credit	*46.9*	*9.4*	*11.8*
Existing budgets	*38.3*	*7.9*	*7.5*
Total funding available	*85.1*	*17.3*	*19.3*
PFI charge	*86.6*	*17.4*	*20.3*
Affordability projection	*-1.4*	*-0.1*	*-1.0*

OBCs for Haringey (p.29) Hattersley (p.27) and East Leake (p.27) school's PFI projects

For at least one of these schemes the current financial position is quite different, as in order to make the scheme affordable the Council has had to make substantial calls on its own resources (see table 4, London Borough of Haringey: OBC and most recent affordability projections. on the next page).

More importantly, because the projections are expressed as Net Present Costs, it is impossible to tell how great the afordability gap may be in any individual year [see below, p.18,19]. In order to assess affordability it is necessary to compare the proposed PFI charge with available resources on a year by year basis.

Table 4
London Borough of Haringey: OBC and July 2000 affordability projections

	OBC (1998) NPC (£m)	*June 2000 NPC (£m)*
PFI credit	*46.9*	*53.2*
Existing education budgets	*38.3*	*37.1*
Sub-total	85.2	90.3
PFI charge	86.6	102.7
Shortfall	-1.4	-12.4
Budgets from other services	*0.0*	*13.8*
Affordability projection	-1.4	1.4

Source: London Borough of Haringey OBC (1998); Report of the director of Education Services to school governing bodies (July 2000)

Whether similar problems have emerged at the other schemes is not known due to unavailability of documents at this stage. In its OBC for the East Leake schools' scheme, Nottinghamshire County Council predicted that the (relatively small) affordability gap would be plugged through

> *'further refinement of the required services, detailed negotiations with the preferred bidder and a more detailed costing exercise.'* [p. 26]

However, at the same time the council pledged to meet any increase in the affordability gap that might emerge:

> *'The council recognises that in the event an affordability gap emerges or increases as the scheme proceeds, it will be necessary for the council to make available adequate resources to fund such gap.'* [p. 26]

2. MANAGING AFFORDABILITY PROBLEMS: CHESHIRE POLICE AUTHORITY

Cheshire Police Authority provides another example of an authority which is meeting its PFI costs through reductions in other, unrelated budgets. The first OBC (1998) prepared for the scheme to replace the police headquarters and training centre had estimated the future PFI charge at £2.8m. This was judged to be affordable on the basis of annual revenue support from government of £1.3m and a contribution from the authority of £1.5m. [OBC 1, p.61]

The authority's existing annual budget for the running costs of the properties involved was already £1.35m, so on this basis the scheme would have been close to revenue-neutral [see OBC 2, p. 61]. When the authority revised the OBC in 1999, the estimated annual charge was £1.8m higher (64 per cent), at £4.6m, creating a significant affordability gap for most of the contract period.

The authority stated in the new OBC that these costs would be met through: 'annual savings generated by a business improvement programme' of £1.78m. [OBC 2, p.61]

The source of these savings was a reduction in the wages bill for police officers engaged in call management. The current cost of this at the time was £3.4m. It was proposed to separate call management into two separate functions: call handling and deployment.

One of the advantages of this was said to be that it would allow,

> *'appropriate deployment of operational and support staff'*

that is, allowing civilian staff to take on tasks currently carried out by police officers.

It was estimated that the savings from this reconfiguration would reduce the wages bill by £2.3m. A projected increase in demand over the first five years of the scheme would reduce these savings to £1.78m – exactly the amount required to make the projected PFI scheme affordable. [OBC p.24]

Table 5
Cheshire Police Authority OBC 2 (1999): Call management budgets – current and projected

Cost element	Current (£m)	Preferred option (£m)	Cash released (£m)	Cash released with increased demand (£m)
Police pay	3.40	1.20	2.40	
Management	0.05	0.15	0.10	
Civilian pay	2.00	2.00	0.00	
Systems	0.35	0.35	0.00	
Total	5.80	3.70	2.30	1.78

The use of reductions in staff budgets to fill PFI affordability gaps is a phenomenon which has been documented in the NHS [Durham, Carlisle reports]. In the NHS this has tended to take the form of reallocating functions from qualified to unqualified nursing staff, which reduced wage costs.

Like the NHS, the police force is a labour intensive industry where most of the cost is wages. Faced with increased capital costs and relatively stable funding, such industries have little choice but to reduce staffing costs. As the authority points out:

> *'The outcomes from the government's Comprehensive Spending Review direct the Police Service as a whole to generate considerable annual efficiency savings as a prerequisite to any budgetary increases. In a service so dependent on human resources, such savings are hard to achieve within current structures and working practices.'*
> [OBC p. 6]

The reduction in the police pay budget in this scheme implies that a reallocation of functions to lower paid parts of the workforce is taking place.

As in the NHS, the proceeds from these 'efficiency' savings are expected to be absorbed in their entirety by the costs of the PFI scheme.

It is clear that in at least some cases assumptions that PFI schemes would be revenue neutral for the authorities concerned and would not require the diversion of resources from other uses proved to be over-optimistic. In the Cheshire case, this was partly due to a serious underestimation of the likely PFI unitary charge.

Glasgow City Council also underestimated the unitary charge for its schools scheme, by an even greater margin, when it carried out a feasibility study in 1998. The estimated cost of the scheme in year 3 rose from £27m to nearly £43m by the time the council completed its Final business Case.

Table 6
Glasgow City Council schools project – estimated charges for accommodation under schools' PFI scheme

Year	1	2	3
	£000	£000	£000
Feasibility study	24,045	26,513	27,015
FBC	36,700	38,000	42,700

Source: Glasgow City Council: Capital Investment Strategy p.60; FBC p.35 (excluding information technology costs)

However, underestimation of PFI payments only goes part of the way towards explaining the extra calls on local authority resources due to PFI schemes. There are other factors at work.

3. Revenue support from government

The system for allocation of central government support is itself one of the factors leading to affordability problems.

The 'capital component' of the PFI charge is that element which goes to meet the cost of:

(1) debt service by the PFI company;

(2) the 'life-cycle' costs of the buildings and equipment;

(3) returns to shareholders (net profits).

In practice, the government allocates funding by assuming that 70 per cent of the PFI charge relates to capital and 30 per cent to revenue costs, rather than by looking at the ratio of costs for individual schemes. This approach is adapted from the regulations governing revenue support for traditionally procured capital schemes [regs 41 and 42], and is known as the 'revenue abatement method'.

Revenue support for PFI is thus based on the existing system for allocating support to local authority borrowing through the Capital Financing Standard Spending Allowance (SSA). The problem is that the profile of payments for PFI schemes is quite different from that for LA debt service.

In providing support for local authority borrowing, payments are front-loaded, i.e. on the basis that as the principal is repaid, the burden of interest payments is reduced. By convention, it is assumed that the debt decreases by four per cent per annum, while support for interest charges is set to reflect market conditions each year.

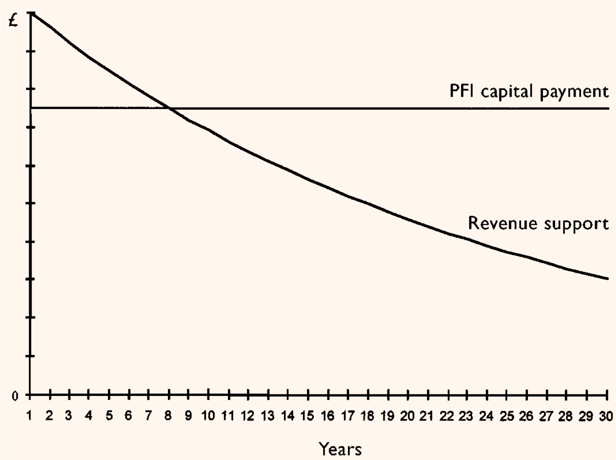
However, PFI payments, in accordance with government guidance, are fixed over the contract period, they do not decline as principal is repaid: the PFI charge is profiled so that as debt service costs decline returns to shareholders increase.

Hence there is a mismatch between the amount of PFI credit provided for any given year and the PFI charge. In early years, councils receive more than is required, but for most years of the contract they receive less. They also continue to receive credits after the end of the contract period. This is one of the reasons why Councils often assume – erroneously – that in the long run the amount of PFI credit does match the costs to be met.

Even if this were the case, which it is not, this would do nothing to resolve affordability problems during the contract period. These can be offset to a limited extent by Councils investing the excess credits they receive in earlier years, but the interest on this is not sufficient to meet the funding shortfall in later years because councils are restricted in their investment to low yielding opportunities such as bank deposits and gilt-edged securities.

FIGURE 1
PROFILE OF PFI COSTS: DEBT SERVICE AND DIVIDENDS

Revenue support for local authority PFI schemes



It should also be noted that initial bids for PFI credits are made before tenders are invited from the private sector. The estimates of required PFI credits are therefore prepared before the level of charges is known. The total amount of PFI credit available for each department is set at the start of the financial year, so revised bids for credits in the light of outturn charges will not necessarily be successful.

There is a question as to how well these issues are understood by members of the authorities who have to decide whether to proceed with PFI schemes or not. One problem is that financial projections given to members are often presented in

Net Present Values or Net Present Costs. No conclusions on affordability can be drawn from this kind of projection.

The mismatch between government revenue support and PFI costs was one of the issues which led to criticism of North Wiltshire District Council by its scrutiny committee. The PFI scheme was for the provision of new council offices. The decision to replace existing offices was prompted by a presentation by KPMG on 7 October 1997 and was ratified by the council 16 December 1997. DETR 'sanctioned' PFI in 1998 (noted at Policy and Forward Strategy meeting 10 February, ratified 24 February).

The Scrutiny Committee's final report states:

> *'the NPV (Net Present Value) method... understates the additional costs that will be incurred by the council over the 25 year period. It is not a true reflection of future costs to be incurred due to the unrealistically high discount rate.'*
> [Scrutiny Committee final report p.10-11]

The scrutiny committee also argued that members had decided to go ahead with the scheme on the basis of financial information which they did not fully understand.

> *'It was evident as the work of the group progressed that the complex financial models required explanation and justification and there was little attempt to summarise financial information in the form that could be understood by members'.*

An earlier scrutiny working group report stated bluntly,

> *'What we need to know is what it is going to cost in hard cash and can we afford it.'*
> [Scrutiny Working Group, Report by Cllr. R. MacGregor, for consideration by group dated 2 February 2000]

These comments no doubt need to be placed in the context of political disagreements within a local authority. However the reference in the above quotation to the complexity of the financial models on which PFI decisions are required to be based is justified.

It can be added that the way in which the results of financial modelling are presented to local authority members does not always make clear the assumptions underlying the models. In particular, authority members need to be aware that they cannot make an informed decision on PFI on the basis of NPVs/NCPs as these do not directly reflect the amounts they will actually have to pay out under the terms of the contract.

The question is how aware members are of this. In one example we have seen documents supplied by council officers to members of one London Borough consistently headlined the NPV of PFI credits and PFI capital costs, which could easily be read as implying the scheme was revenue neutral. The projected annual cashflows, which were the only basis on which affordability can be judged were relegated to an appendix.

4. Other sources of affordability problems

The shortfall in PFI credits means that local authority PFI schemes almost inevitably give rise to 'affordability gaps'. In other words, the PFI payments exceed the resources available to fund them and further resources have to be identified: the schemes are not 'revenue neutral' for the commissioning authorities.

Affordability problems can also arise for other reasons. These include:

- (1) It is almost inevitable that over the course of a 25-35 year contract, unforeseen requirements will arise. Any extra work required on the part of the SPV (Special Purpose Vehicle) would fall outside the terms of the original contract and would require extra funding. Departures from the original contract of this type are known as contract variations.

The standard contracts being used for schools PFI schemes allow variations to be proposed by the SPV as well as by the local authority and the schools, and that the decision on whether proposed variations should be undertaken rests with the parties to the contract, for instance, the authority and the SPV, not with schools, which are entitled to be consulted only.

◗ (2) The funding available to the public sector clients may decrease as a result of population change or changes to the funding formula. The unitary fee is a fixed payment which must be met whether or not public sector bodies have sufficient funds.

For example, while a schools PFI contract may allow some reduction to the payment for support services in the light of a reduction in pupil numbers, there is no likelihood the capital element of the PFI payment can be reduced. Similar points apply to any public sector function which is funded through formula, such as the NHS.

Any shortfall in the sources of funding – and, as we have seen, shortfalls are almost inevitable – has to be met by either the council or the schools. In the case of schools, this opens up the possibility that PFI costs might compete with other budgetary items (for instance, teaching budgets).

Experience at a number of recent schools schemes suggests that local authorities are unwilling to indemnify governing bodies against this risk, for example by placing a cap on the contribution that will be required form schools' delegated budgets. If on the other hand authorities resolve to pick up the shortfall using other budgets , the affordability problem is simply displaced on to other services.

Affordability issues need to be rigorously distinguished from 'value for money' issues. Due to the way value for money is appraised by government and local authorities, it is possible for a scheme to demonstrate good value without being affordable to the authority or schools. Indeed where different options for investment are being compared, the scheme which shows better value for money can be less affordable than the alternative, as is shown by the Cheshire Police Authority scheme (see case study, Appendix one, page 28).

Decision makers considering PFI procurement need to ensure that the financial information they receive allows them to form a judgement of the annual budgetary impact of the PFI proposals and the alternatives. This means considering the annual costs of each option in cash terms rather than taking the result of a complex financial model on face value.

3. Accountability, value for money and evidence-based policy

1. Discounting and value for money

The current policy rationale for PFI stresses value for money to the exclusion of all other issues. All PFI schemes have to be compared to the notional cost of traditional procurement, using a 'Public Sector Comparator'. Because all PFI projects have had to pass this 'value for money' test, it is argued that PFI has already proven itself to be more effective than a traditional procurement route. It is not always recognised that the methodology for assessing value for money involves complex financial models which draw on assumptions which are in some cases open to question and in others blatantly unrealistic.

The appraisal of PFI schemes for value for money is strongly influenced by the discounting of future cash flows at 6 per cent per annum to yield discounted 'Net Present Costs'. The effect of discounting is to place a higher value on expenditure in earlier years and a lower value on expenditure in later years. The higher the discount rate used the more pronounced this effect is. The impact on the estimated costs of PFI and public sector options is quite different. The high upfront costs of investment have a disproportionate effect on Public Sector Comparators: because the expenditure is incurred early, it counts for more than expenditure in later years. In the appraisal of PFI options these costs are spread over the entire period of the contract, meaning that the total Net Present Cost is lower than that of the PSC.

In simple cash terms - without discounting - PFI options tend to be considerably more expensive than their public sector equivalents. Which approach – NPC or cash – is appropriate for measuring value for money, given that they yield completely incompatible results? In fact both approaches are unsatisfactory as they do not measure like with like.

Cash comparisons fail to recognise that public authorities will spread their costs over several years by borrowing, and will therefore have to make interest payments on their debt. This would increase the cash total for the PSC, bringing it closer to the PFI total. That PFI total already includes interest payments, albeit somewhat higher than those faced by the council. This comparison therefore underestimates the cost of the public sector option relative to that of the PFI option.

But the NPC comparison is also flawed. Because public sector borrowing to spread the cost of investment over time is not recognised in this comparison, expenditure is clumped together in the early years of the PSC appraisal period. As we have seen, in a discounted comparison expenditure is given a higher value if it occurs in earlier years. The effect of discounting, combined with the failure to recognise that the public sector can spread costs over time through borrowing just like the private sector, is to unfairly overstate the cost of public sector options.

One way around this problem would be to carry out the comparison on a cash basis using the assumption that a local authority borrows to fund investment. Table 7 shows the results of such a comparison for one London schools PFI scheme.

Table 7
Costs of Haringey schools scheme if council borrows necessary funding

Cost	*(£m)*
Initial capital expenditure	*32.5*
Interest @ 7.4 per cent	*43.3*
Routine maintenance	*27.2*
Life cycle costs	*14.0*
Services	*71.1*
Total	*188.0*
PFI	*267.9*

On a cash basis, with no account of the profiling of expenditure, there is a significant difference between the PFI and public sector options, of £79m. This is more than twice the value of the initial capital expenditure. It is hard to see how this could be justified on the basis of risk transfer as the bulk of risk transferred relates to the initial capital investment. It is highly unlikely that a public sector client would under normal circumstances contemplate accepting a bid with a costing for contingencies approaching 100 per cent of required expenditure.

2. 'Refining the comparator' – Haringey schools' PFI scheme

Despite the advantage to PFI options created by the use of a high discount rate and the assumption that public bodies can not spread their costs through borrowing, the history of PFI procurement shows a marked tendency for Public Sector Comparison (PSC) costs to be revised upwards in the light of bids from the private sector.

Earlier work on NHS PFI schemes suggests that many of these adjustments are illegitimate, carried out with the clear intention of receiving approval for PFI schemes rather than an objective measurement of relative costs. Revisions to the PSC for the Haringey schools scheme suggest that the same is happening in the local government sector.

Table 8
Haringey outline business case: PSC and PFI options

	PSC (1998) NPC (£m)	*PFI (1998) NPC (£m)*
Base cost	*69.8*	*82.6*
Risk adjustment	*12.2*	
Private sector efficiencies		*-2.8*
Lower educational achievement	*4.8*	*N/A*
Total	*86.8*	*79.8*

In the original OBC, Haringey estimated the future PFI charge at £82,668,000 Net Present Cost (NPC). This estimate was then reduced by £2,787,000 to take account of assumed efficiencies on the part of the PFI consortium and assumed extra income from commercial use of premises outside school hours. This brought the projected net present cost of the PFI option down to £79,881,000.

The PSC was initially costed at £69,760,000 (NPC). This value was then adjusted upwards to reflect the value of risk transfer (£12,218,000) and the value of improved educational attainment as a result of PFI (£4,828,000). This brought the value of the PSC up to £86,806,000.

The assumption that PFI would give greater educational benefit than a public sector equivalent is surprising. In the OBC the council lists a number of factors which are held to contribute to this objective, including better regulation of temperature in classrooms,

> *'improvements to the visual and operational aspects of the buildings'*

and health and safety improvements,

> *'such as reducing the potential for injury from substandard buildings and building services'.*
> [Haringey OBC, p. 24]

In order to translate these claimed advantages into financial values the council assumed that one per cent more school leavers would get a job as a result of the PFI scheme, yielding a net benefit to the Exchequer of £4.8m.

We are unable to accept the reasons the council gives for its assumption that the PFI scheme would yield greater educational attainment than a public sector option which was intended to deliver exactly the same outputs. As these would also be features of a publicly funded scheme, the additional advantage claimed for the PFI seems inexplicable (see table 9).

Table 9
Haringey – revision of PSC and PFI cost estimates

	PSC NPC (£m) (ITN)	PFI NPC (£m) (ITN)	PSC NPC (£m) (2000)	PFI NPC (£m) (2000)
Base cost	*79.6*	*N/A*	*87.9*	*102.7*
Risk adjustment	*14.4*	*N/A*	*16.6*	*N/A*
Total	*94.0*	*N/A*	*104.4*	*102.7*

Source: Invitation to Negotiate (December 1998) Annex 5, p7; Report to governing bodies 3 July 2000

As the table shows, the council has continued to develop the PSC since the OBC stage. Costs are not directly comparable between the OBC and the current position due to the adoption of different discount rates by the council. Most of the changes introduced have had the effect of increasing the cost of the public sector option. These revisions to the PSC deserve closer examination, as they took place after bids had been received which were clearly in excess of the original PSC. The effect of the changes was to increase the PSC to the point where the PFI scheme showed better value.

The reasons given by the council for the increase in PSC costings between 1998 and 1999 are outline in table 10.

Table 10
Haringey – reasons given for the increase in PSC costings between 1998 and 1999

	NPC (£m)
Upward revision of services costs	*+7.4*
Construction delay	*+3.0*
Risk	*+2.1*
City Learning Centre costs	*+1.5*
Design development	*+1.4*
Removal of St Thomas More school	*-5.0*
Total	*10.4*

Source: Report to governing bodies 3 July 2000

Several of these factors deserve critical attention:

- Upward revision of services costs

The cost of services was the main contributor. In the original PSC, private sector efficiencies were expected to reduce the cost of the PFI charge by nearly £2m. According to the council, in revising the PSC, services were recosted at prevailing market prices, increasing the PSC by £7.4m. Why the council should do this, rather than make use of the current cost of services is not explained. Clearly, if services were coasted in the PSC at their current price, the PFI scheme would not show better value.

- Establishing the market price

What is particularly surprising is the council's approach to establishing the market price. Two points deserve special attention.

1. The council states:

> *'For each line in the services section of the PSC the benchmark price has been taken as the lowest quote from the three bidders in response to the council's ITN'.*

In other words, having established that the cost of services was higher under all the PFI bids than under the public sector comparator, with the result that the deal did not represent value for money according to Treasury criteria, the council appears to have substituted the higher PFI costs for the lower public sector costs in the comparator.

2. The council added on to the cost of the PSC costs associated with building inflation, apparently on the assumption that the availability of PFI capital would lead to an earlier start on the project. This would seem to conflict with government policy statements to the effect that PFI should be used only because it represents better value, not because it makes funding more easily available.

We do not accept that any of these extra costs – a total of £12.5m – genuinely reflect advantages associated with the PFI deal. It is particularly surprising that the council should have increased the cost of services in the PSC in the light of PFI bids. If the PFI bids were higher than the current cost of providing services, the council should have excluded the services from the contract, as transferring staff to a PFI contractor clearly does not represent value for money in its own right.

3. Value for money and risk

In all of the business cases we have examined, the value for money of the PFI option is dependent on the valuation of risk transferred to the private sector. Risk transfer also plays a major role in the promotion of PFI. Local authorities and government both argue that the advantage of PFI is that if things go wrong, the public sector faces no financial consequences.

This view may be due to a misunderstanding of the financing arrangements which support PFI deals. PFI contractors raise capital in two forms, debt and equity. In the case of local authority school building schemes, the equity stake has never exceeded 20 per cent of the capital raised by the SPV. The remaining 80 per cent plus is in the form of debt.

Providers of debt are not in the business of taking on risks. The very low interest rates at which PFI contractors are able to borrow can only reflect the judgement of lenders that there is very little risk that they will not receive anticipated interest and the repayment of the debt in full.

On the face of it this should be surprising. Debt service is funded through the availability component of the PFI charge. If a PFI consortium fails to perform, the availability component should reduce, thus reducing the amount of cash the consortium has to meet debt service costs. Why do lenders nonetheless not regard their investment as being at risk?

Payment of the availability charge is formally conditional on the assets being 'available' for use by the public sector client. 'Availability deductions' can be made from the charge if any of the assets fail to meet the minimum requirements set out in the contract.

For example, if a classroom could not be used due to a leaking roof, the availability payment could be reduced until the problem was put right. In principle, the payment could be reduced to zero in the event of the contractors completely failing to deliver on the contract. Persistent failure to correct defects can lead to the public sector terminating the contract.

Clearly, lenders do not regard this as a threat; otherwise they would charge a risk premium on their lending or require consortia to contribute more equity. Why then are PFI interest rates so low? There are two possible reasons:

- (1) The possibility that the availability payment could reduce to the point where it threatens debt service is seen as being remote; for example they may expect any reductions to the availability payment to be minor in relation to the annual payment; or they may believe the availability payment to contain a cushion which is so substantial that even a severe reduction in the payment would not threaten debt service payments, so that the availability payment comfortably exceeds the costs it is required to meet.

- (2) Lenders are confident that even if this were to happen, they would nonetheless be compensated for the outstanding debt, including accumulated interest. For example the lenders may have claims against the parent companies of consortia in the event of default on the part of consortia (this can be excluded due to the limited recourse nature of the finance); or, more importantly the lenders stand to benefit from claims of failing consortia against the public sector client.

We should bear in mind the costs that availability payments are required to meet and the hierarchy of claims on the payment stream, as exemplified in this adapted extract from a PPP proposal. The revenue stream from PFI payments ultimately funds the debt service costs of the consortia, with any remainder constituting pure profit. First, however, other claims on the payment stream have to be met (see figure 2).

As part of their due diligence process, lenders test the projected PFI payments to see how much cash is available for debt service each year, and how this compares with the debt service payments to be made. The ratio between these two figures is the Debt Service Cover Ratio (DSCR).

Figure 2
Determinants of debt servicing

	Total income (availability payment and services payment)
less	
	operating costs (staff and bought in supplies and services)
	cyclical maintenance
	capital maintenance
	tax/VAT
equals	
	cash available for debt service

Source: adapted from Glasgow City Council Better homes, stronger communities p.28

Tests carried out by Standard and Poor (a credit rating agency) on the bond issue for the South Tees hospital trust PFI scheme indicate an average annual cover ratio of 1.37 on the base case, that is, on the assumption that nothing goes wrong. This means that after covering all other costs, the availability payment is 37 per cent greater than debt service charges.

The question here is of how much the availability payment is likely to reduce as a result of poor performance on the part of the PPP consortium, and of how this would affect debt service. Standard and Poor estimate that if the availability payment reduced by 15 per cent, the cover ratio would reduce to 1.28 (that is, there would still be a surplus of 28 per cent of debt service costs), with a minimum ADSCR of 1.04 in year four.

They estimate that it would require a 20 per cent reduction in the availability payment throughout the life of the contract 'before the [PFI] project company is unable to meet all of its senior debt service obligations despite suffering delays of over one year (senior debt is the debt that comes first in the hierarchy of claims on the payment stream).

In this case, lenders seem to be calculating that there is little likelihood of the availability payment reducing to the point at which debt service would be threatened. However, they can also be confident that if this were to happen, they would still be compensated by the public sector for outstanding debt and interest.

4. Can the public sector terminate the contract?

The three-way relationship between the public sector client, the contractor and the lenders is important in this context. If the cover ratio falls below the prescribed level because of poor performance then the contractor is in breach of its agreement with the lenders, who can then terminate their contract with it. At which stage, the crucial relationship is that between the lenders and the purchasing authority.

What happens next depends on the contract terms and the decision of the lenders: they may elect to appoint a new contractor to take over the work, in which case the public sector will continue to pay the unitary charge to the new contractor, who will pay the lenders.

On the other hand, they may choose to have no further involvement. In that case the public sector client would have to find a new service provider itself but it would also be obliged to compensate the lenders, who will seek to ensure that compensation matches the outstanding debts of the contractors, which are likely to be considerable. To be accurate, the public sector would have to compensate the contractors, who would use the compensation to meet their debts to the lenders.

The fact that PFI contractors are entitled to receive compensation when a contract is terminated due to their own breach may seem surprising. This is how the Treasury Taskforce explains the policy:

> *'One question that may be asked is why compensation should be paid to the Contractor when it has failed to perform in accordance with the Contract. Under a typical service contract, not only would no compensation be paid but the non-performing party could expect the innocent party to bring claims for damages. The reason that compensation is paid is that a failure to compensate could unfairly benefit the Authority [ie. the Public Sector Client].'*

The argument is that the public sector could conceivably make 'windfall' gains through contract termination, as it would have ownership of an asset for which it has not fully paid. However, the motivation of the policy is also to do with the effect on costs. Where a contract virtually guarantees that all debts will be paid off by the public sector client even in the event of the SPV failing to deliver, this reduces the interest rate at which the SPV can borrow, thus allowing it to charge a lower availability fee.

The price of this however is that the public sector continues to carry a considerable amount of risk. Any notion that the cost of PFI to the public sector is entirely dependent on the performance of the private sector should be dispelled. The bulk of the availability payment (i.e., the proportion dedicated to debt service) would have to be met even if the contractor lost the contract. PFI arrangements tie the public sector into inescapable expenditure commitments and these commitments are conditional on performance only to a very limited extent.

Not only are purchasing authorities liable for debts they have not themselves taken out. Due to the very high compensation payments they would be obliged to make in the event of termination of a PFI contract, they are very unlikely to seriously contemplate taking this step, even if a contractor is blatantly failing to meet its obligations. Moreover, purchasers will be unwilling to make full use of their power to reduce PFI payments in the light of poor performance if this is likely to put the contractor in breach of its agreement with the lenders, as this would also expose the purchaser to compensation claims.

5. Who is accountable?

The debate over the PFI has tended to focus on individual decisions to proceed with PFI schemes at local level, and campaigning has targeted the authorities which are taking those decisions. For example, the Worcester Royal Infirmary scheme has been the subject of a political campaign and a series of reports all challenging Worcestershire Health Authority's decision to rebuild the WRI using private finance. Haringey trade unionists have campaigned against the London borough's policy of passing all secondary school infrastructure to the private sector.

In Glasgow, the city council has been attacked for planning to transfer all its housing stock to a PPP company. In all these cases there must be a sense that the bodies being attacked are not ultimately in control of decision making. Rather they are implementing policies handed down from above.

This does not mean that authorities have no choice. Unfortunately, the choice they face is frequently between no investment in services or PFI. In many of the cases examined in this report there can be no doubt that investment is urgently required in order to remedy decades of neglect leading to seriously diminished life chances for some of the most disadvantaged groups in the population. There can also be no doubt that public servants and elected representatives are in many cases promoting PFI as a solution to investment backlogs because they see no alternative if services are to be maintained.

Decision makers are faced with the further problem that although the main reason for using the PFI is the lack of alternative sources of finance, this is not a sufficient reason to justify the decision in the eyes of the Treasury. The case for PFI has to be made on grounds other than lack of public sector capital if Treasury approval is to be forthcoming. Authorities must demonstrate not only that investment is required, but that the PFI is the best way to deliver that investment. This report has chronicled some of the contortions that public sector bodies have undertaken in order to prove this point.

The Treasury approval process, coupled with the Treasury's imposition of PFI on departments, has created a bizarre feedback loop. Authorities are required to demonstrate to the satisfaction of the Treasury that their schemes represent better value than public sector provision: this is then used as evidence by government that the PFI delivers value for money, which in turn allows government to claim that this is the only motivation for the policy.

Thus earlier this year a report commissioned by the Treasury from Arthur Andersen claimed that PFI schemes were delivering on average cost savings of 17 per cent. This report continues to be widely cited by ministers as evidence that the PFI is cheaper than conventional procurement, which in turn makes it possible to argue that saving money and improving the quality of services is the motivation for the policy. In fact the 'cost savings' claimed by Andersen were estimates prepared by authorities seeking Treasury approval for schemes. Those authorities were obliged to show estimated cost savings in order to win approval and thus receive investment. This vicious circle leaves the government's position unassailable: PFI is simply a procurement method which has been proven to be more effective than public sector provision. The circularity of this argument is rarely acknowledged.

Finally it is worth noting the distribution of responsibility for PFI decisions and the implications for proper accountability. Accountability for the decision to sign a 30 year PFI contract ends with the purchasing authority and the liabilities arising from the that contract rest with the same body. The approval process means that at every stage the local council has to confirm that it has evaluated the PFI option against a public sector alternative and found it to be better value.

The purchasing authority thus takes responsibility not only for deciding to adopt PFI but for choosing PFI from a set of alternatives which as it happens were not available to it. If it were to state that it had taken the decision on the basis of non-availability of public sector capital it would not qualify for PFI credits. This creates a double bind for local authorities, hospital trusts and other public sector bodies. They are unable to make clear the basis for their decisions if they want to secure the investment necessary to discharge their statutory duties.

Appendix 1: Cheshire Police Authority

The role of the PFI in re-engineering public service provision can be illustrated by the example of a scheme for a new headquarters for Cheshire Constabulary. Here a scheme which was originally put forward as a solution to estate problems was only affordable on the basis of the reallocation of tasks from police officers to civilians.

The original project involved relocating Cheshire Constabulary's headquarters and forces training centre to a single site. It was selected by the Conservative government in 1996 as one of 14 'Pathfinder' Home Office PFI projects. [OBC 1 p.1]

An OBC was submitted to in March 1998: at this stage, the project was to replace existing facilities,

> *'on a like for like basis, with no reconfiguration of services'.*

At the same time a second stage of the project, Phase II, was flagged up, under which services would be reconfigured.

However, in the OBC the PFI failed to pass the VFM test when compared with a 'do nothing' option and with a publicly financed investment. As table 12 shows, the ranking of options in the original business case placed the PFI proposal last. This ranking held whether costs were presented in cash terms (without discounting), as Net Present Costs (discounted) or as 'risk-adjusted' Net Present Costs [see table 11].

It should be noted that at this stage the publicly funded options had both been inflated to take account of claimed cost overrun risk. Design and construction costs were inflated by 15 per cent, and operating costs by five per cent.

Table 11
Cheshire Police Authority OBC 1 (1998): Ranking of options

OBC 1 (£m)	*base cost cash (£m)*	*base cost NPC (£m)*	*risk added NPC (£m)*	*adjusted cost NPC (£m)*
status quo	*49.9*	*21.64*	*2.46*	*24.1*
publicly financed investment	*50.1*	*25.196*	*4.704*	*29.9*
PFI investment	*74.5*	*33.0*	*0.00*	*33.0*

In the OBC the authority, while conceding that the PFI option did not represent value for money, argued that the Phase II development of the scheme would alter the ranking.

> *'During Phase II the base input assumptions will alter significantly as service reconfiguration opportunities are identified. At this stage, the Project Board is confident that a PFI solution will offer a Value for Money alternative.'*
> [p25 our emphasis]

At this stage the project had been underway for nearly two years. Initial evaluation of the PFI option had shown that it was considerably more expensive than a publicly financed alternative. It could be expected therefore that the Home Office would turn the scheme down on value for money grounds.

The fact that the project had already been chosen (albeit by the previous government) as a 'pathfinder scheme' may have influenced the Home Office's decision to allow the authority to continue with the scheme. An independent report on the OBC from the Centre for Public Services concluded:

> *'There is an apparent determination that there will be a PFI project but there is a major lack of evidence to support the case'.*
> [Centre for Public Services analysis of Outline Business Case Sheffield, 1998]

The message from the original OBC was that in order for a PFI scheme to show value for money, it would be necessary to reconfigure services.

> *'The convergence of Phases I and II will take place in September 1998 in a full outline business case which will set out the operational efficiencies and improvements in service delivery afforded by business change'* [OBC 1, p.1]

In the event the second OBC was submitted nearly a year later, in February 1999. By this stage PricewaterhouseCoopers had been hired to undertake 'process level service delivery assessments' of the authority's activities to identify cost cutting measures as part of the authority's 'business improvement programme'. The areas earmarked for reconfiguration were call management, crime management and training management. Of these the most significant in terms of freeing up cash was call management.

The first OBC had estimated the future PFI charge at £2.8m. This was judged to be affordable on the basis of annual revenue support from government of £1.3m and a contribution from the authority of £1.5m [OBC 1 p26]. The latter is fairly close to the authority's existing annual budget for the running costs of the properties involved, of £1.35m [OBC 2 p61].

The project was thus estimated to be revenue neutral for the authority at this stage, while failing to show value for money. Although the authority had predicted that Phase II work would show that the PFI offered value for money, the estimated annual charge in the 1999 OBC was actually 64 per cent higher, at 4.6m, creating a significant affordability gap for most of the contract period.

The authority states in the new OBC,

> *'the Constabulary has identified three sources from which the monies will be released',*

the most important of which were:

- Annual building running cost budgets – £1.35m
- Annual savings generated by the business improvement programme - £1.78m [OBC 2 p61]

The source of the business improvement programme savings was a reduction in the wages bill for police officers engaged in call management [table 12]. The current cost of this at the time was £3.4 m. As part of the reconfiguration of services it was proposed to separate call management into two separate functions: call handling and deployment. One of the advantages of this was said to be that it would allow,

> *'appropriate deployment of operational and support staff'.*

It was estimated that the savings from this reconfiguration would reduce the wages bill by £2.3m. A projected increase in demand over the first five years of the scheme would reduce these savings to £1.78m – exactly the amount required to make the projected PFI scheme affordable. [OBC p.24]

Table 12
Cheshire Police Authority's Second OBC (1999): annual call management budgets - current and projected

Cost element	*Current (£m)*	*Preferred option (£m)*
Police pay	*3.40*	*1.20*
Management	*0.05*	*0.15*
Civilian pay	*2.00*	*2.00*
Systems	*0.35*	*0.35*
Total	*5.80*	*3.70*

Source: OBC 2 p.15

The use of reductions in staff budgets to fill PFI affordability gaps is a phenomenon which has been documented in the National Health Service [see *'The only Game in Town'* and *'Downsizing for the 21st Century'*, published by UNISON. Details in Appendix

2]. In the NHS this has tended to take the form of reallocating functions from registered to non-registered nurses, and therefore less expensive staff.

Like the NHS, the police force is a labour intensive industry where most of the cost is wages. Faced with increased capital costs and relatively stable funding, such industries have little choice but to reduce staffing costs. As the authority points out,

> *'The outcomes from the government's Comprehensive Spending Review direct the police Service as a whole to generate considerable annual efficiency savings as a prerequisite to any budgetary increases. In a service so dependent on human resources, such savings are hard to achieve within current structures and working practices.'* [OBC p.6]

The reduction in the police pay budget in this scheme implies that a reallocation of functions to lower paid parts of the workforce is taking place.

As in the NHS, the proceeds from these 'efficiency' savings are expected to be absorbed in their entirety by the costs of the PFI scheme.

Table 13
Cheshire Police Authority OBC 1 (1998)/ OBC 2 (1999): Projections of annual PFI unitary charge

	OBC 1 (1998) (£m)	*OBC 2 (1999) (£m)*
Estimated PFI charge	*2.8*	*4.6*

The revised OBC approaches the appraisal of value for money in a different way to the earlier OBC, making direct comparison between the two impossible in the absence of full financial models. The considerably higher costs for all options presumably reflect the inclusion of the costs of all services in the appraisal rather than the PFI costs alone. This makes it impossible to tell which of the claimed savings are due to the PFI option and which to other changes in the delivery of services. Note that the cash costs are already risk adjusted.

On a cash basis publicly financed investment is still clearly the cheaper option by some £30m even when risks have been adjusted for [table 14]. On a discounted NPC basis, however, the PFI option shows marginally better VFM. As noted above, narrow margins indicate that the result of the appraisal is largely an artefact of the discount rate and the scoring of public investment . It can not be held therefore that this business case convincingly demonstrates better value for the PFI option being promoted.

Table 14
Cheshire police authority OBC 2 (1999): Ranking of options

OBC 2	*Cash risk adjusted (£m)*	*net present cost risk adjusted (£m)*
Status quo	*345.2*	*55.5*
Publicly financed investment	*128.5*	*40.1*
PFI investment	*158.5*	*36.8*

Source: OBC 2, p.53-57

Appendix 2: Resources

Contributors to the report from the Health Policy and Health Services Research Unit, School of Public Policy, University College London:
Declan Gaffney
Dr Neil Vickers
Professor Allyson Pollock

Useful Publications
Most of these can be found on the websites listed below:

Availiable from the Health Policy and Health Services Research Unit
School of Public Policy
The Rubin Building
29/30 Tavistock Square
London WC1H 9EZ

Health care funding and organisation

Pollock AM. *PFI is bad for your health*. Public Finance. 6 October 2000:30-1

Pollock AM, Vickers N. *Private pie in the sky.* Public Finance 14 June 2000: 22-24

Pollock AM, Price D, Dunnigan M. *The real cost of PFI in Worcester.* Public Finance 14 July 2000: 26-7

Pollock AM, Price D, Dunnigan M. *Kidderminster's unkindest cuts.* Public Finance 9 June 2000: 26-7

Pollock AM, Price D, Dunnigan M. *Benefits before Patients: A Report on the Worcester Royal Infirmary PFI and Worcestershire Hospitals Reconfiguration.* 2000

Gaffney D, Pollock AM, Price D, Shaoul J. *The politics of the private finance initiative and the new NHS.* BMJ 1999;319:249-53.

Pollock AM, Dunnigan M, Gaffney D, Price D, Shaoul J. *Planning the 'new' NHS: downsizing for the 21st century.* BMJ 1999;319:179-84.

Gaffney D, Pollock AM, Price D, Shaoul J. *PFI in the NHS – is there an economic case?* BMJ 1999;319:116-9.

Gaffney D, Pollock AM, Price D, Shaoul J. *NHS capital expenditure and the private finance initiative – expansion or contraction?* BMJ 1999;319:48-51.

Globalisation and health care regulation

Pollock AM, Price D. *Rewriting the regulations: how the World Trade Organisation could accelerate privatisation in health care systems by undermining the voluntary basis of the GATS.* The Lancet: forthcoming Dec 2000

Price D, Pollock AM, Shaoul J. *How the World Trade Organisation is shaping domestic policies in health care.* The Lancet 1999;354:1889-1892.

Transport

Gaffney D, Shaoul J, Pollock AM. *Funding London Underground: Financial Myths and Economic Realities.* 2000 (available from the school of Public Policy)

Available from UNISON Communications:

Stock No.	Title
1763	*Challenging the private Finance Initiative, Guidelines for UNISON Branches and Stewards*
1350	*PFI – Dangers, Realities, Alternatives*
1439	*PFI in Local Government - A briefing for Activists*
1589	*Step by Step: A UNISON Guide to the Private Finance Initiative Process*
1658	*PFI: Negotiating Guide for Branches*
1659	*PFI: UNISON's Guide for School Governors*
1704	Price, D and Pollock, A. *The Only Game in Town?* A Report by UNISON Northern Region on the Cumberland Infirmary Carlisle Scheme written by the School of Public Policy
1237	*Your Questions Answered about PFI*

1426 *Back in the Team? Review of Market Testing*

1604 Gaffney, D and Pollock, A. *Downsizing for the 21st Century* (2nd Edition) written by the School of Public Policy

Available from UNISON Health Care Service Group

Putting a Price on the PFI: The Illusionist Economics of the PFI

PFI in the NHS: Interviewing Short-listed Bidders

Useful websites:

School of Public Policy:
www.ucl.ac.uk/spp/about/health.htm

UNISON website:
www.unison.org.uk/pfi/index.htm

There are direct links from the UNISON PFI webpage to:

The 4ps – The Public Private Partnership Programme Ltd (established to promote PFI in local government)

DETR (Department of Environment, Transport and the Regions)

Treasury Taskforce PFI website

Scottish Office (Government website holding general information on PFI as well as the list of PFI schemes in Scotland)

Links are regularly updated on the UNISON website.

Useful contacts:

In addition to contact your regional office and the service group at head office you may also find it useful to contact:

UNISON Bargaining Support Unit
UNISON
1 Mabledon Place
London
WC1H 9AJ

Tel: 0171 5511 267
Email:

Centre for Public Services

In campaigning against PFI reports have been produced such as those on the Durham and Carlisle hospital PFI schemes. If you think this would be an appropriate course of action on a PFI proposal in your area you should contact the regional office for advice.

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CU/January 2000//stock no. . Printer's ref: