HM TREASURY

Reform of the Private Finance Initiative

December 2011

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1 Introduction

1.1 The case for a new model

The Government is committed to continuing sustainable investment in the assets we need to deliver public services, including our schools, hospitals, roads, waste facilities, prisons, housing, defence facilities, libraries, fire stations and more. However, we need to ensure that this investment is cost effective and that the taxpayer is getting maximum value for money. The Private Finance Initiative (PFI) has been used to deliver around 700 new facilities across a range of sectors in the UK since its inception in 1992 but the Government shares some of the commonly identified concerns that PFI contracts can be too costly, inflexible and opaque.

Fundamentally reforming the PFI model will be the next in a series of steps that this Government has already taken to improve the cost effectiveness and transparency of PFI. We abolished PFI credits at the Spending Review 2010 to create a level playing field for all forms of public procurement. We also introduced new assurance and approval arrangements in April this year, to strengthen the scrutiny given in the approval process of all projects, including those using private finance. In July, to improve transparency, the Government published, for the first time, the unaudited Whole of Government Accounts which included an assessment of the PFI liabilities and we announced a plan to deliver £1.5billion of savings from the existing stock of PFI contracts in England.

The Government believes private sector innovation and skills can and should play a strong role in improving the delivery of public sector assets and services. At the same time, as financing markets change and develop in response to changing financial regulation and a changing global economy, we must ensure that if private finance is used to deliver public sector assets and services, we access wider financing sources; and that the costs of private finance are more than offset by the wider benefits of private sector delivery.

This Government now intends to undertake a fundamental reassessment of PFI and wants to develop a new delivery model that draws on private sector innovation but at a lower cost to the taxpayer and offering better value for our investment in public services.

1.2 Objectives of a new model

Central to the development of a new model are the objectives of long term value for money for the taxpayer, more effective use of private sector innovation and skills, reducing costs, improving flexibility and increasing transparency. The Treasury will also be looking to retain the benefits that successful PFI can deliver – in getting projects built to time and to budget and in creating the correct disciplines and incentives on the private sector to manage risk effectively.

Government's aim is to balance these objectives in a new approach to the delivery of public facilities that:

- is less expensive and uses private sector innovation to deliver services more cost effectively;
- can access a wider range of financing sources, including encouraging a stronger role to be played by pension fund investment;

- strikes a better balance between risk and reward to the private sector;
- has greater flexibility to accommodate changing public service needs over time;
- maintains the incentive on the private sector to deliver capital projects to time and to budget and to take performance risk on the delivery of services;
- delivers an accelerated and cheaper procurement process; and
- gives greater financial transparency at all levels of the project so that the public sector is confident that it is getting what it paid for and that the taxpayer is sure it is getting a fair deal now and over the longer term.

1.3 The call for evidence

This document supports a broad based engagement process with interested parties, led by HM Treasury, to help bring forward proposals for a new approach to using the private sector in the delivery of public assets and services. In considering what the future model should be, it will be important to learn from the past while making full use of the wealth of experience that exists across the public and private sectors. We also want to learn from international best practice.

This document invites all parties with an interest in the delivery and financing of public assets and services to share their views on what reforms should be implemented for future projects. In particular, feedback is sought from industry participants with an active role in the delivery and operation of public facilities, from those with an interest in investing in these projects, as well as from across the public sector, academics, think tanks, employees and wider stakeholders.

Primary areas of focus for this call for evidence are set out in chapter 2 of this document, but views are welcomed on other issues, not limited to the questions highlighted. Further detail on how to participate in the call for evidence is set out in chapter 3.

1.4 Scope of call for evidence

The evidence gathered in this exercise may be used to inform policy development and to inform future Ministerial decisions on the form of new approaches for projects which are yet to enter procurement, where the private sector could be expected to play a role in any of the delivery, or financing or operation of the assets and related services. Any policy developed in this area will be done with reference to the following Government programmes:

- the National Infrastructure Plan
- Government's Construction Strategy
- the recommendations of HM Treasury's Infrastructure Cost Review
- the LEAN Procurement Review
- Government's Property Strategy
- the Priority School Building Programme.

The new model could apply across all government sectors including transport, education, health, waste management, housing, defence and justice. However, it is not proposed that a single, rigid, template will become mandatory for all new projects. Instead, it is expected that the model is tailored appropriately to reflect the requirement in each case.

The call for evidence and any subsequent policy development will apply in England only, as PFI policy is devolved in Scotland, Wales and Northern Ireland.

2 Reform areas and questions

This section sets out the primary areas of focus for this call for evidence but respondents should not be constrained by these areas or the questions highlighted. Views and evidence are actively welcomed on other issues that respondents consider are important. It is also not necessary to answer all questions in responding. Respondents can if they choose submit proposals for alternative delivery models in addition to, or instead of, responding to questions on individual features of the current delivery model. Detail on how to participate is in chapter 3.

2.1 Role of the private sector

PFI is a long term contractual arrangement that makes the private sector responsible for, and bear the risks of, designing, building, financing, maintaining and sometimes operating a public sector facility (e.g. a school, hospital or road) to output specifications set by the public sector. The public sector commits to make a unitary payment to the private sector for use of the maintained facility, once it is operational, over the life of the contract (typically 20 to 30 years). The private sector generally establishes a new special purpose project company to deliver the contract requirements. The project company raises private finance to cover the costs of the project and sub-contracts with third parties for the delivery of construction and facilities management services required under the contract with the public sector.

The private finance that is raised to cover the costs of the project is done at a higher cost than that at which Government can borrow and so a value for money judgement is required for all privately financed projects, to confirm that the additional costs of private finance are more than offset by the benefits of risk transfer and private sector delivery.

Question 1: Do respondents think that the private sector has a role to play in the future delivery of public sector assets? Are there specific sectors where the private sector should not have a role?

Question 2: Are there other delivery and procurement models used in the delivery of public assets in the UK and internationally that respondents consider work well? What are the key features of these model(s)?

Question 3: How should the use of private finance be evaluated when considering the best procurement route to deliver a public asset?

Question 4: Are there features of the PFI model that should be retained?

2.2 Institutional investment

Current equity investors in PFI projects are a mix of industry sponsors who have a sub-contractor interest in the project, third party project developers and financial investors, who are generally PFI specific or general infrastructure funds. Project debt is provided by banks or by institutional investors through project bonds.

Pension plans and other long term institutional investors that invest in PFI are usually indirect investors through intermediary funds. A relatively small number of funds currently invest from the outset of PFI projects and through the construction phase; and they generally seek to exit

the investment in the medium term. A larger number of funds are active investors in PFI projects when they reach operational stability and they tend to retain the investment for the long term. The relative appetite of funds for investment in the construction or operation phase of projects is influenced by the yield objectives of the funds' underlying investors and their in-house capability to assess development risk. However, feedback from the market suggests that appetite is changing, with an increasing number of institutional investors interested in earlier involvement in projects, from the development and construction phases and over the long term.

Recent developments in the market have seen the launch of PFI debt funds that are targeting institutional investor appetite. Institutional investors have also indicated an appetite for alternative capital structures for projects that would feature a lower level of project gearing or no gearing, enabling them to invest larger volumes of capital in a project and to access both equity and debt like returns.

Ensuring that future projects can access as wide a set of financing sources as possible would have a positive impact on the financial sustainability of a privately financed model for public assets and services.

Question 5: What changes to the current approach to the allocation of risk and the procurement and delivery of public facilities and services would increase institutional fund investment appetite, either directly or through intermediary investment vehicles?

Question 6: Would alternative approaches to the current typical capital structure of projects be favoured by institutional investors? What constraints currently exist to adopting these approaches, and how could these be addressed?

Question 7: Are there other actions that could be taken, by the public or private sectors, to increase institutional investment in public assets and services, and what are these? What would be the expected implications for cost, risk transfer and value for money?

2.3 Government's role in project funding – capital contributions, co-lending, guarantees and underpinning

Under the current PFI model, a contracting authority can elect to contribute some of the capital funding requirement to the project, with the effect of reducing the amount of capital funding that is raised by the private sector and reducing the ongoing project financing costs that are included in facility charges to the public sector. The value of capital contributions to a project can vary, but are limited under current guidance to 30 per cent of the project capital value, generally contributed at the end of the construction phase and subject to maintaining appropriate risk transfer and private sector performance incentivisation. Under international public private partnership models, there are examples of a higher level of capital contributions being made and of options for the public sector to purchase the asset outright at the end of the construction phase of a project.

Alternative approaches to reducing the net public sector cost of projects adopted internationally include partial government underpinning of project risks, usually to increase the quantum of debt that can be raised for a project and/or to reduce its cost.

Question 8: What if any role should public sector capital play in the financing of the construction or operational phase of public assets and services? How and when might public sector capital be best used to improve investor/lender appetite and pricing without adversely affecting risk transfer and performance incentives? What constraints should apply to the quantum of public sector capital grants?

Question 9: What if any role should public sector risk underpinning or guarantees play in partially de-risking the construction or operational phase of public assets and services? In which areas could underpinning or guarantees have a beneficial impact on investor and/or lender appetite and pricing? What are the constraints to this approach, with particular regard to risk transfer and performance incentives?

Question 10: If public sector capital grants are made to part-finance the construction phase of projects, what constraints should apply and what impact would a level of capital contributions in excess of the current 30 per cent be expected to have on equity and debt investors' investment appraisal and pricing, and on risk transfer and performance incentives?

Question 11: If public sector loans are made to part-finance the construction or operational phase of projects, what impact would this have on equity and debt investors' investment appraisal and pricing, assuming pari-passu ranking with senior debt? What approach should be taken to lender voting rights and what other constraints or procedures would be relevant?

2.4 Debt finance

To date, the preferred bidder for a PFI project has raised long term bank or bond finance, with a maturity almost as long as the term of the contract, typically 20-30 years. Debt for PFI projects is usually structured on a ringfenced, project finance basis although, in some cases, the contractor has funded the project from corporate borrowing arrangements. The provision of long term privately raised debt finance underpins project risk transfer to the private sector contractor; and lender due diligence and monitoring of project risks has increased confidence of investors and the public sector in project deliverability.

For the majority of PFI projects, the cost of long term project borrowing has been fixed through long term interest rate swaps, which has enabled a proportion of PFI costs to be fixed, supporting long term budgetary certainty of the contracting authority. However, long term fixed rate bank or bond finance raised at the outset of long term projects has impacted on the flexibility of contracts by locking in the term and profile of debt service commitments, including in the context of termination liabilities.

Current regulatory changes (including Basel III, Solvency II and the Independent Commission on Banking) are reducing the appetite of bank lenders and bond investors for long term lending. In general, bond finance for PFI projects has not been cost effective since the demise of a functioning monoline credit insurance market or alternative credit enhancements which helped investors to achieve the necessary investment grade credit rating.

In the past, bidders were required to submit bids that were fully underwritten with a commitment from lenders to provide the required debt finance. Since 2006, Treasury guidance has been in place on the use of privately led and publicly overseen debt funding competitions after the appointment of the preferred bidder for debt raising greater than £50 million, to provide a transparent process for the selection of debt providers under competitive conditions and to give lenders sufficient information to make a commitment to lend to the project.

Question 12: What alternative approaches to the debt finance of projects should be considered that would address regulatory pressures on the market, while maintaining current benefits of lender due diligence and risk monitoring - thinking about both bank finance and capital markets solutions?

Question 13: What is the view of respondents to an approach which financed the construction period of projects separately from the operational phase?

Question 14: What impact would a shorter term debt finance approach be expected to have on financing costs? What if any implications would there be for the lenders' due diligence approach and for the transfer of asset design, construction and maintenance risk? What factors would enable the transition from bank debt funded projects to capital markets refinancing?

Question 15: What factors are relevant to consideration of the appropriate allocation of refinancing risk between the public sector authority and the contractor? Is it possible for project performance and credit factors to be separated from market factors when allocating refinancing risk?

Question 16: What are the views of respondents on the effectiveness of preferred bidder debt funding competitions? Could a wider application of debt funding competitions enable more effective access to the debt markets and what role should the public sector play in this, at a local or central level?

Question 17: What alternative approaches could be considered to inflation risk and interest rate risk management, taking into consideration trade offs between budgetary certainty and operational flexibility?

2.5 Equity return

In a typical availability based PFI accommodation project, between 7 per cent and 15 per cent of the project financing requirement is provided through private sector equity. Over the life of the project, profits in excess of bid expectations have not generally been limited by the public sector and neither has government underpinned investor losses. However, reforms have been made to the PFI model over time that have allocated to the public sector a share of gains that have arisen due to market events, for example debt refinancing gains and sharing of insurance cost variations.

In other markets, different approaches are taken to limiting or regulating the economically efficient level of return that can be made by investors in infrastructure networks and services.

Question 18: Would a regulated asset model be more economically efficient than the PFI concession model?

Question 19: What are respondents' views on an approach that capped equity returns or that provided for public sector sharing in returns achieved above a specified level? What impact would this be expected to have on investor appetite and pricing and on project performance? At what level should any cap or sharing threshold be set?

Question 20: Should the public sector limit the transferability of PFI equity? What nature and quantum of limit would not adversely impact on investment appetite and pricing, and on project performance?

Question 21: Should the public sector share in gains on sale of PFI equity, and what impact would this have on investment appetite and pricing?

Question 22: What views do stakeholders have on public sector co-investment or joint venturing alongside private sector equity? What quantum or terms of public sector equity stake would not adversely impact investment appetite and pricing, and on project performance?

2.6 Risk allocation

At the core of the PFI model is the principle that risks should be allocated between the public sector and the private sector to the party best placed to manage them. The standardised contractual framework for typical, availability based PFI projects transfers construction and availability risk to the private sector, as well as general risks of asset ownership (which are typically managed through insurance provisions). In some transport public private partnership (PPP) projects, demand risk has also been taken by the private sector, although generally this is only successful where there is an established market with a good track record and where appropriate levers are available to the concessionaire to develop the market and manage demand effectively.

For some other areas of risk that have been transferred under the PFI model, the private sector may not have effective means to mitigate or lay off the risk. This can result in a higher risk premium being charged to the public sector or in an inefficient capital structure and/or capital reserves being maintained.

It is recognised that the principles of risk transfer, cost and flexibility in PFI arrangements are linked – for example, changes to the contractual framework to increase flexibility for the public sector may increase risk for the private sector. Equally, however, where Government decides that it is appropriate to reduce risk transferred to the private sector in some areas, it would expect this to be reflected in lower costs charged back to the public sector. In these circumstances, however, it is important that the potential cost of this risk, in the hands of the public sector, is assessed.

Question 23: In what areas do respondents consider that a change to the conventional PFI risk allocation as between the public sector authority, sponsors, funders and suppliers could reduce costs and/or improve the flexibility while still offering value for money?

Question 24: Are there other ways in which the conventional contractual framework could be simplified in a way that would enable the private sector to price more cost effectively?

2.7 Procurement and contract management

The procurement process for PFI projects in England follows European procurement rules, in particular the procedures for Competitive Dialogue. Projects have usually been procured locally by the authority that will use the PFI facilities and services over the contract term. A local public sector contract manager will generally take over responsibility for the interface with the private sector contractor when the PFI facility is delivered.

A standardised form of PFI contract has been applied for PFI projects in England for some time (Standardisation of PFI Contracts, the current version being SoPC4)[1], with refinements that have been introduced to reflect market developments and lessons learned from experience of PFI delivery.

Public sector procurement processes seek to maximise competition between bidders, to achieve an affordable, deliverable and value for money solution for the public sector; and to deliver a robust, effective contractual framework for the commercial and operational engagement between the public and private sector over the project life. However, there can be tensions between public sector procurement objectives - in the high level trade-offs between cost, risk transfer and flexibility, as well as in more complex areas such as competition and accessibility for small and medium sized enterprises.

In addition, the experience of PFI has been that procurement processes can be lengthy and costly for both the public and the private sector. Procurement can be delayed by complexities that are specific to the project (such as site due diligence and planning approvals), as well as by changes in policy, regulation or legislation, and by contract negotiation. The Government announced on 20 November 2011 a package of measures to improve public procurement process and dialogue with suppliers and reduce procurement times.[2]

Question 25: What further improvements could Government consider to the standard approach to PFI procurement in order to streamline the process and reduce costs, while meeting wider objectives for effective competition, accessing bidder innovation and maintaining a robust contractual framework?

Question 26: Are there particular ways in which the private and/or public sector approach to contract management can be improved in order to manage contracts more cost effectively?

2.8 Balancing innovation and standardisation in contract specification

One of the original objectives for PFI was to access private sector skills and innovation. In order to achieve this, a project output specification is set by the public sector, enabling private sector bidders to propose how the specified assets and services would be configured to deliver the specified outputs.

However, over time the public sector approach to procurement and the features of PFI may not have provided sufficient incentives for innovation. Long procurement timetables and a private sector interest in protecting proprietary design or technical expertise may have resulted in less bid innovation. The role of investor due diligence in assessing risks also favoured delivery solutions with an established track record, rather than novel, untested approaches. Significant time and resource has been expended by multiple project bidders in the development of bespoke

[1] SoPC4 is available at http://www.hm-treasury.gov.uk/ppp_standardised_contracts.htm
[2] The Cabinet Office announcement is available at: http://www.cabinetoffice.gov.uk/news/radical-package-unveiled-support-business-and-promote-growth

solutions for bids that were ultimately unsuccessful. The industry's need to recover these development costs has increased the cost to the public sector of the PFI programme overall.

For the Priority Schools Building Programme, an approach is being developed that will adopt a degree of standardisation for some aspects of the project output specification, to make the procurement process more efficient and less costly.

Question 27: What is the right balance of output based versus standardised specification, when considering the twin objectives of accessing greater contractor innovation and reducing costs?

Question 28: Could a different approach to the engagement of contractors in the procurement process access greater private sector innovation?

2.9 'Soft' facilities management services

SoPC4 allows for changes to be made to the specification of soft services at the time of value testing. However there are concerns about the inflexibility of contracts to changes in services between value testing dates; and that value testing may often not give confidence in effective competitive repricing over long timeframes.

In some PFI arrangements, soft services have not been contracted as part of the PFI arrangements and Treasury's 2006 Value for Money Assessment Guidance makes recommendations on assessing the value for money of inclusion or exclusion of soft services from PFI contracts.

A case can be made that excluding soft services allows contract managers more flexibility to ensure service requirements can be adapted to changing needs, and without requiring complex contractual variation and approval requirements. However, for some projects there is a risk that this approach could risk losing integration benefits of the whole life design and costing of the asset and related services.

Question 29: Should soft services continue to be included within the contractual model alongside the delivery and finance of the public facility?

Question 30: Are there alternative approaches to the contractual framework for soft service delivery for a long life facility that could result in a better balance of risk transfer, flexibility and competitive pricing?

Question 31: What impact would the separate contracting of soft services be expected to have on equity and debt investors' view of the project's risks and rewards?

2.10 'Hard' facilities management and lifecycle maintenance

Under the current PFI model, maintenance of the asset is the responsibility of the private sector, to deliver the required contract services and to meet agreed end of project life asset hand back conditions. The whole life costs are set (subject to indexation) at the project outset. The cost of hard facilities management and lifecycle maintenance requirements is therefore a risk that is transferred to the contractor, underpinning a principle of optimising whole life asset design and maintenance efficiency. In some cases, the contractor passes lifecycle risk through to a sub-contractor and, in other cases, this risk is retained by the project company and its investors.

SoPC4 allows the public sector visibility of the contractor's forward work plan each year. However, this is designed to help fit construction work around public sector access to the asset rather than to scrutinise the level of investment and make changes to the work plan. Critics of

the PFI model have observed that a lack of transparency of lifecycle maintenance investment means that the public sector does not have confidence in the value for money of this aspect of risk transfer.

Question 32: Under the current PFI model, how effectively has the party who holds hard facilities management and lifecycle risk been able to price those risks?

Question 33: Reflecting on the long term nature of the contracts and changing user requirements as well as changing approaches in maintenance contracts, for example improvements in technology that drive greater efficiency, how could the public sector have better confidence in the ongoing value for money achieved from hard facilities management and lifecycle risk transfer?

2.11 Insurance

Under the vast majority of PFI contracts in England, the risk of damage or failure of the assets during the project life is transferred to the private sector contractor. Most contractors are special purpose project companies who lay off this risk by taking out required insurances in the market. Their estimates of future insurance premiums over the long contract term are included in their bid pricing of future unitary charges to the public sector. The insurance market is cyclical and contractors build in contingencies against adverse future movements in the insurance premiums.

The standardised PFI contract terms have been developed over time. Insurance cost sharing mechanisms were introduced in 2002 and standardised in 2006, whereby the public and private sector share the risk of fluctuations in market pricing of insurance premia. These provisions aim to minimise the inclusion of risk contingencies within private sector contract pricing, while still incentivising contractors to seek the keenest insurance pricing.

In addition to insurance market pricing cyclicality, there is a broader question whether the insurance market is pricing PFI risks efficiently and whether the apparent low claims record of PFI projects is fairly reflected in insurance premia. Alternative approaches to risk management, such as self insurance or pooled insurance models, have been applied in other areas of public sector activity and in some parts of the private sector, particularly where large portfolio interests offer scope for effective risk diversification and for specialist risk management techniques to be applied.

Question 34: Are the insurable risks of PFI projects most appropriately dealt with (a) by the private sector with a fixed cost passed through to the unitary charge, (b) by a premium risk sharing mechanism or (c) by the public sector? Please specify reasons for your choice.

Question 35: Are changes in insurance costs that are attributable to project-specific factors (eg claims-history, poor security, quality of build material, installation of sprinklers, security arrangements , etc) most appropriately borne by (a) the private sector, (b) the public sector, or (c) borne on a shared basis? Please specify how.

Question 36: Are there (a) certain types of project (eg housing, office accommodation, specialist accommodation, highways, street lighting, equipment etc) and (b) certain types of risk (eg negligence of the contactor/supply chain, business interruption cover for banks, officer's liability, statutory cover, third party liability, vandalism, construction phase cover, property damage all risks), which are more/less suited to coverage by the public sector. If so, which are they and why? What are the concerns, constraints or procedures that would be relevant or required for any such public sector self-insurance?

Question 37: If the public sector provided cover for insurable risks for any future PFI projects, what incentives or penalties would be needed to promote a private sector interest in managing risks effectively to reduce/avoid claims?

Question 38: Would you favour the establishment of a framework of insurers for PFI contractors to use (with the use of mini-competitions)? If so (a) should the use of the framework be mandatory and (b) would it lead to better value for money for the public sector compared with contractor–led portfolios?

Question 39: Do you consider that the ratio of premium income to claims paid for PFI projects indicates that (a) commercial insurance does or does not represent good value for money and (b) the commercial insurance market is or is not operating efficiently in this area? Please specify reasons for your view.

2.12 Flexibility

A design feature of PFI is a long term commitment to the provision of the contracted asset, maintenance and facilities management services. The long term nature of the commitment has the advantage of providing certainty for both the procuring authority and the supplier and also ensures that the asset is appropriately maintained over time. There may be instances, however, in which the authority's service requirements change, for example where there is a policy change or changing demographics that make some or all of the contracted assets or services redundant.

The current standardised terms have specific compensation arrangements for the voluntary termination of a contract by the contracting authority. In addition, SoPC gives guidance on the option of building in to the contract specified break points that are priced by the contractor at the outset. The market value principle used to calculate voluntary termination compensation reflects the full expected period of investment by the private sector under the original agreement, irrespective of how early or late in the contract the voluntary termination event arises. The option of priced authority break points is intended to provide greater transparency and certainty of costs to assist the public sector authority with budgetary planning. However priced break options have not been widely used in practice.

Question 40: Should there be more and/or earlier break points in contracts and what would be the expected pricing impact for the public sector? Are there specific points that break points should be linked to?

Question 41: What are respondents' views on the current approach to determining voluntary termination compensation, are there alternative approaches that should be considered, in particular should there be differentiation in compensation amounts reflecting the point at which the termination arises?

2.13 Transparency

This Government is committed to the principle of increasing transparency in government and the delivery of public services.

Under SoPC4, the authority is entitled to project and financial information from the private sector project company, to assist in their monitoring and management of the PFI arrangements. However, financial reporting is generally limited to requested information rather than regular periodic reporting, and information provided is generally limited to the project company, and so does not include project owners or sub-contractors.

A lack of financial transparency can be an obstacle to effective asset planning and contract optimisation by the authority. In addition, there is a risk that contracting authorities do not have sufficient clarity or confidence of the ongoing value for money of contractual arrangements.

Question 42: What degree of financial transparency should be adopted for future privately financed and delivered assets and services?

Question 43: What are respondents' views on the potential extension of project information requirements to periodic financial reporting and disclosure from project sub-contractors and shareholders, including sub-contractor out-turn costs, project equity transfers and achieved project and equity returns?

Question 44: Would a different approach to project governance improve transparency? What if any role should be played by the public sector in the governance of privately delivered and operated projects?

3 How to participate in the call for evidence

3.1 How to respond

This document invites all parties with an interest in the delivery and financing of public assets and services to share their views on what reforms should be implemented for future projects. In particular, we would welcome input from industry participants with an active role in the delivery and operation of public facilities, from those with an interest in investing in these projects, as well as from the public sector, academics, think tanks, employees and wider stakeholders.

As set out in chapter 2 interested parties should not be constrained by the topic areas and questions in this document if they have views on other areas which they consider important. Respondents can if they choose submit proposals for alternative delivery models in addition to or instead of responding to questions on individual features of the current delivery model.

Responses to this call for evidence document should be received by Friday 10 February 2012. We would be grateful if respondents could use the Reform of the Private Finance Initiative response template when responding to the call for evidence. This is available at:

http://www.hm-treasury.gov.uk/iuk_pfi_reform_call_for_evidence.htm

You can respond in one of the following ways:

- emailing it to: PFIevidence@hmtreasury.gsi.gov.uk; or,
- sending it to PPP Policy Team, Room 2/S1, HM Treasury, 1 Horse Guards Road, London SW1A 2HQ;

When responding it would be helpful if interested parties respond with any evidence, research or reference project examples where possible. To help us review responses it would also be helpful if interested parties can explain their particular interest in the discussion and also make clear if their response is as an individual, on behalf of a group or a representative body.

All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations.

3.2 Next steps

The Treasury will consider the evidence received and may, where appropriate, follow up on stakeholders ideas through further engagement to obtain further detail. Following the review of the evidence the Government may use the evidence received to inform decisions on the direction of policy.

3.3 Confidentiality

To meet the Government's transparency commitments the Treasury intends to publish all responses received to this call for evidence this including the names of companies, organisations and their named representatives submitting their evidence. However, we do not intend to publish the names of respondents who respond in an individual capacity. The contact details that are supplied will not be published and used only for the purpose of the evidence gathering exercise.

If you want some of the information you provide in your response to be treated as confidential and not published please note that on your response and include the information in a separate annex. However, please be aware that, under the Freedom of Information Act 2000 (FOIA), there is a statutory Code of Practice with which public authorities must comply and which deals with, among other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided to have the quality of 'in confidence'. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury.

HM Treasury will process your personal data in accordance with the Data Protection Act and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties, other than the publication of the names of representatives of organisations and companies as stated above.

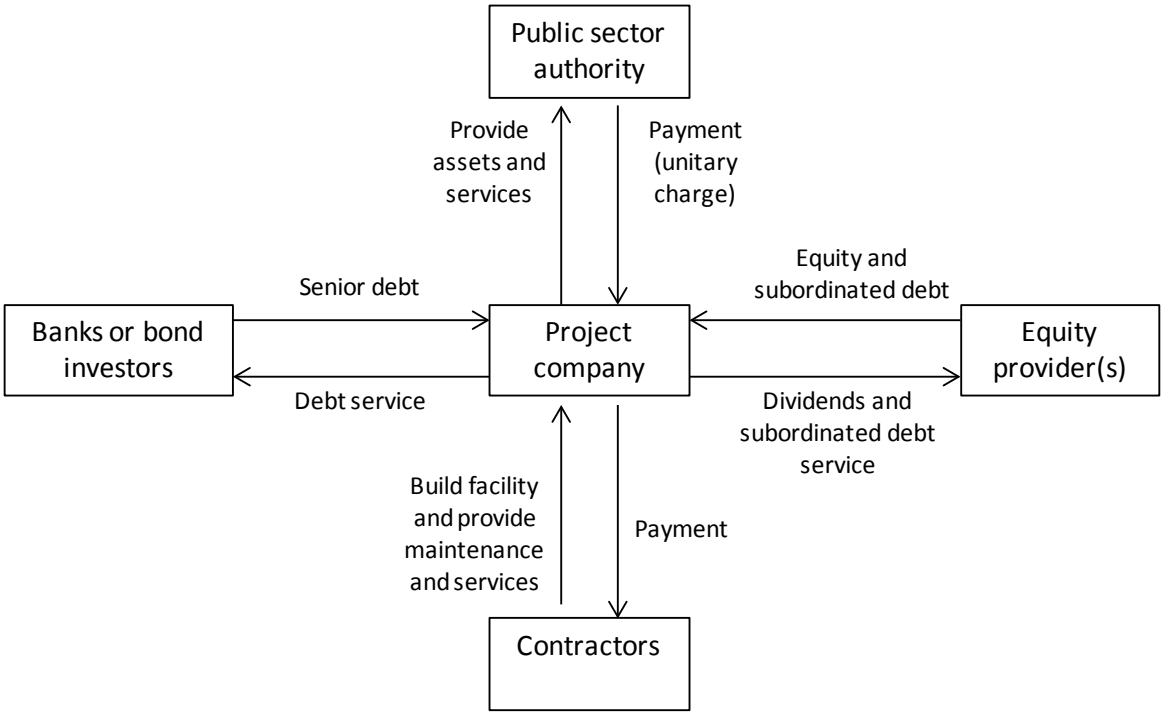
A Overview of current Private Finance Initiative model

A.1 What is the Private Finance Initiative?

PFI is a long term contractual arrangement that makes the private sector responsible for, and bear the risks of, designing, building, financing, maintaining and sometimes operating a public sector asset (e.g. a school, hospital or road) to output specifications set by the public sector. The public sector commits to make a unitary payment to the private sector for use of the maintained asset, once it is operational, over the life of the contract (typically 20 to 30 years).

The private sector generally establishes a new special purpose project company to deliver the contract requirements. The project company raises private finance to cover the costs of the project, and sub-contracts with third parties for the delivery of construction and facilities management services required under the contract with the public sector.

PFI structures are usually highly geared, with 85 per cent to 93 per cent of the finance coming from debt and the remainder coming from equity.



The contract between the public sector procuring authority and the private sector project company formalises the transfer of risk. This will follow the Standardisation of PFI Contracts (SoPC) approach adopted in July 1999. The current version of the guidance is SoPC4, most recently updated in April 2009, can be accessed at

http://www.hm-treasury.gov.uk/ppp_standardised_contracts.htm

A.2 Background on the use of PFI

PFI was launched in the UK in 1992 as a way to deliver public sector assets and services in partnership with the private sector. PFI has been used to deliver schools, hospitals, highway maintenance, street lighting, waste management, social care, prisons, libraries, fire stations and more, and there are around 700 signed contracts across the UK. HM Treasury collects information on PFI projects from procuring authorities via central Government Departments. This project information is published on the HM Treasury website[1], including project name, capital values and future annual unitary charges on existing PFI projects.

HM Treasury holds responsibility for PFI policy in England and PFI policy is devolved in Scotland, Wales and Northern Ireland.

Typical availability based PFI projects have the following features:

A.3 Risk allocation

The standardised contractual framework for typical availability based PFI projects transfers construction and availability risk to the private sector, as well as general risks of asset ownership (which are generally managed through insurance provisions). A central principle of PFI is that risk should be transferred to the party best able to manage them.

A.4 Flexibility

A design feature of PFI is a long term commitment to the provision of the contracted asset, maintenance and facilities management services. The long term nature of the commitment provides certainty for the contracting authority and the supplier, ensures that assets are appropriately maintained over the project life, and can have the effect of reducing the whole life costs for the public sector. However the long term contractual commitment reduces flexibility for changing public sector service requirements. The standardised contract terms contain specific compensation arrangements for the voluntary termination of a contract by the contracted authority. In addition, SoPC gives guidance on the option of building in to the contract specified break points that are priced by the contractor at the outset.

A.5 Soft facilities management services

Soft facilities management services are included in many, but not all, PFI contracts. Where soft services are included, they are generally sub-contracted for medium term periods that are shorter than the long term PFI contract. The authority's PFI contract will generally contain provisions for the value testing and/or benchmarking of pricing of the soft services at intervals during the contract term, and these provisions will be mirrored in the sub-contract. Changes can be made to the specification of soft services by following variation procedures in the PFI contract. The points at which sub-contracts are relet or benchmarked provide an opportunity for the pricing of changes to the original service requirements under competitive conditions.

In some PFI arrangements, soft services have not been included in the PFI arrangements, and are contracted separately by the public sector authority.

A.6 Hard facilities and lifecycle maintenance

Maintenance of the PFI asset is the responsibility of the private sector contractor, to deliver the required contract services and to meet agreed end of project life asset hand back conditions. The cost of hard facilities management and lifecycle maintenance requirements is a risk that is transferred to the contractor, underpinning a principle of optimising whole life asset design and maintenance efficiency. In some cases the contractor passes lifecycle risk through to a sub-

[1] http://www.hm-treasury.gov.uk/ppp_pfi_stats.htm

contractor of hard facilities management services, and in other cases this risk is retained by the project company and its investors, and may be mitigated through the use of lifecycle cash reserves.

A.7 Finance

The preferred bidder for a PFI project raises long term bank or bond finance to meet the project senior debt requirement. Debt finance typically covers the whole life of the contract (typically 20-30 years), with increasing amounts being drawn down as the asset is constructed and then being paid off over the operational period.

Private finance is raised at a higher cost than Government can borrow, and so a value for money judgement is required for all privately financed projects, to confirm that the additional costs of private finance are more than offset by the benefits of risk transfer and private sector delivery.

Debt for PFI projects is usually structured on a ringfenced, project finance basis, although in some cases the contractor has funded the project from corporate borrowing arrangements. The provision of long term privately raised debt finance underpins project risk transfer to the private sector contractor, and lender due diligence and monitoring of project risks has increased confidence of investors and the public sector in project deliverability.

The cost of long term project borrowing can be fixed – either through fixed rate bank loans, or floating rate bank loans with long term interest rate swaps, or through fixed rate bonds – or can be floating. This has enabled a proportion of PFI costs to be fixed, providing a degree of long term budgetary certainty for the contracting authority. In other cases project borrowing has been raised through index linked bonds.

After the construction phase, project companies may choose to refinance project senior debt to the extent that there would be a benefit from accessing lower funding rates. Refinancing gains are shared with the public sector.

A contracting authority may contribute some of the capital funding requirement to the project, reducing the amount of capital funding raised from the private sector, and reducing ongoing project funding costs. The value of capital contributions to a project are limited under current guidance at up to 30 per cent of the project capital value, subject to maintaining appropriate risk transfer and private sector performance incentives.

A.8 Equity

Typically between 7 per cent to 15 per cent of the project financing requirement is provided by the project sponsors through equity and subordinated loans. Equity and subordinated loans are paid a return (as dividends and subordinated loan interest) from surplus project cashflows after all other project costs have been met. Equity carries a first loss position in the project company (eg for performance penalties that reduce revenues or liabilities associated with asset ownership), and mitigates risks through insurance and through passing through risks in the terms of sub-contracts awarded by the project company.

Equity and subordinated loans in PFI project companies are usually transferable, subject to any restrictions set out within individual project contract terms.

Returns in excess of bid expectations that may be earned by equity and subordinated loan investors are not limited under the terms of most PFI contracts.

HM Treasury contacts

This document can be found in full on our website: http://www.hm-treasury.gov.uk

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