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PRELIMINARY EXECUTIVE SUMMARY OF
THE PPP REVIEW OF THE UNITED KINGDOM
DRAFT

8th Meeting of Senior Public-Private Partnerships and Infrastructure Officials

OECD Conference Centre,
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OECD REVIEW OF PUBLIC GOVERNANCE OF PUBLIC-PRIVATE PARTNERSHIPS IN THE UNITED KINGDOM
DRAFT

PRELIMINARY EXECUTIVE SUMMARY MARCH 2015

1. The *OECD Review of Public Governance of Public-Private Partnerships in the United Kingdom* discusses the UK PFI framework according to the 2012 Principles for Public Governance of PPPs. The Principles are thus referred to as a point of departure to address the UKs' PFI experiences in order to provide a basis for a peer-to-peer discussion at the 8th Annual Meeting of Senior PPP Officials on the 23rd of March 2015, in Paris.

2. The overall conclusion is that the UK firmly lives up to the Principles and that the Principles allow a comprehensive assessment of a national PPP program. This summary will be followed by a report that expands on each of the messages found below.

3. The OECD would like to thank the UK for agreeing to cooperate in this review process and acknowledges that the document still needs to be finally approved with respects to accuracy by the UK.

4. This summary is structured in the following way: The new developments with regards to PF2 are introduced followed by the institutional framework, the issue of value for money and the budgetary framework.

New developments – introduction of PF2

5. The private finance initiative (PFI) in the UK was introduced in the early 1990s to provide an alternative mode of infrastructure financing at a time where traditional government financing was showing its limits both in terms of execution and in terms of finance. Since then, PFIs and the framework surrounding them have evolved significantly in the UK. They are today part of an integrated framework and are considered a choice, among others, on how to procure infrastructure. As a devolved matter, governments in the UK have updated the PFI model in a number of ways. The Scottish Government replaced PFI with the Non-Profit Distributing (NPD) model of procurement which has been used to deliver a pipeline of projects in recent years. Wales has recently announced a pipeline of projects using a similar model to NPD. This report focuses on the evolution PF2 in England.

6. The PFI model has been adjusted over time as experiences have been absorbed and rules and norms have been updated. Gradual changes include the treatment and sharing of re-financing gains, the definition of force majeure and the basic risk sharing arrangements to the standard PFI contract. The PFI model has been adjusted over time as experiences have been absorbed and rules and norms have been updated. A standard contract for PFI was introduced in the late 1990's and has been continually updated as the market developed and matured. A few of these updates were significant (like the introduction of

sharing the benefits from refinancing) but most involved the gradual refinement of the risk sharing arrangements.

7. Private Finance 2 (PF2) was introduced in 2012 as an update of the Private Finance Initiative (PFI) in order to inject more transparency, flexibility, and public oversight into private partnership projects. This update stems from a political need to address criticism expressed by public and private stakeholders to speed up the procurement process, to have more transparency regarding project returns, and to make available more innovative financing, among others. Under PF2, the government will take minority equity positions in the SPV project company. This is meant to alleviate information asymmetry and will give the government part in the return on investment from the SPV. This increased government involvement is not expected to significantly reduce the price of capital for the project. The government's equity participation potentially comes with increased project risks and potential conflicts of interest – the latter being mitigated by the newly established Infrastructure UK equity unit in HM Treasury.

8. While public and private stakeholders are largely supportive of PF2, some bank and industry voices would like a stronger PF2 project pipeline. Two PF2 contract has come to financial close since the launch of the program two years ago, and a few more are currently under way. There are, nonetheless, more than 800 PFI projects currently in operation, making the UK still one of the most active PFI markets in the world.

The institutional framework for PFIs in the UK

9. The first PPP principle emphasises the importance of the political leadership ensuring public awareness of the relative costs, benefits and risks of PFIs and conventional procurement. Transparency on the costs, relative benefits and challenges of PFIs is evident in the UK and indeed in the debate leading to the introduction of PF2. In its Whole of Government Accounts (WGA), HM Treasury discloses commitments and future liabilities of PFI/PF2 contracts. The Office for Budget Responsibility also does a dedicated job in making contingent liabilities transparent in a readable manner. The National Audit Office (NAO) plays a key role in informing the public debate about PFIs in the UK through its regular reports to Parliament.

10. The second PPP principle focuses on the importance of clear institutional roles and strong capacities across involved institutions. The institutional set up and public sector capabilities for PFIs and capital projects generally are clear and coherent. Public officials understand what their role is, and what the role of their counterpart is. HM Treasury's Infrastructure UK (IUK) is well capacitated and its different units regularly advise procuring authorities, Ministers, and HM Treasury regarding the appropriateness of PFI as a procurement mode for infrastructure. HM Treasury's spending teams review and approve significant investment projects, including PFI projects, at appropriate decision points. They are informed by advice from IUK and other oversight institutions such as the Major Projects Authority. As the Supreme Audit institution, the NAO assesses projects and programmes for value for money and derives lessons for the future in order to further improve the framework for PFI/PF2 projects[1]. Local Partnerships have been established to provide dedicated commercial support to local authorities across different stages of the project cycle, including through procurement and delivery. There can still, however, be a capacity gap at the local level.

11. The third PPP principle calls on countries to ensure that all significant regulation affecting the operation of PFIs is clear, transparent and enforced. The UK follows contract law for PFIs and EU procurement directives. There are no apparent issues with respect to the current regulatory framework. Efforts are ongoing to further strengthen this framework through stronger central oversight over the

[1] Note that devolved administrations and local authorities have separate audit bodies.

procurement process, and more standardized processes and documents to speed up projects' financial close. Under PF2 projects the competitive phase of the procurement process is expected to be no longer than 18 months.

Ensuring value for money from PFI

12. The fourth PPP principle focuses on prioritisation, requiring all investment projects to be prioritised at senior political level. The UK National Infrastructure Plan and its 'Top 40 projects' is a good example of a cabinet sanctioned priority process. The allocation of funds and final affordability test happens as part of the budget process.

13. The fifth PPP principle emphasises that countries should carefully assess which investment method is likely to yield most value for money. All infrastructure projects are subject to the Green Book business case and appraisal process. This process encompasses five interrelated aspects which are developed from the outline business case to the final business case: the strategic case (is there a robust argument for change?), the economic case (how to optimise value for money), the commercial case, if relevant (is the delivery model commercially viable?), the financial case (is it financially affordable?), and the management case (can it be delivered successfully?).

14. There has been much debate about the Public Sector Comparator (PSC). The PSC value for money test was never meant to be a 'pass or fail' test, it was meant to be an element in a careful case that the line department should build in order to choose the appropriate procurement strategy. The centrally developed value for money test was initially introduced so that departments did not have to develop tailor made models. However, on balance, HM Treasury has concluded that a more bespoke model feeding into the comprehensive Green Book process is probably the better approach, which is why the quantitative, centrally-issued value for money model was removed in 2010.

15. The discount rate that was applied for PFI projects has been questioned in the past by the NAO. The NAO argued that instead of the time preference rate, a rate reflecting the government's cost of borrowing could be used instead. HM Treasury holds that the time preference rate is appropriate since a line department must take the government's borrowing limit as given. The OECD team agrees with this approach as it considers the value for money exercise as an extension of the classical investment appraisal process. Government agencies in a number of countries have developed methodologies for establishing value for money, often based on methodologies developed initially by the UK Government. Such exercises tend to over-focus attention on the numerical result of the exercise rather than the full set of considerations as reflected in the full Green Book process. The recent changes in UK assessment guidelines are therefore important beyond its borders. The changes are intended to achieve a better balance in the evidence presented to decision makers which is a positive development.

16. The sixth PPP principle states that the risks should be transferred to those that manage them best. By doing so, it is hoped to achieve better risk management, leading to enhanced cost efficiency. Standardised contracts in the UK provide a sound basis for the allocation of generic risk in a PFI project. In general, apart from expert opinions, (too) little is known empirically on the impact of risk transfer for the overall value for money of projects. However, as part of the UK's appraisal of the PFI model, evidence was collected from stakeholders identifying certain issues with regards to the allocation of risk to the party best able to manage it. Many respondents suggested changes to the typical risk allocation framework, highlighting that the retention and management of certain risks within the public sector could potentially improve value for money. Greater risk retention by the public sector, such as utility consumption risk, can now be noted under the new PF2 scheme to address these issues.

17. The seventh PPP principle emphasises that procuring authorities should be prepared for the operational phase of PFI projects. In terms of maintaining and evaluating VfM during the operational phase, the technical/operational performance of PFIs is difficult to assess due to a lack of comparable systematic data collection. Preliminary evidence suggests that performance has been good in terms of on-time and on-budget delivery of PFI assets, which also mirrors OECD research[2]. The issue of sufficient monitoring and negotiation skills on the public side has often been raised. Some initiatives have been started to mitigate this, but the effects are unclear at this time.

18. The eighth PPP principle underlines the importance of maintaining value for money when renegotiating a PFI contract. The NAO (2008) surveyed 171 PFI projects (from all sectors) for the year 2006, in which they found the monetary impact of changes to contracts amounting to a 1.1 % increase in unitary charges for the projects that were renegotiated. The general impression for the UK is that, on average, contract renegotiations do not appear to be an issue, at least not to the extent that would incentivize strategic behaviour as a rule by parties to the contracts.

19. The ninth PPP principle requires government to ensure sufficient competition in the market and a competitive tender process. The UK's market in term of engineering, construction and financial companies is open and vigorous. With respect to both ordinary PFI and other types of social and economic infrastructure type projects, such as roads, housing, or universities, there is little to indicate that there is insufficient competition in the market. A more mixed message emerges with respect to very complex and unique mega projects where the number of bidders in some cases has been less than what would have been preferable. This is essentially a feature of large complex projects that can also affect PFI. The public sector's task in such a situation will be to ensure that the market remains contestable.

20. The assessment of value for money in general requires data and although the UK government goes to greater lengths than many other governments to make information on PFI projects available publicly, some of the data that would be required to compare the overall costs of projects financed through alternative mechanisms is not collected. In particular, and somewhat paradoxically, this concerns data on publicly financed projects for use in making comparisons with PFI projects. For PFI projects data is more complete, but with such a wide range of projects it has been difficult to compile data in a sufficiently comparable and accessible format. It is worth repeating the oft-made recommendation that collecting this data is useful and should be undertaken, but this needs to be balanced against what is feasible in terms of collecting and making good use of such data.

21. A final point with regards to value for money concerns its wider impact on the non-PFI sphere. The perceptions of advantages brought by the involvement of PFI have varied over time and between jurisdictions and agencies. The ability of off-balance sheet finance to advance projects that would otherwise strain accounting limits has been a driver of certain projects in the past. However, the overarching drive for pursuing the PFI procurement mode in the UK is the pursuit of value for money, both for the government and end-users. More than 20 years of experience with the PFI model have brought the UK government important lessons and improvements, both with regards to PFI and in general with respect to infrastructure procurement and life-cycle management. One advantage of delivering a significant share of investment through PFIs has been to spread discipline in cost control to all forms of infrastructure procurement. Minimising alterations to project specification through the planning and construction phases has been the key to achieving a higher rate of on-time, on-budget delivery for routine building projects (for example in the health, education and government sectors) in comparison to past chronic failures with traditional public procurement. Maintenance of assets to design standards throughout their planned lifetime is another strength of private finance and something that is seen in the UK as having been successfully delivered by PFIs.

2 OECD (2013) Government at a Glance. OECD Publishing: Paris.

The budgetary framework for PFIs in the UK

22. The tenth OECD PFI principle emphasizes that, in line with the government's fiscal policy, the Central Budget Authority should ensure that the project is affordable and that the overall investment envelope is sustainable. Several checks are in place in the UK to ensure affordability of all capital projects within an integrated, comprehensive framework. Spending Reviews set a medium term expenditure framework, with firm spending limits for line Departments, followed by specific approval procedures for major investment decisions such as PFI/PF2 contracts. The iterative business case prepared for each project includes an assessment of its affordability and financial sustainability by the procuring authority within the expenditure limits already set. HM treasury is responsible for issuing approvals during the appraisal process for all PFI/PF2 projects. With the PF2 scheme, HM Treasury also introduced a new control total of GBP 70 billion for PFI/PF2 projects up to 2020 in addition to caps that are already in place for capital expenditures, such as in Scotland. Complementary analysis by the Office of Budget Responsibility (OBR) also helps the government, and the public, keep track of the fiscal sustainability of its expenditures.

23. With regards to the budget, PFI projects at the outset were not on-balance sheet in the UK, and could thus be considered a form of off-budget borrowing. Consequently, there may have been an inclination by public authorities to pursue the PFI procurement route because of this. In Scotland, the NPD programme was used to accelerate public sector capital investment over and above the capital budget made available to Scotland. As a measure of sustainability, long term investment commitments on NPD are monitored as part of a centrally set cap on estimated future revenue commitments.

24. For reasons of accountability and risk management, the transparency of PFIs in the budget process is important, which is emphasized in the eleventh PPP principle. Through individual departmental accounts, the WGA, and the OBR, the government presents regularly updated information on PFI/PF2 contracts to the rest of the public sector and end users. There is a high degree of transparency regarding liabilities, guarantees and long term financial contracts. Despite the WGA, there can still be an accounting incentive to use PFI, but this stems mainly from compliance with Eurostat rules. Practically all PFIs are on balance sheet in the WGA, providing a detailed picture of the UK public sector liabilities.

25. The OBR in its Fiscal Sustainability Report 2014 estimates the total capital liabilities in WGA arising from Private Finance Initiative contracts to be GBP 37 billion. Only GBP 5 billion of these were on the public sector balance sheet in the National Accounts and therefore included in Public Sector Net Debt (PSND). If all investment undertaken through PFI had been executed through conventional debt finance, the OBR estimates, PSND would be around 2% of GDP higher than currently measured.

26. The twelfth PPP principle underlines the importance of governments guarding against waste and corruption by ensuring the integrity of the procurement process. This is an ongoing priority in the UK as has also been touched on above. The newly established IUK public equity team helps separate the public sector's equity shareholder and client role of procuring authorities by serving on behalf of line Departments on the PF2 project's board. In addition to simplified, more streamlined procurement procedures, government also focuses on capacity building to strengthen procurement skills of its public officials. Efforts for higher integrity and accountability are also witnessed in the 2014 *Anti-Corruption Plan* which draws together several reforms pursued by government to reduce bribery and corruption during the procurement process. Corruption, however, is not a challenge with respect to PFI in the UK.