

Private Finance Initiative – its rationale and accounting treatment

The Scrutiny Unit in the House of Commons supports the work of committees in scrutinising draft bills and co-ordinates the evidence-taking sessions of Public Bill Committees; and it supports departmental select committees in examining Estimates and Supplementary Estimates, Departmental Annual Reports, Autumn Performance Reports and Resource Accounts, by providing analysis and briefing to those committees.

- 5 1. The Scrutiny Unit has produced this note for two main reasons–
 - 10 • to explain the rationale for the Private Finance Initiative. PFI has often divided opinion, and has long generated opposing assessments of whether it has been a cost-effective procurement vehicle. It is not our intention to join that debate, but rather to assist those who want to increase their understanding of the principles.
 - to explain the accounting treatment of PFI, and show how Resource Accounts can be used to draw out information on a government department’s PFI projects.
- 15 2. The paper reflects statistics on PFI published alongside Budget 2008, and discusses the implications of the Budget decision to adopt international accounting standards (including those affecting PFI accounting) from 2009-10.

Background

- 20 3. Private Finance Initiative (PFI) projects are a type of public-private partnership (PPP), used to fund major capital investments. PPPs refer to a wide range of different types of collaboration between public and private bodies. They cover a range of business structures and partnership arrangements, including joint ventures, the sale of equity stakes in state-owned businesses and outsourcing where private sector operators use existing public sector assets, as well as PFI itself.¹ This Scrutiny Unit note focuses specifically on PFIs.
- 25 4. With PFIs, the private sector is typically responsible for designing and building the asset, raising the necessary finance and then also operating a service that uses the asset.

¹ For a record of public-private partnerships in the UK, see <http://www.partnershipsuk.org.uk/PUK-Projects-Database.aspx>

Because of these various aspects of a PFI, contracts are often awarded to a consortium of companies with experience in each of those fields.

5. In conventional public sector projects, Government builds or purchases physical assets, retains ownership and uses public sector employees or a private contractor to deliver the required service. With PFI, Government contracts for a service with the private sector, and although the service depends on capital assets this should be of secondary importance, with the private sector responsible for obtaining and maintaining the assets it needs to provide the contracted service. This type of arrangement is now common for roads, prisons, hospitals and schools.

Public Sector conventional provision	PFI provision
Government is purchaser of <i>assets</i> .	Government is purchaser of <i>services</i> .
Government generally designs or builds the asset to its own specification.	Private sector consortium generally designs, builds, owns, operates and maintains physical assets.
Government directly meets the cost of designing and building the asset, as those costs are incurred.	Private consortium designs and builds the assets, and funds that work, in the expectation of recovering the cost over the life of the contract through continuing charges that the Government will pay for the service.

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6. The Conservative Government introduced PFI in the early 1990s. In the 1994 Autumn Statement, they announced that PFI should be considered for any public sector project – the ‘universal testing rule’. The incoming Labour government abandoned the universal testing rule, and in 2000 announced a change in the way PFI projects were going to be managed in *Public Private Partnerships: The Government's Approach*. It set up a joint public-private sector body, Partnerships UK, to provide project support to PFI schemes and the Office for Government Commerce to be responsible for general

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procurement strategy. A House of Commons Library research paper of 2003 provides extensive background on the development of the PFI initiative up to that date.²

7. In 2004, the Treasury made significant changes to the appraisal process for PFI. The changes require a quantitative economic appraisal earlier in the PFI process, and places more emphasis on a qualitative appraisal and testing of the market conditions within which a PFI would operate. The process is outlined in **Annex 1**.

8. The Government has created an Operational Taskforce, acting on behalf of HM Treasury, but based in Partnerships UK for the purposes of assisting public sector partners with operational PFI issues.

9. As at March 2008, 625 PFI projects had been signed with a total capital value of £58.7 billion.³ At the time of the 2008 Budget, the Treasury stated that:

The PFI programme continues to play a small but important part in the Government's investment plans with £5.3 billion of capital investment talking place in 2007 through PFI projects. The pipeline of future PFI deals is strong: £23.2 billion worth of projects are due to be signed over the next five years.⁴

10. PFI has become a major element of capital investment in some government departments. Since 1997, 80 PFI schemes amounting to £17 billion of capital investment have been given the go-ahead by the Department of Health.⁵ Between 1997-98 and 2003-04, PFI was the main source of funding from the former Department for Education and Skills for building new or replacement schools.⁶ Under the new Department for Children, Schools and Families, PFI remains the favoured funding route for building new schools.⁷ Since 1995, the Prison Service has signed nine PFI contracts for the design, construction, financing and operation of new prisons. In

² House of Commons Library Research paper 03/79, *The Private Finance Initiative (PFI)*, 21 October 2003, <http://www.parliament.uk/commons/lib/research/rp2003/rp03-079.pdf>

³ HM Treasury, *Infrastructure procurement: delivering long term value, March 2008*, p 6/ HM Treasury provides a list of signed PFI projects in http://www.hm-treasury.gov.uk/documents/public_private_partnerships/ppp_pfi_stats.cfm

⁴ HM Treasury, *Infrastructure procurement: delivering long term value, March 2008*, p 7

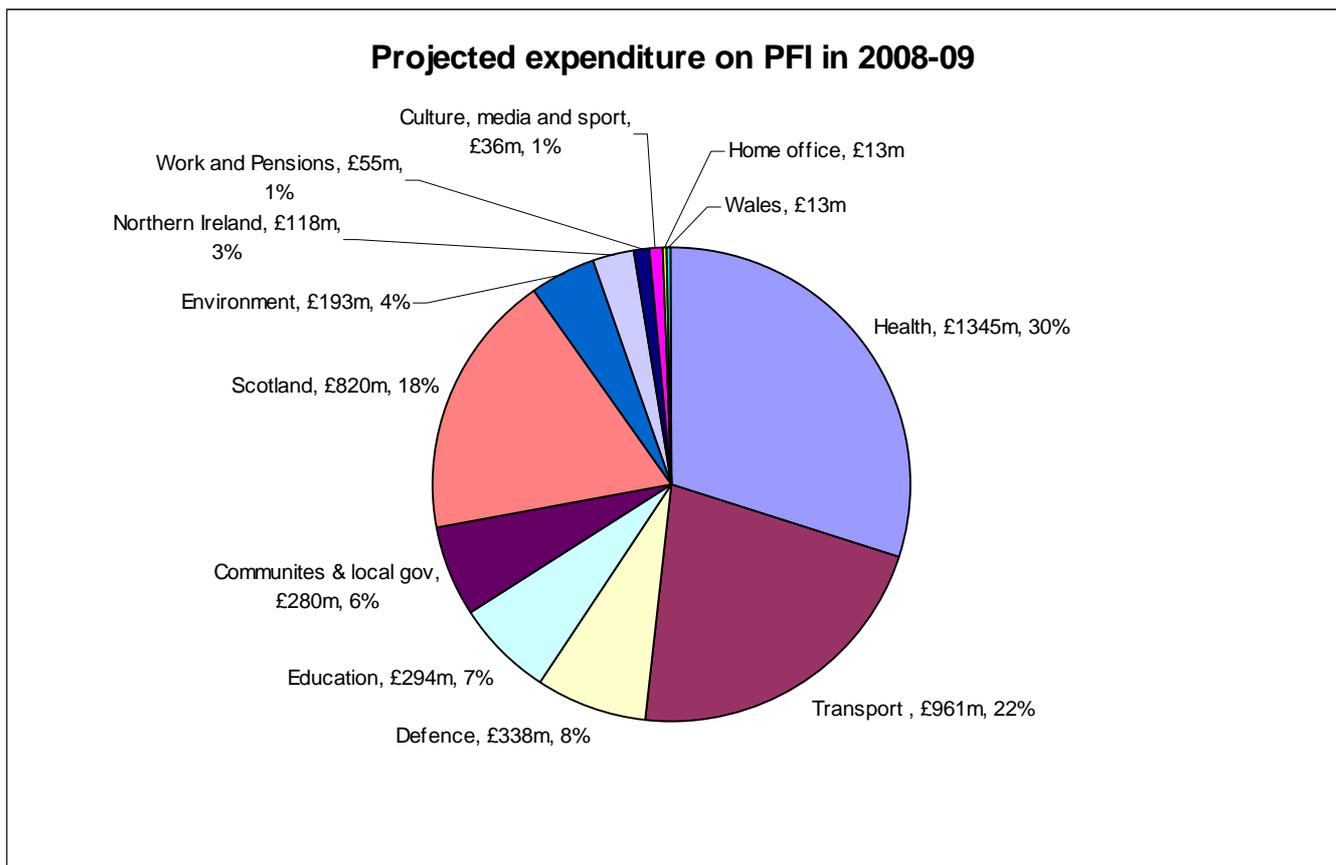
⁵ *Department of Health Website, PFI Prioritised Capital Schemes approved to go ahead since May 1997 (England) (as at 20 May 2008)*

⁶ Audit Commission, *PFI in Schools*, January 2003, para 1.2.

⁷ Building Schools for the Future website - <http://www.p4s.org.uk/>

2003, PFI prisons accounted for about 5% of the prison estate and held 5,000 prisoners, around 7% of the total prison population.⁸ As at March 2008, the Ministry of Defence had 53 PFI projects in operation with a capital value worth over £6 billion (excluding the largest PFI deal that they recently signed).⁹ PFI deals have ranged from small projects, such as the £100,000 Littlehampton Community School ITC facilities project in West Sussex, to the recently signed £13 billion Ministry of Defence contract for air to air refuelling.¹⁰

11. Departmental expenditure on PFI contracts was £5,267 million in 2007–08 and is planned to be £4,466 million in 2008–09.¹¹ The education, health, transport and defence sectors together comprise 67% of the total (see chart below).



Source: *Budget 2008: the economy and public finances—supplementary material, HM Treasury, Table 18, p 32*

⁸ National Audit Office, *Operational Performance of PFI prisons*, HC (2002–03) 700, 18 June 2003, para 2, p 5

⁹ PFI signed projects list (http://www.hm-treasury.gov.uk/documents/public_private_partnerships/ppp_pfi_stats.cfm)

¹⁰ House of Commons Library Research paper 03/79, *The Private Finance Initiative (PFI)*, 21 October 2003, p 10; Ministry of Defence Press notice, 27 March 2008, 'RAF signs deal for A330 aircraft as future tankers'

¹¹ *Budget 2008, the economy and public finances—supplementary material, HM Treasury, Table 18, p 32*

12. Most recently, with the 2008 Budget, the Treasury has discussed the scope for ‘alternative delivery models’ of private sector involvement which, it states, may sometimes be more appropriate than either PFI or conventional procurement.¹² Such alternative models might include ‘strategic infrastructure partnerships’, where a private sector partner would commit to a programme of continuous improvement in return for exclusivity of service provision.

The rationale for PFI

13. In the past some advocates of PFI have argued that PFI projects have allowed more investment than would have been possible through conventional procurement methods. Other supporters argue that PFI projects are generally more efficient than projects undertaken through conventional procurement because they enable private-sector innovation, and because they allow some risks to be better managed by transferring them to the private sector.

Allowing more capital investment, and greater value for money

14. In 2000 the Treasury Committee reported that “the original justification for PFI in the Autumn Statement of 1992 was that it would enable more investment to take place”.¹³ The Treasury saw it as a way of tackling past capital under-investment.¹⁴ Later, government announcements tended to focus on PFI generating ‘value for money’. Treasury guidance on PFI, published in November 2006, highlighted value for money as the condition for choosing PFI as a procurement option:

PFI should only be pursued where it represents VfM in procurement. VfM is defined as the optimum combination of whole-of-life costs and quality (or fitness for purpose) of the good or service to meet the user’s requirements. VfM is not the choice of goods and services based on the lowest cost bid.¹⁵

15. A common view is that for PFI projects to generate value for money for the taxpayer, they have to be more efficient than projects wholly within the public sector because

¹² HM Treasury, *Infrastructure procurement: delivering long-term value*, March 2008

¹³ Treasury Committee, Fourth Report of Session 1999–00, *The Private Finance Initiative*, HC 147, para 18

¹⁴ HM Treasury, *PFI: Strengthening Long Term Partnerships*, March 2006, p 14

¹⁵ HM Treasury, *Value for Money Assessment Guidance*, November 2006, p 7

Government has a lower cost of capital than the private sector. The argument is that Government can raise cheaper finance than any private sector business because its tax-raising powers mean that it is a risk-free borrower in the financial markets. An opposing view that has been put forward, however, is that the real cost of borrowing is the same for public and private sectors, because while the public sector has lower interest costs the taxpayer still bears the risk of project failure but (unlike the private sector) without the prospect of any higher rate-of-return reward for bearing that risk.¹⁶ Another argument runs, in a similar vein, that the real cost of government-raised finance is the opportunity cost of the use to which those funds are put – that is, the rate of return possible on alternative investments – and government would expect similar rates of return as the private sector for a given level of project risk.¹⁷

16. Whichever theory is considered, value for money depends not only on the cost of capital but on other factors such as the quality of service delivered and the risks allocated between the public and private sector. The cost of capital is just one of the factors that need to be considered in order to ascertain which procurement route will deliver value for money for the tax-payer. (See Annex 1 for the process by which the public sector should decide whether PFI is the optimal procurement option for a particular project).

17. If PFI provides the opportunity to tap potentially more efficient private-sector procurement and service delivery, that opportunity also needs a competitive tension between prospective PFI bidders to ensure the price the public sector will pay is minimised. An NAO report in March 2007 on the PFI tendering process found that while the majority of projects had three or more bidders competing, the number with only two bidders had increased from 15% of deals concluded up to 2003 to 33% for those settled between 2004 and 2006. The report found that high bidding costs and a lengthy tendering process were putting some potential PFI bidders off.¹⁸ In January 2006, a *competitive dialogue* procedure was introduced by an EU directive with the

¹⁶ *Funding the London Underground*, Prof Lord (David) Currie, London Business School, 2000, pp14-17

¹⁷ *The value of PFI: hanging in the balance (sheet)*, Pricewaterhousecoopers, 2008, pp19-20

¹⁸ National Audit Office, *Improving the PFI tendering process*, HC (2006-07) 149, 8 March 2007, pp12-15

intention of encouraging better and earlier communication between procurers and potential suppliers. An important feature of this procedure is that a greater part of the deal is agreed during the competitive phase of tendering with all bidders, before a winning bid is selected. The National Audit Office reported that although competitive dialogue has the potential benefit of maintaining competitive tension for a longer period of time, there is also an increased risk that the private sector will become more selective in the face of potentially higher bid costs and longer periods without certainty of winning the competition.¹⁹

Enabling private sector innovation, and better procurement control

10 18. If government specifies requirements in terms of the results to be achieved (outputs), this should give a private-sector contractor scope for innovation in designing and building assets and in the way they would be used to deliver the required service. And by linking PFI payments to service delivery rather than to the costs of asset construction, PFI projects give an incentive to contractors to build reliability and maintainability into the asset design – to use ‘whole-life’ design techniques. This contrasts with conventional public sector procurement where the public sector specifies the design of the assets. The risk with conventional procurement is that capital cost estimates are minimised to obtain project approval, potentially leading to problems of maintenance back-log due to poor design.

20 19. Evidence on whether PFI projects have improved innovation has been mixed. The National Audit Office has found some evidence that PFI projects have improved innovation in the prison sector:

25 the use of the PFI helped sustain an alternative group of prison providers, which has helped to reduce costs and has acted as an incentive to improve prison performance. PFI contractors have brought innovations in three main areas: in the treatment of prisoners; in the more flexible deployment of staff; and in the use of new technology.²⁰

¹⁹ National Audit Office, *Improving the PFI tendering process*, HC (2006-07) 149, 8 March 2007, para 1.5, p 10; para 2.14, p 14

²⁰ National Audit Office, *Operational Performance of PFI prisons*, HC (2002-2003) 700, 18 June 2003, para 12

20. With prison PFI projects, the contractor has provided the whole service, including custody, education and healthcare for prisoners. Early road projects, on the other hand, had less scope for innovation because they were mainly concerned with the provision of the assets and because, as the NAO found, “the design of the roads was limited by the core technical requirements which bidders were required to meet”.²¹ The private sector consortia were asked to build, finance and maintain the roads to the Highways Agency’s technical requirements.
21. There is some evidence, however, that PFI projects have delivered assets with less slippage and fewer budget over-runs than under conventional procurement approaches. PFI should provide incentives for contractors fully and accurately to estimate construction costs because they would bear any cost over-runs once the PFI contract is signed, and to complete construction as soon as possible because the public sector customer does not pay PFI service charges until the asset is completed and the service commences. An NAO report in February 2003 surveyed 37 PFI projects and found late delivery on 24% of PFI projects compared with 70% of conventional procurements, and cost over-runs on 22% compared with 73% of conventional procurements. PFI projects had slipped less, partly because of the pressures on contractors to bring service delivery payments on stream quickly, and partly because specifications are worked out in more detail and cost and time targets are set later in the procurement process than under conventional procurement.²² The NAO found that, where there had been cost over-runs on PFI projects, these had been due to the public sector customers changing their specifications. This NAO survey was carried out five years ago, however, and the performance of PFI and conventional projects may well have changed since then. Office of Government Commerce Information Notes give the latest information on performance of construction projects carried out by central government departments .²³

²¹ National Audit Office. *The Private Finance Initiative: The First Four Design, Build, Finance and Operate Roads Contracts*, HC (1997–98) 476, 28 January 1998 (<http://www.nao.org.uk/pn/9798476.htm>)

²² National Audit Office, *PFI: Construction Performance*, HC (2002-03) 371, paras 5-10

²³ http://www.ogc.gov.uk/construction_achieving_excellence_information_notes.asp

22. A more recent NAO report which looked at how changes in operational PFI projects were managed, found that although for the most part PFI deals were offering sufficient flexibility to the private sector, large changes to the contracts had not always been competitively tendered and the public sector's PFI project management was often not sufficiently resourced in order to manage the change process.²⁴

Certainty about costs, and enabling risks to be better managed

23. Treasury guidance emphasises that PFI should offer value for money through “risk management expertise, and greater certainty for the public sector that services will be delivered to the specified standard.”²⁵

24. Whereas conventional procurement often involves a payment for inputs (payment is made to the private sector for building an asset), PFI usually involves a payment for outputs (payment is made for a service delivered using the private-sector provided assets). Thus, PFI ought to reduce the risk to government of an asset being built that is inappropriate for the service requirement. If the asset cannot be used to provide the required service, government would not pay for it through service charges.

25. A recent NAO report listed the following two key advantages of PFI contracts over conventional procurement:

- a planned and consistent approach to maintenance, as the contractor is under an obligation to maintain the asset in good condition until the end of the contract period and, if maintenance is not undertaken, it risks being penalised for not meeting agreed availability and performance standards; and
- transparency of pricing in that the public sector knows in advance how much it will be paying and the contract is for the provision of services on a whole-life basis. This removes the possibility of asset replacement costs arising unexpectedly in any one year or being delayed in the event of budgetary constraints.²⁶

²⁴ National Audit Office, *Making changes in operational PFI projects*, HC (2007-08) 205, 17 January 2008, p 6, paras d/ e

²⁵ HM Treasury, *PFI: Strengthening long term partnerships*, March 2006, p p 4-5

²⁶ National Audit Office, *Making changes in operational PFI projects*, HC (2007-08) 205, 17 January 2008, para 1.4, p 7

26. A potential benefit of PFI is that it transfers risks, or uncertainty, to the private sector, or, more precisely, it allocates particular risks to the party best able to influence and manage them. The Treasury gives the following risks that the public sector typically seeks to transfer to the private sector in PFI projects:

- 5 • *cost overrun risk during construction*. For example, the private sector is expected to cover extra costs should buildings require more extensive foundations.
- *timely completion of the facility*. No payments are generally made to the private sector until the asset becomes available, and the contracted service commences.
- 10 • *meeting required standards of asset delivery*. For instance, the private sector is expected to pay for the cost of redesigning the asset, should it not meet required service needs.
- *the underlying costs to the operator of service delivery*, including the future costs associated with operating and maintaining the asset.
- 15 • *risk of industrial action or physical damage to the asset*, and certain market risks associated with the project. For example, in some road schemes, the risk of wear and tear associated with actual traffic volume using the road.²⁷

There are also other types of risk which have to be allocated: *Demand risk*, the risk that the demand for the property will be greater or less than predicted; the possibility of generating *third party revenues*; *the risk of obsolescence*, including the effects of changes in technology; and *residual value risk*, the risk that the value of the property at the end of the contract will be different from that expected.

27. As stated in Treasury guidance, “the benefits of PFI flow from ensuring that the many different types of risks inherent in a major investment programme are borne by the party best placed to manage those risks”.²⁸ Some risks might be better retained by the public sector because they would be better able to manage them. For example, the risk

²⁷ HM Treasury, *PFI: Strengthening long term partnerships*, March 2006, p38-39

²⁸ HM Treasury, *PFI: Strengthening long term partnerships*, March 2006, p 38, para3.38

associated with uncertainty about the volume of government demand for the service might be better retained by the public sector. If the private sector had this risk, perhaps through a service charge that varied with demand volume, it might add a premium to its PFI bid to cover the uncertainty about whether the service charge would cover its costs. A fixed service charge that did not vary with demand volumes would keep such risks out of the PFI contract price. This is illustrated in the case of prisons PFIs. In the first prison projects, the Prison Service proposed to pay contractors according to the occupancy of the prisons. Essentially the Prison Service wanted to transfer the risk that the prisons might not be fully used to the contractor. This was resisted by bidders on the grounds that the Prison Service would remain responsible for allocating prisoners to prisons. So, the payment mechanism was based on prison places availability, recognising that private sector contractors could manage the number of places available but not the number of prisoners that are given custodial sentences.²⁹

28. On the other hand, demand risk for prospective third-party users of the service might best lie with the private sector because that would encourage it to market additional third-party use of the assets, and thereby minimise the public sector's costs subsumed in the PFI service charges.

29. Any sub-optimal allocation of risks between the public and private sectors will have cost consequences for the PFI project. This is because business raises finance for a project in the capital markets and the cost of that finance depends on investors' perceived risk – or uncertainty – that loans might not be repaid or returns on investment not materialise. And prospective PFI contractors will price their bids to reflect their financing costs.

30. Some commentators argue that in practice certain risks, such as the risk of cost overrun during construction or the underlying costs for the operator of service delivery, can never be wholly transferred to the private sector. For instance, Michael Meacher MP argued in 2004 that “whenever a major PFI contractor went bankrupt, the

²⁹ National Audit Office, *The PFI Contracts for Bridgend and Fazakerley Prisons*, HC (1997–98) 253, 31 October 1997, para 2.33, p 32

Government would have little alternative but to bail it out” and that “this has already been demonstrated in the case of Railtrack, the Channel Tunnel consortium, the Criminal Records Bureau, air traffic control, and the Benefits Agency”.³⁰ Manchester Business School, which looked at the cost of using private finance in the first twelve PFI NHS hospitals in England, found that the annual charges paid by hospital trusts to PFI contractors were in some cases much higher than anticipated, raising questions about the reliability of the original value for money case underpinning the decision to use PFI. They also found that a quarter of the increase in trusts’ funding between 2000 and 2003 went to pay for PFI charges on new hospitals.³¹

31. More recently, the taxpayer has ultimately had to pay for cost over-runs for maintenance of the London Underground as a result of Metronet, one of the private sector contractors, going into receivership in July 2007. The bulk of the company was financed not by shareholder equity but by £2.6 billion of debt guaranteed by the Government. Because of that guarantee, the public sector ultimately bore the lion’s share of the project’s overall risk, irrespective of the allocation of demand or construction risks. In February 2008, the Department for Transport provided £2 billion to Transport for London to take on Metronet’s existing and prospective debts (as the debt guarantee required) as well as some incidental costs.³²

32. On the other hand, there are examples of failed PFI projects where the private sector rather than Government has had to bear the large proportion of the costs of business failure. With regard to the termination of the PFI contract for the National Physical Laboratory, the National Audit Office concluded:

For the private sector parties, the project has been a clear failure: the investors in Lasers [special purpose company owned jointly by John Laing plc and Serco] lost all of their investment, and John Laing plc [construction company] told us that it lost about £67 million on the construction project, excluding losses of at least £12 million absorbed by its sub-contractors. The Department [the former Department of Trade and Industry] has also not achieved all it wanted because of

³⁰ <http://www.epolitix.com/EN/MPWebsites/Michael+Meacher/ba7469b0-88cc-4797-82ff-c94b6e939bdd.htm>

³¹ ACCA, *Evaluating the operation of PFI in roads and hospitals*, research paper no 84, 2004 (Pam Edwards, Jean Shaoul, Anne Stafford, Lorna Arblaster)

³² House of Commons Debates, 6 February 2008, 74W5

delays in completing the buildings and because some work still needs to be completed. However, the Department has much to show from the project, in buildings that are largely complete and which the Department expects substantially to complete over the next few years.³³

5 *Refinancing*

33. The overall risk lying with the private PFI contractor is borne ultimately by its financial backers (shareholders and lenders). They bear the risk that the project will not earn the returns required to pay off the debt incurred for the project and give shareholders an acceptable rate of return on their investment. That risk is translated into the cost of finance raised for the PFI project. At first sight, the public rather than the private sector appears to be best placed to manage the risk of raising finance because its risk-free solvency allows it to borrow more cheaply than the private sector. However, Metronet apart, PFI financing risk is usually transferred to the private sector, with the private sector raising the funds for the project, which is accordingly incentivised to deliver a successful PFI project.

34. Once the assets have been built and the required service has been successfully launched, the overall risk of the project is less, and therefore the risk borne by the financiers is less. At this point, the PFI contractor might raise such cheaper finance and pay-off the more expensive initial finance, reducing the contractor's overall costs and generating additional profits. This is called 'refinancing'.

35. The large refinancing gains accruing to some PFI contractors have attracted criticism. The Public Accounts Committee called the gains made by the company, Octagon, from the refinancing of Norfolk and Norwich Hospital "the unacceptable face of capitalism".³⁴ However, Neil Bentley from the Confederation of British Industry argued that:

the refinancing gains, which were shared with the trust, were only possible in the first place because the contractor had successfully delivered the project. As a result

³³ National Audit Office, *The Termination for the PFI Contract in the National Physical Laboratory*, HC (2005-06)1044, 10 May 2006, Para 4.14, p 36

³⁴ PAC Press Notice 35 of 2005-06, 3 May 2006

http://news.bbc.co.uk/1/hi/uk_politics/4967030.stm

of this and of falls in interest rates between the signing of the deal and the opening of the facility, it as able to obtain better financing terms.³⁵

36. Initially, only one in four of the early PFI contracts had clear arrangements to share refinancing gains with the public sector. The Office of Government Commerce
5 launched a new voluntary code of practice in October 2002 that stated that departments should generally receive a 30 per cent share of future refinancing gains on existing PFI deals and that gains from refinancing deals on new projects should in general be shared 50:50.³⁶ The public sector sometimes still has to take on added risks in order to share in the refinancing gains. For instance Darrent Valley Hospital had to
10 extend its contract and take on the risk of an additional liability if the PFI contract ended early in order to share the PFI refinancing gains with the private contractor.³⁷

37. In March 2007, the Public Accounts Committee reviewed PFI debt refinancing and the PFI equity market.³⁸ It pointed out that proceeds for government from refinancing under the voluntary code (only £93 million) were significantly below the £175-200
15 million refinancing gains foreseen by the Office of Government Commerce in 2003. The Report suggested that the shortfall of expected refinancing gains was due to “investors opting to defer refinancing in favour of realising gains through selling their shares in the secondary equity markets”.³⁹ It pointed to a lack of expertise in the public sector in negotiating contracts with the private sector:

20 Most of the negotiating of refinancing deals is undertaken by the public sector at a local level where officials often lack commercial awareness. Some of the locally negotiated refinancing have produced very high investor returns and increased risks for the public sector such as higher termination liabilities and longer contract periods. All staff undertaking refinancing negotiations should undergo suitable
25 training to equip them for this role.⁴⁰

³⁵ Public finance, *Standing by the PFI*, Neil Bentley, 26-07-2007, p 19

³⁶ National Audit Office, *PFI Refinancing Update*, HC (2001–02) 1288, 7 November 2002, p 11

³⁷ National Audit Office, *Darent Valley Hospital: The PFI Contract in Action*, HC (2004-2005) 209, 10 February 2005, p4, para 7

³⁸ For working document containing details of the equity holders of signed PFI projects, see http://www.hm-treasury.gov.uk/media/E/A/pfi_equityholders_march2008.xls

³⁹ Public Accounts Committee, Twenty-fifth Report of Session 2006-07, *Update on PFI debt refinancing and the PFI equity market*, HC 158, p 5

⁴⁰ Public Accounts Committee, Twenty-fifth Report of Session 2006-07, *Update on PFI debt refinancing and the PFI equity market*, HC 158, p 5

38. The NAO report also looked at equity financing which involves contractors selling their shares in PFI projects to realise a profit while the service delivery phase of the PFI project was still underway. Unlike debt refinancing, the Treasury does not require investors' gains on selling equity in PFI projects to be shared with the public sector. It takes the view that, whereas a debt refinancing affects the public sector's rights and interests as a purchaser, a change in the equity ownership of the project is a transaction outside the project and does not affect the public sector's interests, provided the PFI equity market is operating efficiently.⁴¹ The Public Accounts Committee warned, however, that there were signs that the equity market was not operating as efficiently as it should: "The PFI equity market has shown signs of consolidation in recent years" and if shares become too narrowly held these investor may be able to dominate the market with "less competition in the pricing of the equity for new deals".⁴²

Benchmarking and market testing of services

39. As mentioned above, one PFI risk that would normally be transferred to the private sector is uncertainty about the contractor's on-going costs of providing the contracted service, because the contractor should be best placed to manage that risk. Providing for 'value testing' of services in a prospective PFI contract can reduce that risk and produce a different PFI bid price. Value testing involves either comparing the costs underlying the contractor's service with other comparable sources (*benchmarking*) or inviting other suppliers to compete with the incumbent contractor for some cost items (*market testing*). The National Audit Office has found that at least half of PFI projects have provisions in their contracts that require the value of certain services, such as catering and cleaning, to be tested at intervals, typically every five to seven years.⁴³

40. Recent Treasury guidance suggests that market testing is better than benchmarking:
Market testing allows a more flexible approach to the provision of services than benchmarking because it ensures that the soft service provision for the project can be re-assessed to match public sector requirements at the time the exercise takes

⁴¹ *Ibid*, para 12

⁴² *Ibid*, pp 5–6

⁴³ National Audit Office, *Benchmarking and market testing the ongoing services component of PFI projects*, HC (2006-2007) 453, 6 June 2007, p 4, para 1

place. Market testing also offers greater opportunity for transparency and competition. Consequentially, and because of a greater maturity in the soft services market, it is now the Treasury's view that for simple soft services, market testing, rather than benchmarking, is generally most likely to yield the best value for money. However benchmarking, with a fall back to market testing if parties fail to agree on the outcome, in some cases remains an acceptable alternative.⁴⁴

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The National Audit Office examined the contractual provisions for value testing in a sample of 34 PFI contracts and evaluated the early experience of 11 PFI projects in England that had carried out value testing. It emphasised that for the potential benefits of market testing to be realised there needs to be strong competition, and that when benchmarking costs the economies of scale available to different providers are taken into account. It also recommended that departments compare costs and quality under a PFI with conventional outsourcing.⁴⁵

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⁴⁴ HM Treasury, *Operational Taskforce Note 1: Benchmarking and market testing guidance*, October 2006, para 1.11, p 6

⁴⁵ National Audit Office, *Benchmarking and market testing the ongoing services component of PFI projects*, HC (2006-2007) 453, 6 June 2007, pp 7-8

Accounting treatment of PFI

41. An increasing area of controversy surrounds the accounting treatment of PFI, specifically whether accounting treatments are transparent and consistently applied, and how PFI accounting might affect the Government's continuing ability to meet its fiscal rules.

Accounting treatment

42. With a straightforward lease – known as an 'operating lease' – the leasing company remains the owner of the leased asset and bears the risks associated with providing and maintaining the asset, and the entity leasing the asset simply pays a hire charge for the duration of the lease. Many PFIs have been regarded as similar to such operating leases, with the public sector accounting as though the PFI contractor has retained, in commercial substance as well as legal form, the ownership of the assets it provides, with the public sector body paying a service charge for its use – effectively a lease hire charge. The position becomes more complicated if the (public sector) lessee bears most of the risk of providing the asset rather than the lessor (the PFI contractor). There might be little difference in substance between such a lease arrangement – called a 'finance lease' – and an outright purchase of the asset, with the lease charges effectively representing the spreading of the purchase costs over the life of the asset.

43. Accounts seek to present the underlying reality of a lease arrangement, or a PFI deal, irrespective of whatever its legal form might take. Departments' Resource Accounts are based on the accounting standards that are used in the commercial sector (known as UK Generally Accepted Accounting Practice), though with some adjustments where their direct application in a public sector context would not be appropriate.⁴⁶

44. The treatment of PFI projects in government accounts is currently driven by the following accounting standard and Treasury guidance (although this will change as international accounting standards are adopted from 2009-10 – see below):

⁴⁶ The Financial Reporting Advisory Board reviews accounting standards, and makes recommendations to the Treasury on how they should be adopted or adapted for central government and NHS accounts.

- Statement of Standard Accounting Practice 21 on Leases (SSAP 21), issued by the Accounting Standards Board on August 1984,⁴⁷
- Financial Reporting Standard 5 on Reporting the substance of transactions (FRS 5) of April 1994, and an ‘Application Note F’ of September 1998 giving guidance on applying FRS 5 to PFI contracts, both issued by the Accounting Standards Board.⁴⁸
- A ‘Technical Note 1’, issued by the Treasury PFI Taskforce after the Accounting Standards Board published its Application Note F, giving public-sector specific guidance, supplementing FRS 5.⁴⁹

45. These standards and guidelines seek to allow accounts preparers and auditors to judge whether the property use underlying a PFI is *in substance* an ‘operating lease’ or a ‘finance lease’. The overriding principle that dictates whether a PFI asset in commercial substance belongs to the public sector (akin to a finance lease arrangement) is whether it or the PFI contractor has the major elements of the ‘risks and rewards of ownership’. These include demand risk, essentially the impact of any uncertainty that the demand for the asset will be greater or less than predicted; residual value risk, that the value of the property at the end of the contract will be different from that expected; the risk of unanticipated changes in future costs, including those arising from future technological change; and the risk of changes in third party revenues.

46. The FRS 5 Application Note lists these risks and gives guidance on how to judge whether the asset should appear on the public sector or private sector balance sheet. The Treasury Taskforce Technical Note gives additional guidance for the public sector, but in recent years there has been some controversy about a perception that it produces different results from the Application Note. In particular, there was a view that the Technical Note tended more often than the Application Note to indicate an operating lease type arrangement rather than a finance lease, and as result the assets of some PFIs

⁴⁷ <http://www.frc.org.uk/asb/publications/>

⁴⁸ <http://www.frc.org.uk/asb/technical/standards/pub0100.html>

⁴⁹ http://www.hm-treasury.gov.uk/documents/public_private_partnerships/additional_guidance/ppp_technicalnotes_index.cfm

might have been on no balance sheet – neither the public sector’s nor the private sector’s. The Comptroller and Auditor General has voiced concern for a number of years that, in the local government and health sectors, some assets have been recorded off-balance sheet when it was not appropriate to do so, and that “it is clear that differing interpretations of the accounting guidance have been applied to projects in different parts of the public sector”.⁵⁰

47. A Treasury-led working group, set up in response to concerns over possible inconsistency in PFI accounting across different parts of the public sector, found some evidence that the Technical Note might have produced some differences of interpretation of the standards to the Application Note.⁵¹ The Financial Reporting Advisory Board agreed with the working group’s conclusion that the Technical Note should be withdrawn but deferred making such a recommendation to the Treasury until it received the Treasury’s proposals.

48. However, the Board’s deliberations were overtaken by the Government’s announcement in Budget 2007 that from 2008-09 the accounts of government departments would be prepared using International Financial Reporting Standards (IFRS), adapted as necessary for the public sector. IFRS will affect the way PFI projects are accounted for and, because they apply different principles to the existing accounting standards, IFRS will make both the Application Note and the Technical Note redundant. The 2008 Budget then announced that the transition to IFRS would be delayed for a year, to 2009-10.⁵² In its Report on the 2008 Budget, the Treasury Committee expressed concern about the “potential for arbitrage” between the Application Note and the Treasury’s Technical Note, maintaining the potential for different interpretations of PFI accounting treatment.⁵³

49. Under IFRS, the key standards are:

⁵⁰ National Audit Office, *Financial Auditing and Reporting General Report of the Comptroller and Auditor General*, HC (2006-2007) 148, 9 February 2007, p 24, para 3.25

⁵¹ FRAB Paper, *PFI Update*, 11 December 2006, http://www.hm-treasury.gov.uk/media/C/5/frab83_pfiupdate_111206.pdf

⁵² *Budget 2008*, HC 388 p 202, para C.103. The delay was because two departments (MoD and Dept of Health) would not have been ready to implement IFRIC 12 for 2008-09.

⁵³ Treasury Committee, Ninth Report of Session 2007–08, *The 2008 Budget*, HC 430, para 66

- International Accounting Standard 17 on Leases (IAS 17), issued in 1982, the international equivalent of the UK's SSAP 21. Like SSAP 21, IAS 17 considers where in substance the risks and rewards of assets lie. The current UK standards include a '90% test' to help establish whether sufficient risk and reward lies with the lessee to identify a lease as a finance lease for accounting purposes – that is, whether the present value of the future minimum lease payments is more than 90% of the value of the asset. IAS 17 uses a different yardstick – whether 'substantially all' of the risks and rewards of ownership lie with the lessee – which may increase the number of projects classified as finance leases. IAS 17 also requires leases which involve land and buildings to be subdivided into separate assessments, and in practice the building component is more likely to be assessed as a finance lease.
- International Financial Reporting Interpretations Committee's IFRIC 4 on Lease Type Arrangements, which deals with the substance, rather than legal form, of projects, much as FRS 5 does.
- IFRIC 12 on Service Concession Arrangements (issued November 2006), which provides accounting guidance for private-sector 'operators' of 'service concessions' granted by the public sector, arrangements which would encompass PFI projects. The Interpretation considers whether a concession's assets would belong to the public-sector 'grantor' on the basis of whether it 'controls' the use of the asset or 'regulates' the service, rather than using the 'risk and reward' criteria of other accounting standards. The Financial Reporting Advisory Board has recommended that the principles underlying IFRIC 12 should apply to public-sector grantors' accounts when IFRS is adopted in 2009-10. Most commentators believe that this should bring greater clarity to the balance sheet accounting of PFI assets and that most of those assets determined to be off the public sector bodies' balance sheets under the Treasury Technical Note guidance would be accounted for as on balance sheet under the IFRIC 12 principles.

How PFI transactions appear in departments' Resource Accounts

50. Information about PFI is disclosed in various places in a set of Resource Accounts – in the Operating Cost Statement, Balance Sheet and various Notes attached to the audited financial statements. The treatment of the PFI transaction will be dependent on whether the asset is recorded on or off balance sheet. **Annex 2** shows in detail how information on a department's PFI projects can be gleaned from its Resource Accounts, using the Ministry of Defence as an example.

Budgets and the impact of PFI on the Government's 'sustainable investment' fiscal rule

- 10 51. The way PFI projects affect Departmental budgets closely reflects the accounting treatment discussed above. **Annex 2** sets out the details.
52. The budgetary treatment of PFI expenditures and assets brought onto departments' balance sheets also affects the Treasury's management of the Government's fiscal rules. These include a Sustainable Investment Rule which seeks to maintain public sector net debt at a 'stable and prudent level'. The Government set a limit for net debt of 40% of GDP over the economic cycle.⁵⁴ The way PFIs are accounted for directly influences the Sustainable Investment Rule because the ONS, like the currently applied accounting standards, looks at whether the Government or the private sector has the substantial risks and rewards of ownership, and counts assets procured through 'finance lease' arrangements as akin to debt-financed procurement.
- 15 53. In September 2006, the ONS identified the notional debt associated with some PFI projects which it considered to be finance lease arrangements. This had the impact of increasing the Government's liabilities by £4.95 billion, or 0.4% of national income.⁵⁵ In September 2007, the ONS transferred the debts of Tube Lines and Metronet on to the public sector's balance sheet, adding 0.1% of GDP to public sector debt.⁵⁶ The 2008 Budget forecast that the Government will only narrowly miss breaching the
- 20
- 25

⁵⁴ Institute of Fiscal Studies, *The Green Budget 2008*, p46

⁵⁵ ONS, *Including finance lease liabilities in public sector net debt: PFI and other*, November 2006, p 27

⁵⁶ ONS Press Release, *Classification of Tube Lines and Metronet*, 24 September 2007

sustainable investment rule, with a net debt of 39.8% of GDP in 2010-11.⁵⁷ The late inclusion in the 2008 Finance Bill of adjustments to the Income Tax basic rate thresholds will also put the net debt figure close to the 40% limit in 2008-09.

54. It remains to be seen what the impact on the level of public sector debt will be if the
5 IFRIC 12 accounting guidance is adopted. The ONS has used government accounts' treatments of PFIs as a pragmatic guide to its assessments of public sector net debt, and it told the Treasury Committee in March 2008 that it was now also examining whether accounts which applied IFRIC-12 and IFRS from 2009-10 would also be appropriate in its future assessments.⁵⁸ The Institute for Fiscal Studies noted at the time of the 2008
10 Budget that “any significant classification change [of PFI projects currently not on the public-sector balance sheet] that increased public sector net debt could quite plausibly result in it being pushed above 40% of national income”.⁵⁹

55. In considering any future PFI indebtedness, however, it is important to acknowledge
15 that part of the charges that will be paid to the PFI contractors represents the delivery of services that are distinct from the provision of the assets themselves, and such payments might be reduced if the services were no longer needed.⁶⁰ The Treasury states that in a typical PFI hospital project, 40-50% of the charges are for the service delivery component.⁶¹

56. The Institute for Fiscal Studies argues that the 40% limit is arbitrary in nature:
20 A significant addition to net debt would increase the risk that the 40% ceiling will be breached over the medium term. But it is important to remember that there is nothing special about the choice of 40% as a ceiling and it could be argued that a significant change in the definition of net debt should be accompanied by an equivalent change in the ceiling under the sustainable investment rule.⁶²

25 57. The Treasury Committee's Report on the 2008 Budget stated:

⁵⁷ Budget 2008, Table C 5, p 184

⁵⁸ Treasury Committee minutes of evidence, HC 451i, Qq 48 and 52-53]

⁵⁹ *Green Budget 2008*, IF5, p55

⁶⁰ *Green Budget 2008*, IF5, p55

⁶¹ HM Treasury, *PFI: Strengthening Long-Term Partnerships*, 2March 006, para 2.25

⁶² Institute for Fiscal Studies, *Public Finance Bulletin*, September 2006

5

It seems highly likely that, following the move to International Financial Reporting Standards for central government, the sustainable investment rule as currently defined and interpreted will be breached in 2009-10 as a result of the reclassification of PFI projects. As such, the delay announced in Budget 2008 in the implementation of International Financial Reporting Standards gives the Government a chance to announce in advance whether and how it proposes to revise the sustainable investment rule in the light of the implementation of International Financial Reporting Standard.⁶³

⁶³ Treasury Committee, Ninth Report of Session 2007–08, *The 2008 Budget*, HC 430, para 39

ANNEX 1: Stages of PFI projects

Appraisal process - whether or not to opt for PFI?

Currently there is a three stage process that enables public sector bodies to identify whether or not PFI is an appropriate procurement process for a particular project.⁶⁴

5 **Stage 1 – Programme Level Assessment** to ensure that PFI is only considered for use in those programmes where it is appropriate and is likely to represent good value for money ;

Stage 2 – Project Level Assessment requiring an upfront procurement appraisal. This replaced the previous Public Sector Comparator (PSC) analysis (see below for explanation of this) and identifies the aspects that are key to Value for Money (VfM); and

10 **Stage 3 – Procurement Level Assessment** which is an ongoing assessment during the procurement phase of a project to ensure that the desired project can be delivered in view of, for example, the level of competitive interest and market capacity.

Stage 1 - Programme Level Assessment

The recommended approach is in two parts, qualitative and quantitative.

15 *Qualitative assessment*

This part considers the viability, desirability and achievability of PFI when assessed against alternative procurement routes.

• *Viability* involves assessing whether there are any efficiency, accountability or equity issues, which mean that it would be better for the Government to provide the service directly rather than through PFI. It is also assessed whether service requirements can be

20 adequately captured and specified in a contract.

• *Desirability* involves assessing the relative benefits of different procurement routes, such as: incentives for the private sector to innovate; risk transfer in PFI versus the Government's lower cost of borrowing in conventional procurement, and the relative

⁶⁴ HM Treasury, *Value for Money Assessment*, August 2004, Chapters 4 to 7

advantages and disadvantages associated with a long term contractual relationships between the public and private sectors.

- *Achievability* involves gauging the level of likely market interest and whether the public sector client would have sufficient capability to manage the complex processes involved.

5 *Quantitative assessment*

The quantitative assessment considers how quantifiable costs and benefits of using PFI as the procurement route are likely to compare with conventional procurement. For the PFI option, it calculates the cost of the project if it were to be funded through private finance, adjusting for factors such as risk. The quantitative assessment replaces previously used comparators of the PFI's costs against a public sector comparator.

Originally the Government judged value for money in PFI projects by comparing the cost of companies' PFI bids with a *public sector comparator*, the cost if the public sector procured and owned the investment itself. The public sector comparator was also adjusted for any risks that were transferred under the PFI option. For instance an adjustment would be made if under the PFI option the private sector bore all the risks of cost over-runs. However the public sector comparator analysis came under a lot of criticism from advocates and critics of the PFI process, as evidence to the Treasury committee in 2000 demonstrates:

Several witnesses questioned the validity of PSCs: the Major Contractors Group said "despite extensive guidance, contractors continue to find that public sector comparators are often unrealistic, do not properly allow for the risks which the public sector would retain under a publicly-funded solution, and do not accurately cost the maintenance and operation elements of a project." Mr David Clements of the Business Services Association said, "Frequently the output specification actually demands a higher standard from the private sector partner than the standard to which the services are [currently] being provided" and called for a corresponding adjustment to the PSC. Professor Pollock and her colleagues argue ... that the adjustment for risk transfer is the result of a "very arbitrary judgment". The TUC suspected that authorities which had no alternative to PFI calculated the PSC in "a half-hearted way" and did not revise it in the light of changes to the proposal.⁶⁵

⁶⁵ Treasury Committee, Fourth Report of Session 1999–00, *The Private Finance Initiative*, HC 147, para 35

The current quantitative assessment, like the original public sector comparator analysis, compares the “conventional procurement option” with the PFI option. However Treasury guidance emphasizes that it is simpler than the conventional public sector comparator analysis and has therefore fewer uncertainties inherent in its process:

- 5 The watch word in developing this tool has been simplicity. The user will, therefore, not find many of the aspects that they would have expected to see in a conventional public sector comparator. Whilst greater complexity could be introduced, the simplicity reflects the level of inherent uncertainty to which any quantitative spreadsheet is subject when used at an early stage of project development, in this case
10 investment and project assessment stages. Equally, it highlights the fact that quantitative analysis is only one element of the VfM assessment and should be used only in conjunction with the qualitative assessment which is completed in parallel. The pursuit of further degrees of accuracy is likely to detract from the underlying qualitative and quantitative reasons that make a given procurement route value for money.⁶⁶

15 **Stage 2 - Project level assessment**

The main aims of a project stage assessment is to verify that the initial decision to use PFI is valid and ensure that it is marketable. The assessment involves

- retesting the assumptions of the quantitative and qualitative test.
- carrying out an affordability test to ensure that the public sector authority
20 involved can afford the PFI.

There would also be likely to be some level of *market sounding* in stage 1 and stage 2 of the process. Market sounding involves determining the potential level of market interest and the current and future capacity by talking directly to potential players, though the Treasury emphasizes that care must be taken to prevent market conditions from affecting the
25 specifications of the project required.

Stage 3 - Procurement Level assessment

The emphasis is on identifying market problems early in the process. The aim of the procurement level assessment is to identify cases of market failure (lack of competition as a result of too few single bidders) and also cases of market abuse (where bid offered is

⁶⁶ HM Treasury, *Quantitative assessment user guide, 2007*, para A.7, p2

significantly above similar PFI projects). Where there are significant cases of market failure or market abuse, the Treasury recommends the decision to use PFI should be reviewed.

Identifying cases of market abuse and market failure involve techniques such as

- reviewing whether there is a market of well qualified bidders
- 5
- benchmarking costs against similar projects

The project will be put out to tender and the contract awarded at stage 3. However the guidance emphasizes that this stage will apply throughout the procurement period, from the issuance of the contract notice through to the end of the contract.

External Scrutiny

- 10 Recent Treasury guidance also emphasises the importance of external scrutiny of PFI contracts and large procurement projects generally: “external scrutiny can be more objective about a project’s prospects, and be less constrained about making appropriate criticisms”.⁶⁷ The Treasury has established the Major Projects Review Group (MPRG), a panel of commercial experts from across government, to give Treasury ministers
- 15 independent advice on the value for money of the largest and most complex procurement projects at an early stage.⁶⁸ The Treasury has stated that “the lessons learned from the public sector’s experience of PFI will be applied to other Procurements”. In essence, best practice regarding managing and scrutinising PFI can be applied across the whole of government procurement.⁶⁹

⁶⁷ HM Treasury, *Infrastructure procurement: delivering long-term value*, March 2008, p 43, para 5.10

⁶⁸ HM Treasury, *Infrastructure procurement: delivering long-term value*, March 2008, p 43, para 5.11

⁶⁹ HM Treasury, *Infrastructure procurement: delivering long-term value*, March 2008, p 45, para 5.24

Annex 2: PFI accounting treatment for government departments

Information about PFI is disclosed in various places in a set of Resource Accounts – in the

- 5 Operating Cost Statement, Balance Sheet and various Notes attached to the audited financial statements. The examples below are drawn from the Ministry of Defence’s Resource Accounts for 2006-07 (HC 697, 2006-07, pp223-278).

The critical issue in Resource Accounts treatment of PFI projects is whether the asset is placed on the public sector body’s balance sheet.

- 10 This is currently determined by accounting standards, supplemented by Treasury guidance, which weigh up whether the public sector or private sector has the substantial risks and rewards of ownership of the PFI asset. When Resource Accounts adopt International Financial Reporting Standards from 2009-10, the principles underlying the international guidance for the private sector on ‘Service Concession Arrangements’ (IFRIC
- 15 12) will be adopted. As such, criteria based on control of the asset and regulation of the PFI service will determine on whose balance sheet the asset should lie.

On-balance sheet projects are in effect capital expenditure by the public sector that has been financed by borrowing from the PFI contractor. Off- balance sheet projects are purchases of services from the contractor, who has created an asset to deliver those

20 services.

If the PFI asset is not recorded on the public-sector balance sheet

		See MoD example below:
In the Operating Cost Statement:	<ul style="list-style-type: none"> The annual ‘unitary charge’ paid to the contractor for the PFI service 	Note 10
In the Balance Sheet:	No data normally included in balance sheet. An exception is: <ul style="list-style-type: none"> The value of any ‘reversionary interest’ in the asset at the end 	

	of the PFI project's life. If the contract involves the asset being transferred later on to the public sector, a reversionary interest is recognised in the balance sheet, with the sum being built up over the life of the project. [see further explanation next to 'Note 14' below]	Note 14
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If the PFI asset is on the public-sector balance sheet:

		See MoD example below:
In the Operating Cost Statement:	<ul style="list-style-type: none"> • The value of the 'unitary charge' paid to the contractor is divided into three elements. A 'reduction in the capital obligation' reduces the amount of the capital debt in the balance sheet over the period of the contract (representing repayment of the asset financing) – this will be reflected in the balance sheet rather than the Operating Cost Statement), while the two other components of the unitary charge are presented in the Operating Cost Statement: <ul style="list-style-type: none"> ○ An estimated service charge. ○ An imputed finance charge of the borrowing implicit in acquiring use of the asset. It represents the interest payment that would have been subsumed in an up-front procurement payment. • The fixed asset will also be subject to an annual depreciation charge • A component of the 'cost of capital' charge (though the PFI asset component of the charge is not separated out). 	Note 10 Note 12
In the Balance Sheet:	<ul style="list-style-type: none"> • PFI fixed assets, reduced each year by the depreciation charge • PFI liabilities, included in the Creditors figures, representing future obligations to pay for the asset, through the PFI annual charges. • (if applicable) PFI pre-payments, included in Debtors figures. 	Note 14 Note 19 Note 17

Notes to the Accounts also include listings of PFI projects; both on- and off- balance sheet (see MoD example below: Note 27).

In the MoD's case, for example, the Resource Accounts tell us that as at 31 March 2007:

- 5 • the MoD had 51 PFI projects (38 of which were recorded on-balance sheet and 13 off-balance sheet);
- the MoD owned PFI assets (on-balance sheet) of £562 million;
- the MoD incurred PFI service charges of £1,148 million in the year;
- the MoD owed £658 million due to PFI finance leases, of which £18 million had to be paid back within one year;
- 10 • PFI projects ranged from provision of training administration and financial management information systems to the army to the provision of communication services to the submarine fleet.

MoD Accounts – Notes supporting the Operating Cost Statement

The table below is an extract from Note 10, showing the PFI service charges for 2006-07. These cover unitary charges of off-balancesheet PFIs, and the service delivery component of the unitary charges of on-balancesheet PFIs.

5

10. Other Operating Costs		
	2006-07	2005-06 Restated
	£000	£000
— PFI service charges **		
IT and Telecommunications	424,930	307,269
Property Management	348,863	243,342
Transport	193,806	182,601
Equipment Support	121,454	123,619
Plant and Machinery	58,607	12,681

10

The extract from Note 12, below, shows the imputed interest cost in 2006-07 of on- balance sheet PFIs (£67.551m).

12. Net Interest Payable		
	2006-07	2005-06
	£000	£000
Interest payable:		
— Bank interest	148	18
— Loan interest	3,237	3,348
— Unwinding of discount on provision for liabilities and charges (Note 20)	126,414	1,211,110
— Finance leases and PFI contracts	67,551	64,480
— Late payment of Commercial debts	9	15
	197,359	1,278,971

15

MoD Accounts – Notes supporting the Balance Sheet

The table below is an extract from Note 14, showing the value of on- balance sheet PFI fixed assets (£562m out of £74,601m fixed assets overall).

The Note also includes a £22m PFI ‘Residual Interest’ (or Reversionary Interest). Typically, a PFI contract which would transfer the asset to the public sector at the end of the contract would be regarded as an on-balance sheet project. However, it is still possible for such a reversionary interest project to be off- balance sheet if other risks lay with the contractor. In such off- balance sheet projects, the value of the asset to the public sector increases the nearer the project gets to its conclusion, and the reversionary interest asset in the balance sheet increases each year. In such cases, the annual cost reported in the Operating Cost Statement is the unitary charge less the increase in the reversionary interest that year.

14. Tangible Fixed Assets

	Dwellings	Other Land and Buildings	Single Use Military Equipment (SUME)	Plant and Machinery	Transport	IT and Comms Equipment	Assets under Construction (SUME)	Assets under Construction (Others)	Total
	£000	£000	£000	£000	£000	£000	£000	£000	£000
Asset Financing									
Owned	2,458,134	13,263,800	34,243,804	2,516,766	4,290,412	1,090,951	12,366,214	1,426,667	71,656,748
Donated****	308,126	1,665,021	-	40,320	123	-	-	-	2,013,590
Long Lease	176,099	102,179	-	-	-	-	-	-	278,278
Short Lease	621	58,193	-	-	-	-	-	-	58,814
Operating Lease	-	8,489	-	-	-	-	-	-	8,489
Finance Lease	-	-	-	-	420	-	-	-	420
On-Balance Sheet PFI	27,421	343,147	-	92,405	56,461	42,575	-	-	562,009
PFI residual interest	-	22,190	-	-	-	-	-	-	22,190
Net Book Value:									
At 31 March 2007	2,970,401	15,463,019	34,243,804	2,649,491	4,347,416	1,133,526	12,366,214	1,426,667	74,600,538

The top half of note 14 (not shown here) also includes details of the movements in the accumulated depreciation balance during the year.

Note 19.1, below, shows the liability for future payments to PFI contractors for on- balance sheet projects. These liabilities represent the obligation to pay that part of the unitary charge that represents the imputed finance debt for the acquired PFI assets – £18m the cost within the next 12 months and another £640m over a longer time horizon.

19. Creditors

19.1 Analysis by type

	31 March 2007	31 March 2006
	£000	£000
Amounts falling due within one year		
VAT	47,131	36,320
Other taxation and social security	234,373	240,255
Trade creditors	880,088	546,569
Other creditors*	266,872	351,519
Payments received on account	14,940	25,920
Accruals and deferred income	5,003,057	4,465,599
Current part of finance leases	2,595	4,378
Current part of imputed finance lease element of on-balance sheet PFI contracts	18,391	15,168
Current part of NLF loans**	1,904	1,797
Amounts issued from the Consolidated Fund for supply but not spent ***	229,588	658,881
Consolidated Fund extra receipts due to be paid to the Consolidated Fund – Received	39,655	102,983
	6,738,594	6,449,389
Amounts falling due after more than one year		
Other creditors	12,186	101,618
Accruals	190,579	176,686
Finance leases	43	2,639
Imputed finance lease element of on-balance sheet PFI contracts	640,107	642,523
NLF loans**	46,431	48,335
Loans – other	85,800	85,800
	975,146	1,057,601

5

Note 17.1, below, shows a debtor balance in respect of PFIs (£41.6m). This may be where payments have been made before the service is provided. Sometimes such 'pre-payment' asset balances might result where assets are transferred to a PFI contractor, and the consideration received by the Department is in the form of reduced unitary payments, with the sales value accounted for as a pre-payment. This prepayment is then reduced (charged to the Operating Cost Statement) over the course of the contract as the benefits of the prepaid element are utilised.

17. Debtors

17.1 Analysis by type

	31 March 2007	31 March 2006
	£000	£000
Amounts falling due within one year		
Trade debtors	233,860	177,539
Deposits and advances	28,207	54,355
Value Added Tax	317,118	320,544
Other debtors	213,501	275,363
Staff loans and advances*	46,072	41,921
Prepayments and accrued income	633,614	506,324
Current part of PFI prepayment	41,647	156,716
	1,514,019	1,532,762

MoD Accounts – other Notes

Note 1, the Statement of Accounting Policies, includes a policy for PFI transactions (paragraphs 1.27 and 1.28). This sets out the accounting treatment that has been adopted
5 by the MoD.

Note 23.4, Analysis of Financing, is attached to the cash flow statement. This note recognises the negative contribution that payments in respect of on- balance sheet PFI contracts makes towards the net financing total in the cash flow statement.

Note 27, below, is a more detailed note on PFI Commitments. This note is split into four
10 key tables:

The first table (note 27.1) shows the total PFI service charge payments that the MoD is committed to make during the next financial year, 2007-08. This is analysed in time bands, according to when the commitment expires.

The second and third tables list all of the MOD's on- and off- balance sheet PFI schemes
15 respectively. These tables include details of the capital value of the scheme and the contract start and end dates.

The fourth table gives a breakdown of the creditor relating to on- balance sheet PFI schemes; or the 'imputed finance lease obligations. The analysis shows the total creditor split according to when the liability falls due. These figures can be tied back to the relevant
20 line of the Creditors note, note 19.

27. Private Finance Initiative (PFI) Commitments

Charge to the Operating Cost Statement and future commitments

27.1 The total amount charged in the Operating Cost Statement in respect of off-balance sheet PFI transactions and the service element of on-balance sheet PFI transactions was £1,147,660,000 (2005-06: £869,512,000); and the payments to which the Department is committed during 2007-08, analysed by the period during which the commitment expires, is as follows.

	31 March 2007	31 March 2006
	£000	£000
Expiry within 1 year	11,028	1,875
Expiry within 2 to 5 years	172,654	81,912
Expiry within 6 to 10 years	178,205	236,188
Expiry within 11 to 15 years	335,233	213,235
Expiry within 16 to 20 years	67,317	54,519
Expiry within 21 to 25 years	219,874	240,046
Expiry within 26 to 30 years	21,213	11,600
Expiry within 31 to 35 years	171,964	120,350

Off Balance Sheet

27.2 The following information is provided for those schemes assessed as off Balance Sheet:

Project Description	Capital Value*	Prepayment 31 March 2007	Contract Start **	Contract End
	£000	£000		
Training, Administration and Financial Management Information System: Provision of training administration and financial management information systems to the Army Recruiting and Training Division	36,000	-	Aug 1996	Nov 2009
Hazardous Stores Information System: Provision of an information management service for hazardous stores safety datasheets with 2,000 users	1,000	-	Oct 1997	Oct 2007
Defence Fixed Telecommunications System: Integration of 50 fixed telecommunications networks used by the Armed Forces and MoD, including the delivery of voice, data, LAN interconnect and other WAN services	70,000	-	Jul 1997	Jul 2012
Medium Support Helicopter Aircrew Training Facility: Provision of 6 flight simulator training facilities, covering three different types of helicopter, at RAF Benson	114,000	-	Oct 1997	Oct 2037
Hawk Synthetic Training Facility: Provision of replacement simulator training facilities at RAF Valley	19,000	-	Dec 1997	Dec 2015
Joint Services Command and Staff College (JSCSC): Design and delivery of a new tri-service Command and Staff Training College infrastructure and supporting services, including single residential accommodation and married quarters. (Of the total amount, £64 million relates to on-balance sheet)	92,800	-	Jun 1998	Aug 2028
Attack Helicopter Training Service: Provision of full mission simulator, 3 field deployable simulators, ground crew, maintenance and armament training	165,000	-	Jul 1998	Sep 2027
Family Quarters Yeovilton: Provision of married quarters accommodation for 88 Service families at RNAS Yeovilton	8,200	-	Jul 1998	Jul 2028
RAF Lydney: Course Treatment: Refurbishment of existing course treatment	2,800	-	Aug 1998	Aug 2022

On Balance Sheet

27.3 The following PFI projects are treated as on balance sheet. The service payment commitments for the year 2007-08 are included in the table shown at 27.1.

Project Description	Capital Value* £000	Net Book Value 31 March 2007 £000	Contract Start **	Contract End
Defence Helicopter Flying School: Provision of helicopter flying training services	93,027	26,866	Apr 1997	Mar 2012
RAF Lossiemouth Family Quarters: Redevelopment and re-provision of 279 family quarters	24,745	27,421	Jun 1998	Aug 2020
Joint Services Command and Staff College: Command and Staff College for military and civilian personnel (also see JSCSC – Off Balance Sheet)	64,000	72,983	Jun 1998	Aug 2028
RAF Fylingdales: Provision of guaranteed power supply	7,486	3,839	Dec 1998	Dec 2023
Main Building Refurbishment: Redevelopment and management services for MoD Main Building	347,914	233,772	May 2000	May 2030
Naval Communications: Submarine fleet communications service	58,491	44,676	Jun 2000	Dec 2030

.....etc

MoD Accounts – other Information

There may be further references to PFI schemes in the narrative parts of the Annual Report and Accounts document. The MoD account has a separate chapter in its Annual Report devoted to ‘Future Capabilities and Infrastructure’. This chapter includes several

5 paragraphs on PFI and the approach that the MoD takes towards it (see paragraphs 165 and 166 on pages 97-98). Paragraph 289 of the Annual Report discloses major contractual commitments, and makes reference to the payments that have been committed to under PFI projects.

The Management Commentary (pg 197), which the Department is required to prepare in

10 order to comply with Treasury guidance, includes discussion of environmental, social, community, employee and other matters. Under this banner, there is a paragraph on contractual arrangements, which notes the Department’s main PFI commitments.

Private Finance Initiative

165. The Private Finance Initiative (PFI) remains a significant delivery tool in the provision of innovative and efficient services for defence. The Department remains committed to involving the private sector where appropriate, and using PFI where the requirement is for long-term services based around the provision or refurbishment of a capital asset or equivalent that can be funded by third party finance. The new MoD Project Agreement was published during the year, based upon Standardisation of PFI Contract version three which is the standard contract and guidance that project teams have to use when drafting their PFI contracts, allowing for a more efficient and effective procurement of PFI updated from Version two produced in 2003). Standardisation and improvement to the procurement process are producing better value for money and at the same time helping to drive down the length of the bidding process and bid cost – when a significant proportion (around 60-70%) of contract is common to all projects, standardisation of these elements of the contract will help reduce both procurement time and cost and these elements of the contract do not have to be renegotiated each time a new project commences. The Department signed one PFI deal in 2006-07 with the Northwood Development project with a capital value of £162M, bringing total private sector capital investment through PFI to over £5.8Bn. Further details on signed PFI transactions are in note 1.27 to the Departmental Resource Accounts on page 233. The Private Finance Unit also supported two public private partnerships, MoDEL (MoD Estates in London) and the Combined Aerial Targets Service projects, to reach contract close during the reporting year. At the 2007 Public Private Finance Awards, the MoD Private Finance Unit won Best Government Team, MoDEL won Best Public Sector Project Team and the Judges' Award for Innovation; Combined Aerial Target Service won best UK Deal to Sign; and C Vehicles won the best Operational Defence Scheme. The Defence Sixth Form College PFI was also highly commended in the category of Operational Project with the Best Design.

166. The Department received a total gain of £2.2M from the refinancing of the PFI projects for the Very Low Frequency Naval Communications Service (VLF) in December 2006 and the Tornado GR4 Synthetic Training Service (TSTS) in March 2007. These were undertaken in compliance with the Voluntary Code on Refinancing. The Department's forward PFI programme (see Table 6) has an estimated capital value of approximately £4Bn to £6Bn.

Table 6: Major PFI Projects in Procurement as at 31 March 2006

Project Name

Corsham Development Project
Defence Training Rationalisation Project
Future Provision of Marine Services
Future Strategic Tanker Aircraft
Search and Rescue (Helicopter) Project (new for 2006-07)
UK Military Flying Training System

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