

House of Commons
Committee of Public Accounts

**THE USE OF FUNDING
COMPETITIONS IN PFI
PROJECTS: THE
TREASURY BUILDING**

Forty-third Report of Session 2001–02

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*Report, together with
Proceedings of the Committee,
Minutes of Evidence and an Appendix*

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Committee of Public Accounts

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FORTY-THIRD REPORT

The Committee of Public Accounts has agreed to the following Report:

THE USE OF FUNDING COMPETITIONS IN PFI PROJECTS: THE TREASURY BUILDING

INTRODUCTION AND LIST OF CONCLUSIONS AND RECOMMENDATIONS

1. In May 2000 the Treasury signed a Private Finance Initiative (PFI) deal with Exchequer Partnership, a consortium comprising Bovis Lend Lease Ltd, Stanhope Plc and Chestertons International, for the refurbishment of its headquarters building in Whitehall. The 37 year contract, consisting of a two year refurbishment period followed by a 35 year concession to maintain the building and provide facilities management services, will cost the Treasury some £170 million.

2. The history of the deal was complex, including a 15-month period during which negotiations with Exchequer Partnership as the preferred bidder were terminated. When negotiations were re-opened it was on the condition that funding for the project would be obtained through a separate competitive process. The competition, run by Exchequer Partnership with the close involvement of the Treasury, was an innovation which reduced the cost of the financing, saving the taxpayer £13 million.

3. On the basis of a Report by the Comptroller and Auditor General¹ the Committee took evidence from the Treasury, the Office of Government Commerce, Exchequer Partnership and Partnerships UK. We examined whether funding competitions have a role to play in future PFI projects, the role of project management skills in the public sector and the additional costs to the public sector of using private finance. The merits of the underlying PFI deal itself will fall to be considered by the Committee in the light of a further report which the Comptroller and Auditor General has in hand.

4. Our key conclusions are:

Funding competitions should always be considered in future PFI procurements

The competition achieved the Treasury's two objectives: to obtain funding at the best available price; and to help get standardised PFI contract terms accepted by potential funders. The success of the competition raises the question whether such a method should be used to obtain funding in all future PFI deals. Some cases lend themselves to it: projects in mature sectors of the PFI, or those that are relatively simple in terms of the risks borne by the contracting parties. Novel or complex projects will be less suitable. In all cases, therefore, a funding competition should be considered—though it will not always be appropriate to use one.

Departments should place greater emphasis on developing the skills needed to deliver major capital projects

The main justification for the PFI is that it enables private sector project management expertise to be harnessed to ensure that projects are delivered to time and budget. But, however public projects are financed, project management expertise is needed in the public sector too. Departments should recognise the importance both of developing staff with project management skills, and of husbanding those skills.

¹ C&AG's Report *Innovation in PFI Financing: The Treasury Building Project* (HC 328, Session 2001–02)

The additional costs of using private finance need to be clearly identified

The private sector cannot borrow as cheaply as can the Government, and Treasury publications on PFI matters adduce that fact as a potential drawback to the use of private finance. Yet the Treasury surprisingly suggested that no additional net costs in PFI deals might result, provided differences in risk between PFI and conventional projects were taken into account. Funding competitions clearly help to ensure that the external financing costs are minimised but it cannot simply be assumed that the resulting costs of private finance will be no more than that of public finance after allowing for risk. If PFI deals are to be justified on the basis that the benefits of private finance outweigh the costs, then we would expect the Treasury to have a clear idea of what the extra costs of private finance are.

5. Our detailed conclusions and recommendations are:

On the use of funding competitions

- (i) Departments should always make it clear to bidders that they will reserve the right to ask them to secure funding through a separate competition. In this way the prospect of a funding competition would remain a credible threat and would help incentivise bidders to offer the keenest terms available in the finance markets. Furthermore, publication is now urgent of long-promised new guidance on this subject by the Office of Government Commerce.
- (ii) Whenever a department decides that a funding competition is unlikely to improve value for money, the department should nonetheless take a close interest in bidders' funding arrangements to ensure that the proposed funding arrangements do indeed represent good value.

On project management skills within the public sector

- (iii) The skills traditionally required for the most senior ranks of the Civil Service have had more to do with policy advice than delivering public services, leading to familiar weaknesses in implementation. Project delivery skills should be better recognised, and it should be clear that there are career paths to the very highest Civil Service positions based on outstanding project management skills.

On the additional costs of using private finance

- (iv) The Government's actual costs of finance are well known to be lower than those of the private sector. In assessing value for money in this project, the Treasury used a discount rate of 6 per cent to compare the deal, adjusted for risk, with a public sector alternative. That 6 per cent figure implies that public finance would cost more than the actual private sector cost of finance in this project, including allowance for risk. Yet the Treasury suggested to us that, taking account of project risks, there might be no difference between the costs of private finance and public finance. The Treasury should ensure that the appraisal of PFI projects adopts a consistent and defensible approach to the cost of finance.
- (v) If it were indeed true that the risk-adjusted cost of finance for a conventional public project did not differ from that of the corresponding PFI deal, then decisions on whether or not to go for a PFI deal could in principle ignore apparent differences in financing costs and turn instead on differences in the other factors. Several conditions would however need to be satisfied first:
 - ▶ that the market is always given enough information to provide a basis for a thorough assessment of the risk;

- ▶ that the PFI procurement, including financing, is fully competitive, so that the price fairly reflects the risk;
- ▶ that the financing instruments used in PFI do not inherently involve extra costs, as the C&AG's Report, *Channel Tunnel Rail Link* (HC 302, Session 2001–02) suggested that they might (paragraph 2.19 and Appendix 5).

These conditions will not necessarily be satisfied in every case.

THE ROLE OF FUNDING COMPETITIONS IN FUTURE PFI PROJECTS

6. In requiring Exchequer Partnership to hold a funding competition, the Treasury aimed to obtain funding at the best available price, and to persuade project funders to accept standard contract terms for future PFI deals. Both of these objectives were achieved.² Previous guidance from the Treasury had suggested that it was sufficient to have a single competition to optimise the separate elements of a PFI deal, so we asked whether the use of a funding competition was a departure from this guidance.

7. The Treasury said that this deal had been the first to use such a competition and represented an innovation in PFI procurement which could be extended elsewhere. Funding competitions should always be considered for future projects and departments should retain the right to ask bidders to conduct one. The method was particularly suitable for projects that had been developed to a stage where they were commercially viable, as funders would be unlikely to refuse to fund them. Indeed, for large projects that were not too complicated, funding competitions could become common practice.³

8. Asked whether funding competitions should be used in all PFI deals, the Office of Government Commerce considered that they should not. Such competitions were a sophisticated technique which should be used carefully, and as set out in the Comptroller and Auditor General's Report there were many criteria to consider before deciding whether a particular project would be suitable. Nevertheless, the right to request a competition should always remain a credible option for departments to take.⁴

9. The Office was in the process of getting agreement within the public sector on detailed criteria for the use of funding competitions. There would be guidance to departments that they should reserve the right to require a preferred bidder to run a funding competition. The existence of such a right would introduce additional tension into the procurement process to secure competitive financing arrangements.⁵

10. The Office of Government Commerce also believed, however, that there were other ways in which departments could take a close interest in the funding of a PFI project which need not necessarily mean holding a financing competition. Departments should always consult their professional advisers on whether any proposals put forward by bidders were competitive and to what extent bidders had explored the various ways in which a particular project could be financed.⁶

THE ROLE OF PROJECT MANAGEMENT IN THE PUBLIC SECTOR

11. A key factor in the management of the funding competition was the appointment of experienced advisers by the Treasury and Exchequer Partnership.⁷ As the cost of

² C&AG's Report, paras 4–8

³ Qs 1–2, 75, 102, 160

⁴ Qs 10, 180

⁵ Q11

⁶ Q12

⁷ C&AG's Report, paras 1.12–1.14

professional advice had amounted to about £2.6 million, we asked if it was necessary to rely so heavily on advisers. The Treasury said that as it was a complicated process they had equipped themselves with a good advisory team. However, the existence at that time of the Treasury Taskforce meant that the Treasury had not been over-dependent on external advisers. Asked whether there was a case for other departments to build up more internal expertise, thereby reducing the reliance on costly external advisers, the Treasury said that this was the reason for the formation of Partnerships UK. As a repository of PFI expertise available for use throughout the public sector, the existence of such a central body would avoid the risk of the public sector re-inventing the wheel every time a PFI project was undertaken.⁸

12. We asked the Treasury if such a large investment in professional advice would have been made if the project had been a conventional, public sector procurement. They thought that too little would probably have been spent on advice if the project had been procured conventionally, although they did not have a specific figure in mind. Work by the Office of Government Commerce had demonstrated that many public sector projects tended to go wrong from an early stage. The message to departments was that they should invest in getting projects right from the start, whether they were procured conventionally or through the PFI.⁹

13. Poor public sector project delivery may suggest that project management skills have in the past been undervalued within Whitehall, so we asked whether a successful project manager had ever become a permanent secretary. We were told that permanent secretaries needed particular skills that reflected their heavy involvement in policy advice, working very closely with Ministers. The emphasis in the past had been on the policy aspects of the job rather than delivery, and project management skills may not have been as highly rated as other skills. However, there was now a shift in emphasis to successful delivery, which would give project management skills much greater significance and importance in the future.¹⁰

THE ADDITIONAL COSTS OF USING PRIVATE FINANCE

14. The cost of private finance for the project was just over one and a half percentage points above the rate at which the Government could borrow through the gilts market.¹¹ The cost of finance therefore appeared much higher than that at which the public sector could have funded the project, so we asked whether it would have been better value to finance the project with gilts. The Treasury told us that the premium over gilts reflected the inherent risks in the project. If funds had been provided at the gilt rate, this would have meant lending to a risky project, while making no charge for the risk.¹² It would not have been sensible to lend money to a specific PFI project at a privileged rate. If public funds were lent at a properly risk-adjusted interest rate, the cost of finance would be the same for both the public and private sectors. If public funds were lent at a rate below the risk-adjusted rate, then the public sector would be taking an unpriced risk.¹³

15. The Treasury said that the key risks in this project included such items as cost overruns and construction delays, all of which had been transferred to the private sector. Although such risks could be transferred without the need to get the private sector to finance the initial capital costs, experience did not support the argument that risk transfer was successful where the finance was supplied by the public sector. By leaving contractors

⁸ Qs 3–4, 26, 158

⁹ Qs 161–167

¹⁰ Qs 14–16

¹¹ C&AG's Report, para 1.42

¹² Q27

¹³ Qs 96–97, 149, 173

to back their own judgements on project risk, the use of private finance made for better project management.¹⁴

16. In assessing the value for money of PFI deals, Treasury guidance requires that the cost of a deal should be compared against a public sector comparator. The Treasury had estimated that the £170 million cost of the project might be £20 million less than a comparable public sector project, using a discount rate of 6 per cent. Recognising that these cost estimates would be subject to examination by the C&AG in due course, we asked the Treasury whether the percentage discount rate was reasonable, given that real interest rates were at a much lower level. We were told that the discount rate was important in such calculations and that the 6 per cent figure was being examined, although a decision on whether or not to change the number had not been taken. Real interest rates were indeed lower than 6 per cent, but the discount rate was not wholly dependent on market interest rates as it incorporated a number of adjustments to reflect items such as inherent risk and the effects of taxation.¹⁵

¹⁴ Qs 60, 105–144, 168

¹⁵ Qs 49–59

MINUTES OF PROCEEDINGS OF
THE COMMITTEE OF PUBLIC ACCOUNTS

SESSION 2001–02

WEDNESDAY 21 NOVEMBER 2001

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon	Mr David Rendel
Mr Ian Davidson	Mr Gerry Steinberg
Mr Barry Gardiner	Jon Trickett
Mr Nick Gibb	Mr Alan Williams
Mr Brian Jenkins	

Sir John Bourn, KCB, Comptroller and Auditor General, was further examined.

The Committee deliberated.

Mr Brian Glicksman, Treasury Officer of Accounts, was further examined.

The Comptroller and Auditor General's Report on Innovation in PFI Financing: The Treasury Building Project (HC 328) was considered.

Sir Andrew Turnbull, KCB, CVO, Permanent Secretary, HM Treasury was examined; Mr Peter Gershon, CBE, Chief Executive, Office of Government Commerce, was further examined; Mr James Stewart, Chief Executive, Partnerships UK; and Mr Paul Lewis, Managing Director, Exchequer Partnership Plc, were examined (HC 398-i).

* * * * *

[Adjourned until Monday 26 November at half past Four o'clock.

* * * * *

WEDNESDAY 8 MAY 2002

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon	Mr Brian Jenkins
Geraint Davies	Mr David Rendel
Mr Barry Gardiner	Jon Trickett
Mr Nick Gibb	Mr Alan Williams

Sir John Bourn, KCB, Comptroller and Auditor General, was further examined.

The Committee deliberated.

* * * * *

Resolved, That the Committee do visit the Treasury Building, Great George Street, on 25 June 2002, in connection with its ongoing inquiry into PFI Financing: The Treasury Building Project.—(*The Chairman*).

[Adjourned until Monday 13 May at Four o'clock.

WEDNESDAY 26 JUNE 2002

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon	Mr George Osborne
Mr Ian Davidson	Mr David Rendel
Mr Geraint Davies	Mr Gerry Steinberg
Mr George Howarth	Jon Trickett
Mr Brian Jenkins	Mr Alan Williams
Ms Ruth Kelly	

Sir John Bourn, KCB, Comptroller and Auditor General, was further examined.

The Committee deliberated.

* * * * *

Draft Report (The use of funding competitions in PFI projects: The Treasury Building), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 4 read and agreed to.

Paragraph 5 postponed.

Paragraphs 6 to 16 read and agreed to.

Postponed paragraph 5 read and agreed to.

Resolved, That the Report, as amended, be the Forty-third Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order No. 134 (Select Committees (Reports)) be applied to the Report.

* * * * *

[Adjourned until Monday 1 July at Four o'clock.]

MINUTES OF EVIDENCE

TAKEN BEFORE THE PUBLIC ACCOUNTS COMMITTEE

WEDNESDAY 21 NOVEMBER 2001

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon	Mr George Osborne
Mr Ian Davidson	Mr David Rendel
Geraint Davies	Mr Gerry Steinberg
Mr Barry Gardiner	Jon Trickett
Mr Nick Gibb	Mr Alan Williams
Mr Brian Jenkins	

SIR JOHN BOURN KCB, COMPTROLLER and Auditor General and MR JEREMY COLMAN, Assistant Auditor General, National Audit Office, further examined.

MR BRIAN GLICKSMAN, Treasury Officer of Accounts, HM Treasury, further examined.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL: INNOVATION IN PFI FINANCING: THE TREASURY BUILDING PROJECT (HC 328)

Examination of Witnesses

SIR ANDREW TURNBULL KCB, CVO, Permanent Secretary, HM Treasury, MR PETER GERSHON CBE, Chief Executive, Office of Government Commerce, MR JAMES STEWART, Chief Executive, Partnerships UK, and MR PAUL LEWIS, Managing Director, Exchequer Partnership plc, examined.

Chairman

1. Good afternoon and welcome to the Public Accounts Committee. Today we are looking at the funding competition used to finance the Treasury building PFI deal and we are very happy to welcome Sir Andrew Turnbull, who is the Permanent Secretary of the Treasury, Peter Gershon, Chief Executive of the Office of Government Commerce, Paul Lewis, Managing Director, Exchequer Partnership plc, and James Stewart, the Chief Executive Officer of Partnerships UK. Could I ask you this, Sir Andrew: paragraph nine states that all parts of the PFI deal are usually obtained in a single procurement. Was the decision to use a separate funding competition a departure from previous Treasury guidance?

(*Sir Andrew Turnbull*) Yes. The title of the document is "Innovation in PFI Financing." This was a first and we were trying to see whether this was a development which could be successful and, if so, to extend it into other areas of PFI.

2. Based on your experience, are you going to be looking for a funding competition arising in many more PFI deals?

(*Sir Andrew Turnbull*) The whole of chapter two is trying to identify where a funding competition might be possible and where not and recommending that at least it should be a question that is always considered and that people should give themselves the right to opt for it if they want it. It does not say you should always have it; indeed, it indicates some circumstances in which it would not be appropriate.

3. Can I ask you about paragraphs 1.13 and 1.16? It states that the key to the success of the competition was the appointment of skilled advisers. Was it necessary, do you think, to rely so heavily on advisers?

(*Sir Andrew Turnbull*) It was a complicated deal and we equipped ourselves with a good advisory team. If the implication is that we were over-dependent on advisers and that the team we had ourselves was insufficient, I would rebut that. At the time, we had within the Treasury the Treasury Task Force who have now grown into PUK. That was a very important source of advice and we drew on them to be our advisers. The answer is that this was a deal in which there was a balance of both strong, external advisers but also strong, internal advisers.

4. Based on your experience of this deal, do you think that there is a case for Whitehall to have more internal expertise in this area so it does not have to rely so heavily on external advisers?

(*Sir Andrew Turnbull*) That was a conclusion which led to the setting up of PUK, a feeling that throughout the public sector there were too many people inventing the wheel, putting together teams of advisers, very heavily dependent on outsiders for the first time. What PUK has done is taken what was the Task Force, put it into this separate entity and we now have a group of people who work full time on PFI cases. As they finish one case, they are available to be redeployed on another. This should create a cadre of expertise which is available for use throughout the wider public sector.

[Chairman Cont]

5. Mr Lewis, paragraph 1.50 shows that all of the benefits of the competition accrued to the Treasury. What incentives were there for Exchequer Partnership to obtain the best priced financing, given that all the incentives went not to you apparently but to the Treasury?

(*Mr Lewis*) The funding competition was one of the criteria that we were given for carrying on the project.

6. That was the incentive?

(*Mr Lewis*) Absolutely.

7. You had no choice obviously?

(*Mr Lewis*) Not really.

8. There was no other incentive for doing it?

(*Mr Lewis*) We knew that because of the negotiation procedure a funding competition was probably the best route to go.

9. How heavily involved were the Treasury? Would it be fair to say they were all over the funding competition, standing at your shoulder the whole time?

(*Mr Lewis*) The funding competition was run by our financial adviser but he did consult with the Treasury advisers.

10. Mr Gershon, paragraph nine of the executive summary states that there may be a role for funding competitions in future PFI deals. Do you think they should be used in every deal?

(*Mr Gershon*) No, I do not. This is a sophisticated technique which needs to be used very carefully in certain circumstances and the report sets out the sort of criteria that might point clients towards situations where a funding competition might be appropriate.

11. If they are not going to be used in every deal, and you seem to be throwing a bit of cold water on this presumably because of the complexity, are they really a credible option in the PFI process?

(*Mr Gershon*) They are certainly a credible option in projects that meet the sort of criteria that are set out in the report but as the report also indicates there are other ways in which clients should take a close interest in the bidder's financing, which need not necessarily mean running a funding competition; looking to what extent the competitive tension is producing good financing arrangements by, for example, benchmarking. There are also other techniques that could be used to establish whether the financing is of a competitive nature. For the future, we are in the process now of producing revised standardisation for PFI. We will certainly be recommending to all the public sector clients that they always reserve the right to require a preferred bidder to run a funding competition. We would expect that, by reserving that right, that would introduce additional competitive tension into the process to drive through competitive financing arrangements.

12. In the context of funding competitions perhaps not being used on many occasions, can you tell us a bit more about the way pressure can be exerted on the preferred bidder to obtain best value financing?

(*Mr Gershon*) For example, in PFI competitions, the public sector client will have advisers. He should look to his advisers to give an input as to whether they feel the financing that the bidder is putting

forward is of a competitive nature and to what extent the bidders have explored the various ways in which the project can be financed to ensure that the keenest terms are put on the table.

13. Sir Andrew, who was the manager of this particular project?

(*Sir Andrew Turnbull*) There was a structure of relationships. There was a senior responsible officer in the Treasury, who is one of my immediate deputies, advised by a steering group, who then employed a manager from GTMS. It followed the structure of relationships which is advised by OGC.

14. Was there continuity in the management of this project, as far as the Treasury was concerned, or were personnel changing during it?

(*Sir Andrew Turnbull*) There was a remarkable degree of continuity. The Treasury team, with the exception of one person who has retired, is the same team that started on this thing in 1996.

15. So generally this would be considered a success. Just as a matter of interest, why is it that a project manager in Whitehall does not ever become a permanent secretary?

(*Sir Andrew Turnbull*) There is a particular skill set that has been thought to be needed to be a permanent secretary. You are heavily involved in policy advice, working very closely with ministers. I do not rule it out in the future. I think that skill and experience in project Management will become more highly rated in the future. We are all a product of 20 or 30 years of history. If we are looking 20 years hence, it may well be different.

16. Mr Gershon, you are not a product of 20 or 30 years of history in Whitehall. What do you think of this?

(*Mr Gershon*) I am an anomaly. There is a difference between someone coming into the sort of job that I have come into, which is of a fairly specialist nature, where it is not necessary to have a deep understanding of Whitehall ways and skills. I can relate private sector experience and try to bring it to bear in a public sector environment, but I do agree with Sir Andrew. Now there is a tremendous shift in emphasis onto successful delivery that is going to result in project management skills having much greater significance and importance in the future than I sense that they have been in the past, where the emphasis has been much more about the policy aspects of the job rather than the delivery aspects of the job.

Mr Gardiner

17. It is really nice to be on a Public Accounts Committee where we are not having to say, "Why the hell did this go wrong?" and I think it is the first NAO report that I can remember where, on the contents page, part one begins with, "The Treasury competition was a success". I hope that sends out the message to Whitehall that we do not always go digging for muck and spreading it around. Sometimes we can say, "Well done." It is also worth exploring when things do go well. Having said that, one of the things set out—I refer to page two, paragraph 4(a)—is, "The Treasury had two objectives in requiring such a competition: a) to

21 November 2001] SIR ANDREW TURNBULL KCB, CVO, MR PETER GERSHON CBE,
MR JAMES STEWART AND MR PAUL LEWIS

[Continued

[Mr Gardiner Cont]

persuade banks and other project funders to accept standard contract terms for future PFI projects. . . . This was intended to streamline the procurement process and reduce costs for both the public and private sectors.” If we go forward to paragraph 1.19, what is said there—correct me if I am wrong—is that the evaluation criteria in determining who was going to get this contract set out that bidders were to be evaluated on three criteria, one of which was the acceptance of the standard terms and conditions. Presumably, if you were wanting to get those standard terms and conditions accepted, but you were only going to accept bids that do accept those standard terms and conditions, is it not rather a circular way of proving that these standard terms and conditions can be successful?

(Sir Andrew Turnbull) I think it would have been slightly odd if we had said—and I think there was a demand for this from bidders—“We are going to devise some standard terms reconciling a number of different things that have appeared in different contracts”; then to have produced it and said, “We are not going to use it in this particular case.” It is not saying you then had to produce a bid that was standard so there was no scope for imagination in the solution offered. It is the terms that are being standardised; it is not the bid itself.

18. What I am not saying is that if you are trying to establish a model of standard terms and conditions then you should not incorporate that in the model that you are seeking to pilot it with. What I am saying is that if you are going to evaluate those bids that come in for the contract and say, “We are only going to accept those bids that go along with this rather than any bid that deviates from those standard terms and conditions”, that is a bit circular. Am I being unjust?

(Sir Andrew Turnbull) If the standard terms were saying something about the nature of the solution that was being offered, you would be right because we would have been cutting out the scope for innovation but this is trying to reduce the transaction costs of this for the benefit as much for bidders as for the public sector.

19. Of those companies that in the end decided not to bid—I think there were nine—none cited anything to do with the standard terms and conditions?

(Sir Andrew Turnbull) Not to my knowledge although I was not there at that time. I do not think that was the case, no.

20. One of the objectives for the competition was to get the standard terms and conditions accepted by the finance markets. What you are telling us is that there were no problems with those standard terms and conditions. Is that right?

(Sir Andrew Turnbull) I do not think there were. They have gone on to become the standard terms.

21. Mr Lewis, funders usually undertake their own due diligence to examine the risk that they are looking at. Paragraph 1.15 tells us that this did not happen in this case. There was a company that was taken on to provide that facility for all the bidders. Tell us if that worked successfully and why, in your view.

(Mr Lewis) I think it did work successfully. The fact that the Treasury Task Force was trying to use a standardised guidance and that we were asking bidders to bid on standard terms meant that the whole process of running the competition was a smoother one from issuing bids to the financial close. Comparison between one bidder and the other could be done in a much more efficient way.

22. The costs of that were met by which party?

(Mr Lewis) The preferred bidder, us, in this case.

23. You met the costs?

(Mr Lewis) Yes.

24. Despite the fact that normally the bidding parties would do their own due diligence work and here you have a number of bidding parties, all of whom would have incorporated those costs into their own ultimate price, here the Treasury ended up picking up the tab for this?

(Mr Lewis) I am not sure on that point.

(Mr Stewart) The primary reason for doing this was to save time in that the due diligence work could be carried out in parallel with the bidding process such that it would be made available to all bidders and indeed the preferred bidder. To answer your specific question on the costs, normally what would happen is that the banks and the preferred bidder would delay the due diligence process precisely for the reason that you are alluding to, which is that none of the banks will want to take risks on those sorts of costs. Normally, the cost of that is passed on via a unitary charge to the public sector body entering into the contract. I do not think this was any different in terms of the end result to the normal situation.

25. Except that a lot of companies ended up not being successful bidders ended up not bearing the costs of due diligence that they would have normally borne for not being successful bidders.

(Mr Stewart) That is true to the extent that they would enter into an extensive due diligence process. Normally, you would not have got multiple banks to incur the due diligence costs while they were still in competition. There would have been a delay.

26. In terms of the advisers that we had, Kleinwort Benson and Societe Generale, what was the cost of those?

(Sir Andrew Turnbull) Right from 1996 through to the conclusion, I think it was £2.6 million. That is for all the advisers.

27. Paragraph 1.42 says that the bond to finance the Treasury building cost 163 basis points above gilts. Can you explain why that was good value for money and why it would not have been cheaper to finance the project with gilts?

(Sir Andrew Turnbull) I go back to why this 163 basis points existed. Principally, because there was risk in the project and if we had lent money at gilts rate we would have been lending into a risky project but making no charge for the risk, which is a mistake the government has made too often. Another point is whether lending at that rate was a state aid possibly. The main reason is that that 163 was there for a purpose. It was an acknowledgement of the risk of the project.

28. The report does state that it was deemed to be good value for money.

[Mr Gardiner Cont]

(*Sir Andrew Turnbull*) That was by looking at comparisons with other deals going on at the time.

29. Referring to box one on page 12, where you have what in my view is an extremely helpful summary of the different financing characteristics of bank as opposed to bond financing, would it not have been possible to have got parity between bank and bond financing on the project and therefore open up the project to the possibility of getting the banks on board?

(*Sir Andrew Turnbull*) We invited 28 people to bid, of whom 19 responded. A lot of them were banks. In other words, they were not thinking, "This is hopeless. There is no point in my bidding here." They thought that they could come up with a product which could compete. In the end, it did not work out that way as the bond, and the indexed version of it, and in turn the wrapped, insured version of it won out. It was not the case that people said, "You have set this thing up in a way which means that only someone offering an indexed bond has any chance here", because if that was the case they would not have bid. Quite a number of them did bid and quite a number of them got through to the short list.

Mr Bacon

30. On this question of paragraph 1.42, you referred to how it could have been seen as a state aid if you had financed it through gilts. I take it you are saying it could have been seen as a state aid under EU rules, given that you had this Exchequer Partnership project?

(*Sir Andrew Turnbull*) We would be lending to a private sector body at something other than the normal cost of capital.

31. Nonetheless, this is a Treasury building. The thing that interests me about paragraph 1.42 is there is a spread of 163 basis points over gilts to accommodate the risks inherent in the project but why could not the Treasury have financed the development and refurbishment of its own building, which was a state building, using gilts?

(*Sir Andrew Turnbull*) This is the first time this has been done in 90 to 100 years. The Treasury has never engaged in a major property transaction before. The idea of becoming our own developer would have taken us into completely new territory, asking us to do something we have never done before and probably will never do again.

32. Who built the Treasury building in the first place?

(*Sir Andrew Turnbull*) Probably the Ministry of Public Building and Works.

33. Are you saying there was 100 years ago but there is not now expertise within government on managing this sort of project?

(*Sir Andrew Turnbull*) The responsibility for buildings is devolved to departments. The legacy of that was Property Holdings which disappeared some years ago. That is the route that produces the Marsham Street building, if you do it yourself.

34. There is quite a lot in the report on pages 16 and 17 about the bonds and issue of the bonds. Can you say how much money was raised by issuing the bond?

(*Sir Andrew Turnbull*) £125 million.

35. Was the 2.6 million for advisers' fees on top of that or were your net proceeds 122.4?

(*Sir Andrew Turnbull*) The £2.6 million includes lawyers, quantity surveyors and so on.

36. On top of?

(*Sir Andrew Turnbull*) Yes.

37. Was it 127.6 or was it 122.4?

(*Sir Andrew Turnbull*) I think the £2.6 million is what the Treasury has incurred for itself.

38. Is it not normal that if a company is trying to raise money it issues a bond and all the fees associated with raising the money are slapped on the bond?

(*Sir Andrew Turnbull*) All the fees on the EP side would have been, yes.

39. You raised 125 million.

(*Sir Andrew Turnbull*) We did not. EP raised it.

40. 125, excluding the facilities, management and the ongoing costs over the years ahead. Is it right to say that £125 million is the cost of refurbishing the building?

(*Sir Andrew Turnbull*) Yes, more or less.¹

41. You are paying out £14 million per year for the next 35 years?

(*Sir Andrew Turnbull*) Yes.

42. Which adds up to 490 million?

(*Sir Andrew Turnbull*) With a net present value of £169 million.

43. Could you explain in layman's terms the sentence: "The total net present cost of the unitary payments is £170 million"?

(*Sir Andrew Turnbull*) If you take £14 million and, for 35 years, discount back at six per cent I think you get to £169 million.

44. Nonetheless, it is cash out of the door. You are paying 14 million a year?

(*Sir Andrew Turnbull*) Yes.

45. You are, cash out the door, paying £490 million over those 35 years?

(*Sir Andrew Turnbull*) Yes. You have to compare it with what we would have been paying had we done nothing.

46. Forgetting construction costs, what are now the annual maintenance costs of the Treasury building and the running costs, including maintenance where necessary.

(*Sir Andrew Turnbull*) We are paying something like nine but some of that includes a property charge. For the facilities bit, I am not sure I know the figure.

47. £9 million a year?

(*Sir Andrew Turnbull*) Yes.

48.

That is in its 'undone-up' state?

(*Sir Andrew Turnbull*) We pay £9 million for an old slum and we will pay £14 million for a nice, new building.

¹ *Note by witness:* The total sum raised for the refurbishment was £140.985 million, comprising £127.790 from the indexed bond, £6.925 million of equity and £6.25 million of mezzanine debt. Ref answer to Q186.

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[Continued

[Mr Bacon Cont]

49. You say you have a discount rate of six per cent. What were real interest rates when you came up with the six per cent?

(Sir Andrew Turnbull) Probably about three to three and a half.

50. Do you think it is a fair figure or is it too high?

(Sir Andrew Turnbull) It is an issue we have to look at.

51. Does that not fundamentally affect the project, the discount rate that you use?

(Sir Andrew Turnbull) It could do.

52. Are you saying that there are circumstances in which the discount rate that you use would not fundamentally affect the viability of the project?

(Sir Andrew Turnbull) The discount rate would apply both to this project and to the public sector comparator.

53. The discount rate is always going to be important, is it not?

(Sir Andrew Turnbull) Yes.

54. It is always going to determine whether it is viable and whether it makes sense to do it.

(Sir Andrew Turnbull) Yes. What I do not have in my head is whether we would have concluded that we would not have done it because this was a project that we had to do. The one thing we were absolutely sure of was that spending about 50 or 60 million simply to stop the water ingress into the basement, to stop lorries falling through the pavement into the basement, cabling maintenance—we were beginning to get a number of cable fires—and ending up with a building no better than what we have at present was an extraordinarily bad deal.

The Committee suspended from 4.35pm to 4.45pm for a division in the House.

55. Returning to the discount rate, you said you did not have it in your head whether it would have made much of a difference because you would have had to do something anyway. I

paraphrase. I am right, am I not, that real interest rates were quite a lot higher than when you came up with the six per cent discount rate than real interest rates are now?

(Sir Andrew Turnbull) The six per cent is not—

56. That was not my question. Are real interest rates now a lot lower than they were when you originally came up with the six per cent discount rate? Yes or no?

(Sir Andrew Turnbull) Yes.

57. If you were to do it now, you would come up with a discount rate quite a lot lower, would you not?

(Sir Andrew Turnbull) Not necessarily because the discount rate is encapsulating probably three different functions.

58. Including risk?

(Sir Andrew Turnbull) It is encapsulating the pure time preference, risk and the fact that, when you raise money for a project, you have to do it through taxation and there is a welfare cost.

59. Nonetheless, are you looking for future projects at having a lower discount rate?

(Sir Andrew Turnbull) We are looking at the Green Book but there are no decisions or proposals as yet to change it.

60. Could you talk about the question of risk? What are the risks associated with the project?

(Sir Andrew Turnbull) One of the risks that we have is if it exceeds its costs. That makes no difference to us. We still pay 14 million. If they are late, they do not start getting the 14 million until we move in. Next are latent defects. EP and its architects surveyed this building extensively. If it turned out once they started knocking it apart that it was a lot more difficult to deal with or there was a lot more asbestos, for example, and they had to spend more money correcting that and it took them longer to correct that, that was their risk. There was a risk of listing and planning consents. There was broad agreement on the nature of the refurbishment with the planning authority, Westminster, but if it turned out that English Heritage were more fussy about this piece of stucco and that bit of panelling, that was EP's risk. There is the tenancy risk at the other end of the building. If there is a delay in finding a tenant, that is a risk that is transferred. They have to provide a set of facilities and management services to a particular standard. They have made an estimate as to how much it is going to cost them. If it turns out that it cost them a lot more than they estimate, that is again their risk. A risk that we have transferred is a pre-committed level of maintenance. As the tenant, we know that we will get this building maintained. We are not at risk of another part of the Treasury denying us the money in some future spending round to maintain it. That is a very comfortable position to be in. In the process, we have protected the residual value of this building. Summing that up, basically we only pay for what we get. There is quite an extensive risk transfer going on.

61. It says on the Office of Government Commerce website that the net present cost should include an estimate of the risk that would be retained by the public sector compared to the PFI option. Is there a number for that and if so what is it?

(Sir Andrew Turnbull) I do not have a number in my head for that.

62. You do not know how much risk would have been retained by the public sector? How can you begin to make a decision about whether to do this or not if you do not have a figure in your head?

(Sir Andrew Turnbull) In doing the public sector comparator, we made allowances for some of these risks, latent defects, cost over-runs and so on, and they were factored into that alternative calculation.

63. How much risk overall is retained by the public sector compared to the PFI option? That is one of the key things we need to know in order to decide to go the PFI route or not, is it not?

Am I wrong?

(Sir Andrew Turnbull) The risks we retain are probably common to both.

64. This is the definition of net present cost: "This is the net cost (taking into account any project revenues) estimated by the public sector of undertaking a project itself and producing the same or similar outputs under conventional procurement.

[Mr Bacon Cont]

The NPC should include an estimate of the risk that would be retained by the public sector compared to the PFI option . . .”

(*Sir Andrew Turnbull*) This is telling you what you should put into the public sector comparator. We did put an element of risk into the public sector comparator. We assumed, for example, that the cost over-run could be one of three figures, 10 per cent, 15 per cent or 20 per cent.

65. Forgetting the refurbishment costs for the moment, is the building going to cost less to run and maintain in the future than it does now?

(*Sir Andrew Turnbull*) It will cost more. That is because it is a hell of a sight better building. The relevant comparison is will it cost more or less than what we would otherwise have been forced to do with it.

66. £9 million a year sounds quite a lot of money for one building. Over 35 years, that is £315 million. If you add on 125 million, the cost of the refurbishment, that comes to 440.

(*Sir Andrew Turnbull*) What is not in that nine million is the 50 or 60 million that we would have to spend in the next three or four years to rectify the serious defects in this building.

67. Are you saying that the 50 or 60 and the 125 are separate numbers?

(*Sir Andrew Turnbull*) The £125 million was my ball park figure for the value of the bond. Actually, it was £127.8 million. There is then the mezzanine debt and the equity making the capital cost £141 million.

68. It is still only 16 million more than 125?

(*Sir Andrew Turnbull*) Yes.

69. The 60 million that you have talked about that you would have had to spend in the next three or four years and the 141 are completely separate figures?

(*Sir Andrew Turnbull*) One is the cost of patching up: the other the cost of a major refurbishment.

70. Which will mean that you do not have to spend the 50 or 60 million. So I am right. Forget the 50 or 60 million. If you add the 141 and add the existing cost, nine million a year, you come to 315 million, which is the current maintenance cost over 35 years, plus 141. That comes to 456 but you are paying out 490 over the 35 years, are you not?

(*Sir Andrew Turnbull*) We have done the calculation differently.² The net present value of the public sector comparator, allowing for the additional risk that would involve, would have been £189 million. The project we are going ahead with has a net present cost of £169 million. In discounted terms, we think this project is £20 million cheaper than going ahead with a similar modernisation project carried out as a public sector project.

² Note by witness: The calculation by Mr Bacon ignores the interest cost on the £141 million of capital raised. Ref answer to Q188.

Mr Rendel

71. If the project had gone ahead in 1997 rather than being put on hold because there was an election and a change of government, would there then have been financing competition?

(*Sir Andrew Turnbull*) Probably not. This was an idea that was developed by the Treasury Task Force which came into existence in 1997. We have been lucky in that technical progress in the financial world had moved on in that year and a half and when we revived the project a technique was available to us that we had not developed in 1996.

72. Somebody—presumably Exchequer Partnership if they have been sensible enough to go ahead with finding the best funding route—would have been left with an extra 13 million?

(*Sir Andrew Turnbull*) Yes. It could have cost us more. You could say this vindicates the decision to have another look at it.

73. I am trying to find out whether somebody lost 13 million.

(*Sir Andrew Turnbull*) I do not think anyone has lost 13 million.

74. Or lost the opportunity to make an extra 13 million profit.

(*Sir Andrew Turnbull*) We have an indexed flow of payments that we are making and we have come up with the idea of funding that by indexed bond. We have managed to get a match between the nature of the flow of payments and the nature of the finance raised. When you do that, you knock some risk out of the system. There has been a genuine saving to everyone. As it happens, we think we have captured most of that for the Treasury.

75. As a result of going through this process with the better methods that you have discovered and this brainwave that you would go in for financing competition, you are happy that in the second part of this report there are now criteria laid out as to when you might want to do the same sort of thing in the future?

(*Sir Andrew Turnbull*) Peter Gershon is consulting on this at present and has set out the criteria, building on the findings of this report. Some of it we may want to modify in the light of the discussion and conclusions you eventually reach, but we are trying to get agreement on the criteria throughout Whitehall and the public sector on when is a good idea to go down this route and when it is no and at least when you should ask the question.

76. Are you happy that you have now got sufficient controls in place to make sure that those criteria, when you have decided what they are, will be used in the future and therefore we will not in future have you or your successors before this Committee to say, “Why on earth did you not use financing competition because clearly you ought to have done?”

(*Sir Andrew Turnbull*) I cannot say we would never get a project where we regretted not having it. The main sanction is that if we go ahead and it turns out badly then we will have to answer to you. We have quite a lot of influence through PUK on the formative stage of projects, particularly large projects. It is certainly a question we will be putting to any team putting together a proposal.

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[Continued

[Mr Rendel Cont]

77. Mr Lewis, from what we have just heard, it looks as if your original proposals would have cost the Treasury £13 million more than the final position. Why did you get it £13 million wrong to start with?

(Mr Lewis) I would not say that we got it wrong. At the time, we were making certain assumptions about the project. Things had moved on from when we first priced the project and we were going to make certain assumptions in terms of the funding competition. It is possible we would have gone down the index linked bond route. We were looking at different options at the time and when the project was relaunched we had to look at it in a commercial manner.

78. Are you saying that if it had gone ahead in 1997 it would have cost the Treasury £13 million more than it finally did and there is no way you could have avoided that?

(Mr Lewis) I cannot say that because we had not gone into the depth of the funding competition that happened in the end.

79. Why not, given that presumably you could have offered the Treasury a lower price and been more likely to win the contract had you bothered to find out that there were other ways of financing the project which might have cost as much as £13 million less?

(Mr Lewis) In terms of the way the project was funded eventually, at the time there were relatively few index link bonds. From my point of view, things had moved on. The long concession term was one of the issues which we would have had to look at at the time.

80. Can I ask the Treasury for their view on that? Is it correct that there were not any index linked bonds around a few years earlier that could have been used in this way?

(Sir Andrew Turnbull) This is a question relating to corporate index linked bonds. This was a market which was developing.

(Mr Stewart) There were a number of small index linked bonds. There was no real liquidity in the market. There was great uncertainty as to their deliverability. When the funding competition was launched, there was much more liquidity in the index linked bond market and banks were looking at offering an index linked product as well, although they were struggling to do so. The market had moved on between the time when the original bid was put together and when the funding competition was run.

81. Had we gone ahead in 1997, as we would have done if there had not been a government change, the whole project would in practice have cost £13 million more because the option which was finally chosen was simply not available because companies were not producing index linked bonds.

(Mr Stewart) It undoubtedly would have cost more. The Treasury were seen to have influence in the negotiating power and the power of the Treasury generally had an effect on the market at that time. You have to compare a competition that was run by Exchequer Partnership but in close consultation with the Treasury with a competition which was run in isolation within Exchequer Partnership.

82. Mr Gershon, paragraph 1.14. The compensation being offered to Societe Generale if they did not come in with part of the funding—why exactly was that done in the sense that I would have thought it would be more logical to wrap that up in whatever price was being paid to Societe Generale anyway.

(Sir Andrew Turnbull) That is probably for James or I. You have to separate their role as an adviser. We would not want to wrap up their role as a provider of funds with their role as a provider of advice. The explanation for this is that they had, in the original bid, offered to provide this mezzanine level of debt. We wanted to have a competition for that. We wanted to compete that as well as the senior debt, but we were also advised that it was quite difficult just to have a separate competition for that one tranche. We wanted to hope that the people providing the senior debt would also offer this mezzanine debt. There was some doubt as to whether people would do that so you could have got a situation where you had one bidder who provided the senior debt and the mezzanine debt and another bidder who only provided the senior debt. Therefore, you would not have a competition. We arranged with SocGen that they would maintain their offer to provide this, which might get taken up and it might not. In effect, we bought an option with them. What it means was that when we had these two bids come in, we had the Ambac bid which was for both the senior and the mezzanine debt and the FSA bid which was only for the senior debt. We were then able to combine that with the SocGen offer which had been maintained and kept on the table since 1996 and effectively we were able to then have two competing proposals. This was an offer which we think is entirely vindicated because if we had not done it we would have had a problem with this competition. It was worth paying that fee to maintain that option.

83. Can I come back to paragraph 1.25, which talks about the number of institutions originally invited and the number that declined? You said that the need to agree the standard terms was not one of the reasons why any of the nine declined. We are told in the report that the reasons were, "... mainly because they did not feel that they would be able to offer a competitive bid and did not want to commit resources to the competition." I am quite surprised that there were so many that you did not have some pretty good idea in advance that they would not be able to provide competition or the funds.

(Sir Andrew Turnbull) We did not know how many other fish they were chasing at the same time. Some of them said, "We do not want to go in for this because we are making an effort somewhere else", which was a perfectly reasonable, competitive business decision for banks to make.

84. It seems quite a lot to me, that about a third of the total refused to bid at all. Is that usual?

(Mr Stewart) A lot of people often prequalify for these things to find out what is going on, purely to get the information into their hands and the documentation. What the banking market at the time was having to assess was whether they would have a chance of winning. The term of this deal, which is 35 years, means that any bank that was going to be competitive would have to lend extremely

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[Continued

[Mr Rendel Cont]

long term. At this time, the building societies were entering the fray and pushing out the term of debt available in the banking market. To be honest, people looked at the competition, at the Abbey Nationals and the Halifaxes of this world and, because they were beginning to be very competitive, they took the view that it was not really worth the effort of continuing.

85. Or even prequalifying?

(Mr Stewart) There were 28 expressions of interest which were trying to get hold of the initial information and I think the surprising thing is that 19 submitted term sheets.

86. You said 28 expressed interest. I thought it was 28 invited by the Treasury to express interest.

(Mr Stewart) You are right. 28 were invited, received a bit of preliminary information and 19 submitted term sheets of which they short listed down to the six financial institutions and the two bond arrangements. I think 19 is the more surprising figure.

87. We are told “mainly” because of these two reasons. Do you know what the other reasons were? Presumably some of these nine dropped out not for those reasons but for other reasons.

(Mr Stewart) Primarily, it was the fact that they were not going to win. They could not compete on the term or the period of the debt that they were being asked to offer.

88. The fact that they would not be able to offer a competitive bid is listed here as one of the reasons but I am wondering what other reasons there are.

(Mr Colman) It is up to the banks to decide at the time whether they want to proceed and there can be any number of reasons for a particular bank to be unenthusiastic about proceeding.

89. We are told most of the nine dropped out because they could not offer a competitive bid or because they did not have the resources but presumably because it is “mainly” there were some other reasons as well. I am trying to chase up what the other reasons were.

(Mr Colman) We have been told while we were doing this work that some of the banks did not like the standard terms and they were not supposed to like them because the Treasury was wishing to achieve something with the standard terms which might not please all banks. That may have been a factor.

90. We were told by Sir Andrew earlier in answer to Mr Gardiner that that was not one of the reasons.

(Sir Andrew Turnbull) We eventually had a field of 19 bidders to play with. We did not curtail this field to something that was a problem to us.

(Mr Stewart) I have a whisper in my ear that no reasons were expressed by some of the bidders.

Mr Jenkins

91. One of my colleagues asked a question with regard to funding it by gilts and you said it was inappropriate because of state aid rules. If I have a subcontractor and they are the preferred bidder, where does the resource cross the state aid line? If I am giving them special advice, if I am doing the risk

assessment and all that has been funded by the Treasury, where does the other resource, the cash, cross the state aid line?

(Sir Andrew Turnbull) We are paying for some of our own costs, to have our own advisory team. If we then make available money to a private sector organisation which does not reflect the current costs of capital in the market, that is something on which you can frequently find yourself being challenged.

92. There must be a distinct dividing line that says, “This is state aid. If used inappropriately and if I allocate resources of one sort or another to a company in the private sector which may not be able to purchase those resources or gain those resources in the market place such as the risk assessment, such as the special advisers”, where does that not transgress the state aid rule; whereas providing the cash from another resource does? It is both money at the end of the day, is it not?

(Sir Andrew Turnbull) If we just bought it, we would be just back to a conventional construction project. In this case, we are lending money to a private sector organisation which then has access to that capital which is not available generally. It does not reflect what other property companies will have access to.

93. But this is the preferred bidder. This is your contractor. All you are doing is supplying a resource, the money.

(Sir Andrew Turnbull) They still have that piece of business. In the competition, we had never hinted that we would do it this way. There is a change of terms where we say, “One of the things you will get if you take this contract is this money at the gilt rate.” All the people who did not bid or dropped out earlier would think, “Wow, I would have come in if it was on that basis.”

94. You have still confused me here. If I had two different companies they are not going to get any more out of allocated funding. That has all been taken as part of the price of the total contract, the package. This competition does not mean that Exchequer Partnerships are going to get any more money, does it?

(Sir Andrew Turnbull) I interpreted funding by gilts as meaning we borrow the money and on-lend that money to our contractor.

95. You are saying that contravenes state aid rules?

(Sir Andrew Turnbull) I am saying it could do.

96. The truth is it was not even checked?

(Sir Andrew Turnbull) We did not want to do it this way because this is the argument which says the government can borrow cheaper; therefore, anything that it buys from anyone, if anyone selling to us is borrowing in order to fund its activities, it would be much cheaper if we lent them the money. Down the end of that road, you say to the window cleaner, “Do not buy your own ladder. We will lend you the money.” The difficulty with that is that the terms on which people are borrowing in order to equip themselves to provide services to us reflect the risk they are undertaking. It is a distortion for us to lend to people at the risk free rate so we would have to set up a proper banking arrangement so that when we were raising money we were then assessing what were

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[Mr Jenkins Cont]

the risks of the project. What is the creditworthiness of the people to whom we are lending money. We do not have an apparatus like that in government. By and large, the state does not want to be in a position where it is the all purpose lender for everyone.

97. I did not think I said that. I just said if I have a contractor—my window cleaner is a good example—and if he was coming round to do my 2,000 windows every week and I said, “I want to employ you on a labour only contract and I will provide the materials”, it is quite common in business, is it not?

(Sir Andrew Turnbull) It would be probably wise to do it on commercial terms. If you happen to have some privileged source of finance, you would not necessarily assume that because you could borrow at that rate you could lend it to him at that rate.

98. If he is working for me I see no reason why, if I can get the price down by doing that. I would be stupid not to do it.

(Sir Andrew Turnbull) In the calculation you have made in getting the price down, you have to take the risk into account, and you probably have not.

Mr Jenkins: Yes, I would have done, believe me. I would not fund him up-front, I would make sure he got paid on a weekly basis.

Chairman: Can we get back from window cleaners.

99. I want to bring it down to the basics, Chairman, because it is a basic, everyday requirement, raising cash. I have read this report and read about the funding in the city and how effectively it is working and it is a simple way of raising cash to fund this project, but I am more interested in assessing the risks of this project because I think most funders would know what the risks were and would have done it themselves, but we have done it on their behalf. How much risk does that entail, doing the risk assessment for them and then handing the package over to them?

(Sir Andrew Turnbull) We have not done that; they have assessed the risk of all the things I listed in earlier questions. We have not duplicated EP’s assessment of risk. What we have assessed is what are the risks we no longer have to provide for, and in the calculation we then put those risks into our comparison of doing it as a public sector project.

100. So EP, being your preferred bidder, your contractor, has looked at all the risks, where do they finish? Where do you go over the line and say, “We now as the funder recognise the risks we took on, for instance we understood the construction costs, but it has gone awfully wrong, or the cost of raising the money has gone awfully wrong, where is the loophole?” Where do they come back and ask for more money?

(Sir Andrew Turnbull) If they come back and ask for more money, which I do not think is going to be the case, the first thing which would happen—assuming there is a big catastrophe—is that their equity would have been used up, the mezzanine debt will have been used up, so some quite considerable risk transfer would have taken place. You may get this argument which says that the danger of some PFI projects is that you transfer risk and you are kidding yourselves, because if eventually something serious goes wrong you end up taking it back or

renegotiating the contract. We do not think this is that kind of project. That happened in the IT world but this is a building refurbishment. We do not know what the risks are; we need to wait another 35 years to know whether the assessment of risk they made turns out to be correct. What I will observe is that the most risky phase is when you open the building up and start trying to do the construction. We are past that phase now, so I would be very surprised if it turned out to be one of these boomerang projects because I think we are past the point where the most serious risks of this project have been identified.

101. The standard terms and conditions were accepted, and it was important we got these accepted by the bidders, was it not? Very important. How much did it cost us, because some bidders did not come in because they did not want to accept these standard terms and conditions, how much did it cost us to get these accepted?

(Sir Andrew Turnbull) I do not think we know. What we know is that these standard terms have now become the standard terms. The private finance market has continued. If anything it probably has not cost us, it has probably saved money, both for ourselves and for private finance contractors.

102. If no one had taken part in the competition, who assessed the risk that was an outcome?

(Sir Andrew Turnbull) One of the criteria that the C&AG has identified is when is it a good idea to have a competition, and it is when you can be reasonably sure that you get the commercial close—you have the building, the engineering, identified, and you can take that project and finance it. You are not going to get into a position where you go to the financiers and the funders and they say, “This is the kind of deal we do not want to fund.” We were pretty confident we would be able to fund this deal. Obviously the terms on which we might fund it could vary but it was not going to be one of those things where people just said, “This is just not a bankable project.” Paragraph 2.25 says something like: “Using this technique we can be reasonably sure you can settle the commercial characteristics of the deal and then take it away and get it funded.” That is what we thought was the case with this project and it turned out to be right. If we had seriously thought that the funders were going to raise all sorts of questions and start unpicking the commercial part of the deal, then that is the kind of project which would not have been suitable, but we did not think that was the case and it has not proved to be.

103. So there was no fall-back position? You knew you could sell the deal?

(Sir Andrew Turnbull) We were confident we could, yes.

Mr Gibb

104. Essentially this project is the Treasury instructing a contractor to spend £125 million doing up the Treasury and instead of paying the bill, the £125 million, once the private sector had done everything which needed to be done, you wanted it paid over 30 years in HP instalments of £10 million a year? Is that not essentially the difference? That is where you get into this problem of this risk transfer.

[Mr Gibb Cont]

(*Sir Andrew Turnbull*) This is the argument about why are we doing PFI. There are lots of people who think that is what PFI is all about, and they are wrong. You are kidding yourself if you think you are saving money. If you do the true financial calculation, instead of borrowing money and having it added to the national debt and then having an asset, you have a liability spreading out into the future. In terms of your true balance sheet, those two things are equivalent and you should not get into the PFI if that is your only motive. The main reason for getting into this was we thought we could do it better, would get a better project, we could transfer risk, we could get more innovation and all the advantages I listed earlier.

105. I see that in terms of getting a private contractor to do the work, to manage the work, to get a private contractor to take care of the maintenance of the building, all very good, but I do not understand why you need to have the funding of this project done by the private sector.

(*Sir Andrew Turnbull*) The funding is what drives the contractor. The due diligence of the funders is the thing which is exerting pressure on them to do this thing well.

106. Why? I do not understand why that should be. Why is it not just saying, "You can construct the contract to do the repairs, to do the refurbishment, to do the servicing on an annual basis"?

(*Sir Andrew Turnbull*) We have 30 years of experience of borrowing money and getting people to just build things for us.

107. That is when you have managed it yourself. I am saying get the private sector to manage the project, get the private sector to manage the servicing of the building, but not get the private sector to raise the funds and fund it and give you an HP arrangement, which is essentially a big part of this contract.

(*Sir Andrew Turnbull*) But the fact they have raised the funds, they then are managing the risks and—

108. The risks you have talked about today are to do with the building project—the asbestos, the design, the listing problems. Is the Treasury a bad risk in terms of paying this?

(*Sir Andrew Turnbull*) We are not a bad risk.

109. So where is the risk in terms of the funding?

(*Sir Andrew Turnbull*) They have to manage this thing efficiently, they have to make a decision at the start as to how they build it relative to how they subsequently maintain it, and then they have to take that proposition and get it funded.

110. Only because you want them to get it funded, because that is how you want to pay for it. There is nothing inherent in a construction project that it be funded in this way, is there? You could quite easily pay for this up-front.

(*Sir Andrew Turnbull*) You are suggesting we have a design build operation with no funding?

111. Yes.

(*Sir Andrew Turnbull*) We believe that bringing the funding in is what actually creates an additional pressure, because people are then backing their judgment of the risks of this project against the finance they themselves are raising.

112. I think it goes to the motive of the project. I do not accept that at all. It does not make sense to me at all. I am a Conservative member here, so I am not opposed to capitalism and the free market. To go back to the original question, if the motive was simply to get this thing off the Government's books, that would be a wrong thing to do. I see the funding element of this as precisely that. I do not understand where the credit risk is in terms of this project. You are the Treasury, if you are a credit risk, God help the country, frankly.

(*Sir Andrew Turnbull*) They are not lending money to us—

113. But is that not the way you have structured it? Essentially, they are lending the money to you so you can refurbish the Treasury, and the only reason you have constructed it in this complicated way is so you do not have to include this as gilt-edged debt.

(*Sir Andrew Turnbull*) No. We have constructed it in this way because we think we would get a better performance out of the people building the project and subsequently maintaining it if the money they have raised is at risk.

114. I do not see that. You can transfer all that risk to the private sector by just having a construct, design, build contract and maintenance contract. You really can.

(*Sir Andrew Turnbull*) Experience is against you.

115. Where in the Government accounts then is this liability or this long-term financial commitment?

(*Sir Andrew Turnbull*) In the Budget documents we report the future service payments of PFI projects.

116. So it is all spelt out for the financial markets to see. If I get the Red Book out or the PBR in November, I will be able to see in that book—the Green Book or the Red Book—all the financial commitments the Government has entered into in these kind of arrangements in the long-term on an annual basis, is that right?

(*Sir Andrew Turnbull*) I am not sure whether it goes right the way forward for 35 years, but certainly for the medium-term future.³

117. Basically what you are trying to do is shift off the Government's balance sheet significant amounts of debt in the same way that companies in the 1980s shifted off balance sheets—

(*Sir Andrew Turnbull*) That is not our motivation.

118. It may not be your motivation but it concerns me it is the state's motivation to get this stuff off balance sheet, because I do not really see any other justification for it. I do not see that you cannot get this risk transfer in other ways. It can only be that the real motivation somewhere is to get this stuff off balance sheet. My concern is, what is to stop every government department loading itself up with these long-term commitments, provided they can meet the annual payments in the short-run, and then suddenly we discover in 10, 20 years' time we have a state sector riddled with debt which we do not see any sign of in terms of looking at the accounts now.

³ Note by witness: Table C18 of the Red Book 2001 sets out the estimated payments under PFI contracts up to 2025–26.

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[Mr Gibb Cont]

(*Sir Andrew Turnbull*) The resource accounts will include these payments to departments, so they quickly get to the point where the sum total of all the annual payments they are making is actually a charge, is creating a pressure, on their departmental expenditure limit.

119. Can I turn to page 30 in the report. The annual payments are £14.037 million. Am I right in thinking that is split between £10.6 million debt service and £3.433 million service fee? What is the difference between a debt service and a service fee? Is debt service the interest plus capital repayments?

(*Sir Andrew Turnbull*) Yes.

120. And the service fee is the maintenance of the building?

(*Sir Andrew Turnbull*) Security, maintenance, cleaning, all the rest.

121. So that £3.433 million is a considerable drop from the £9 million?

(*Sir Andrew Turnbull*) The £9 million was the total cost of what we are paying at present, some of which included the rental equivalent. Someone asked me, did I have in my head the figure for the facilities management bit of this, and I said I did not but I can—

122. So the £9 million is not the facilities management fee?

(*Sir Andrew Turnbull*) No.

123. That really undermines the answer.

(*Sir Andrew Turnbull*) The £9 million is equivalent to the £14 million. That was clear between us. I do not have a figure for what is the equivalent of the £3.433.

124. Will the £14 million increase over the period?

(*Sir Andrew Turnbull*) The increase will be in line with RPI.

125. So it will go up with inflation every year, the £14 million?

(*Sir Andrew Turnbull*) Yes.

126. When you calculated the net present value of £170 million, did you take that—

(*Sir Andrew Turnbull*) I did that in real terms.

127. What assumption for inflation did you use?

(*Sir Andrew Turnbull*) It was done in real terms.

128. So you used a basis of 6 per cent?

(*Sir Andrew Turnbull*) That is the discount rate. All these Green Book evaluation projects are done in real terms.

129. But the 6 per cent return includes an inflationary element.

(*Sir Andrew Turnbull*) No, it does not.

130. That is real?

(*Sir Andrew Turnbull*) It is 6 per cent real plus risk plus cost of raising the money, so it is a composite.

131. I do not know that I follow that. Maybe there are clever people here who can.

(*Sir Andrew Turnbull*) 6 per cent is not meant to be a nominal rate.

132. So is that the real rate then, the 6 per cent?

(*Sir Andrew Turnbull*) It is the rate which is used to evaluate public sector projects.

133. Yes, but—

(*Sir Andrew Turnbull*) All of which are done at the prices—

134. The Bank of England lending rate at the moment is 4 or 5 per cent, but that assumes there is a certain amount of inflation in the system. When I borrow a mortgage at 6 per cent, that assumes there will be a level of inflation.

(*Sir Andrew Turnbull*) If you are borrowing at 6 per cent, that is not the same 6 per cent as this 6 per cent.

Chairman: I do not think we are shedding a lot of light on this.

Jon Trickett

135. I do think that certainly there is some rigour and some ingenuity in this scheme as revealed in this paper, but I also think there are some flawed judgments, or at least judgments which appear to be flawed in it, and I think we have revealed some of them or hinted at some of them already. I want to return to risk. When you were originally asked about risk you referred to the risk inherent in the building contract. I agree, the risk inherent in the building contract to some extent affects the risk inherent in the financing but the two are conceptually separate. You did not, and have not in fact, indicated any risk involved in the financing part of the competition. It would be hard to say there was any risk since effectively you are exchanging financing for annual payments of several £14 million a year coming from the Treasury, so it is hardly a great risk to any funding institution. The only risk is whether the building contract is produced in line with the original estimates. I want to separate the two sets of risks out. I want first of all to ask about Exchequer Partnerships and the fact they were appointed on a bid which came sometime before it was finally accepted. Why did you not go back out to tender?

(*Sir Andrew Turnbull*) We had to have a project, because we knew otherwise we would have incurred this wasted payment. The first was time, and time in this case was money—each year which went by we would be doing more and more maintenance. Secondly, we had a bid and we were advised within the framework of that bid we could reopen it, negotiate the changes which we and Ministers wanted. It was not without risk to us if we had re-opened. We could have found the new competition was not actually as favourable as the original one. In the same way, EP had invested a lot of time in understanding the building, what its problems were, how it could be used, so too had the Treasury team, so we knew a lot about this. So we thought the best thing to do was to seek the changes we wanted within the original contract but to have various safeguards, the principal one being what we are talking about today, the fact we were—

Jon Trickett: I am going to come to that in a second. Not only conceptually but in reality, there were two separate sets of competitions, and in fact there were two separate sets of risks really. One is to do with financing and one is to do with the building contract. If we can just stay on the building contract for a second, because it impacts on the way in which the financing competition was run, it may be that you may have taken a risk to go out to tender, that you

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may have ended up with a higher price, but there is no certainty of that. The rest of Government operates on the basis of open tender, does it not, and years had elapsed, the building industry changes, each contractor in the market has more or less extensive workloads at the time at which they make a bid, and sometimes they go out and find work. I put it to you that you cannot say to me or to this Committee that you got the best price from Exchequer Partnerships for the building contract. You cannot demonstrate that.

Chairman: Can I interrupt for a moment. To be fair to Sir Andrew, we are just dealing with the finance at the moment, we are going to come back to the wider issue.

Jon Trickett: I accept that but the two relate. I do not want to disagree with you, Chairman, but Sir Andrew himself talks about all the risks being inherent in the building contract. Would you mind if we got an answer to that question and then I will move on?

Chairman: Go ahead.

(Sir Andrew Turnbull) This was a judgment we made. You can always say, had we done it the other way it would have been better, but what we know is that that price, when you take account of the movement in market interest rates generally and the specification change we made, is a better price than we had before, and the indications are that we are going to get into this building next summer.

136. Speed was one of the points you made.

(Sir Andrew Turnbull) It may be that it might have gone better the other way. Hindsight will tell you that. We have so far had no reason to regret the judgment we made.

137. I think you have accepted the point I was making and the Chairman wants me to move on. The reason I raised the building contract was it does seem to me it is inextricably linked to the way in which the matter was financed, and the issue of risk boils down it seems to me to due diligence. This paper is quite clear that the contractors and funders actually minimised the risk by the process of due diligence, presumably using professional insurances and various other methods to draw in other professions to say the building contract was properly constructed. Is my understanding right in terms of the due diligence process?

(Sir Andrew Turnbull) I think so, yes.

138. The due diligence process is used by the financiers, the funders, to determine whether or not the building project is a secure thing to lend money against, and you said that the risk which you were offloading from the Treasury was to do with the building contract, but the truth is you offloaded the risk by the process of due diligence and so did the funders; the process of due diligence was used.

(Sir Andrew Turnbull) No, we transferred risk and then the funders had to assess whether the risks they were taking on were ones they were prepared to fund, and EP were an organisation they believed was competent to manage those risks.

139. The fact of the matter is that this contractor here was really the Treasury by any other name. They were doing what you wanted and this document is an advocacy document for the processes you adopted,

and this document quite clearly states that the funders utilised the process of due diligence, in other words finding professionals and all their insurances and associated techniques which they used, to determine whether or not to lend money against a building price which the building contractors have established. That being the case, there are several questions which come from that. The first is this: why did the due diligence process not operate at the time of the first tender? The first tender, which was £13 million incorrect, not to the advantage of yourselves, must have used due diligence.

(Sir Andrew Turnbull) Not to the advantage of—

140. To the advantage of their chosen funders.

(Sir Andrew Turnbull) We would be paying to the—

141. Had the due diligence process been done twice then? Had it been done in the original tender and then again by yourselves?

(Sir Andrew Turnbull) I think it must have been.

142. That is interesting, is it not?

(Mr Stewart) Can I just clarify what due diligence is?

143. Yes.

(Mr Stewart) Due diligence is a firm of technical advisers, a professional firm, writing a report on behalf of the funders, giving their view of the risks of the project and inherent deliverability. There is no insurance or anything else. There is no risk-taking in that due diligence process, it is just a statement of the factual position.

144. Paragraph 1.16 refers to the insurances and it would be interesting to get a note sometime, if that was possible, Chairman, on what the insurances actually were. Due diligence, nevertheless, is the process the funders used in order to determine whether or not to lend money against particular builders' estimates. That is the truth of the matter. I am interested to discover due diligence was done twice, once erroneously to the advantage of the funders, according to this paper and according to what you have just told me, and a second time resulting in a £13 million less estimate. Am I understanding it right now?

(Sir Andrew Turnbull) What happened between 1996 and the end of 1997, I would have to check up exactly what due diligence process took place.

145. I only have a limited amount of time and I think I have made my point but it would be interesting if you could come up with that.

(Sir Andrew Turnbull) Your question is, was there a previous round of due diligence? Okay.⁴

146. This due diligence process is a fascinating one. I take the view of Mr Gibb, to my left, but for reasons not to do with my favourable attitude towards capitalism, rather the reverse. If due diligence is good enough for the banks, and it clearly was, and you participated in the selection of the professionals, how

⁴ Note by witness: There was no due diligence process between 1996 and July 1997 (when negotiations on the first deal were halted). Although commercial heads of terms had been agreed, arrangements for funding had not and were some way off. It is not until potential funders are engaged that the question of undertaking a due diligence process arises.

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is it that the Treasury does not use due diligence processes itself in building contracts which it is letting? Is that not a way actually of giving you some certainty about building contracts in the future, something which the private sector have invented which we might use to our advantage?

(*Sir Andrew Turnbull*) The experience is over the years a poor one.

147. Have we used due diligence processes like this one?

(*Sir Andrew Turnbull*) We would probably call it project appraisal at that time, examining the project, examining the risks, we would also be looking at the good standing of the potential contractor. All that was done or is done under a conventional procurement, but nevertheless the history is that this has not been done as well and that the intensity of the process, in my experience, is a lot greater when it is the private sector lending in relation to a particular project, rather than simply lending to HMG. They do not have to do much due diligence when they lend to HMG.

148. I would like, if it is possible, Chairman, to see where we used the same rigorous process of due diligence where it failed in relation to Treasury funding, direct public sector funding, relative to private sector funding. When it comes to public sector comparators, it seems to me that if you were to have provided the money yourselves rather than going to the private sector, the money would have been cheaper.

(*Sir Andrew Turnbull*) The money would have been cheaper but the assessment of the risk may have been faulty.

149. That precisely boils down to the issue of due diligence. It precisely boils down to the question of due diligence.

(*Sir Andrew Turnbull*) It was that prospect which lead in the construction of the public sector comparator, drawing on a series of reports from the Efficiency Unit, the Central Unit of Procurement—the history of cost overruns in the public sector—the inclusion of an allowance for cost overruns.

150. I think you have made your point and I have made mine. I want to move on to a judgment made about bonds as opposed to bank financing. A judgment was made at some point that we were going to go down the route of bonds, and I am not sure if I have understood this paper correctly or not but it seemed as if the bonds were lending over a five year period longer than the banks and therefore the annualised payments were less, and that was a prime motivator for you deciding to go down the bond route. Have I misunderstood that entirely?

(*Sir Andrew Turnbull*) That was one of the features which made bonds attractive.

151. My memory tells me that is what this paragraph says. How was the balance struck between the aggregate cost in total and the annualised costs? What balance was struck between the two, since borrowing over 35 years probably reduces the annual payments but may increase the aggregate cost of the scheme as a whole?

(*Sir Andrew Turnbull*) The project itself was for 35 years, which is why it made sense to relate the borrowing to 35 years.

152. I understand that, but the paper says that the annualised costs were reduced by borrowing over a longer period, and that makes sense, since we all know that is how our mortgages work as well. What I want to know from you is, has the aggregate cost increased as a result of the fact we are borrowing it over 35 years rather than 30 years? Is it costing the taxpayer more in the aggregate?

(*Sir Andrew Turnbull*) It is costing us less.

153. In the aggregate?

(*Sir Andrew Turnbull*) On a discounted basis.

Jon Trickett: I would be interested in that calculation. No doubt the C&AG, if he is still looking at the scheme, will be looking at that. Thank you, Chairman.

Mr Davidson

154. Would I be right in thinking, Sir Andrew, that to a great extent this project is going to be a flagship for PFI, and that if this went wrong effectively you would be a dead man? That is a technical expression!

(*Sir Andrew Turnbull*) Let me say yes to the first half and I will pass on the second half. There was no doubt that the Treasury has an overall responsibility for PPP/PFI and in its own project it is very important that it makes a success of it.

155. What difference did that pressure make to the running of the project?

(*Sir Andrew Turnbull*) We put a lot of resources in it and we had the resources of the Treasury Taskforce who worked very extensively on this project.

156. What does that mean in practice?

(*Sir Andrew Turnbull*) Some quite senior and experienced people were deployed from the Taskforce to work on this project.

157. Would the quality of advice and the level of seniority then not be available to the normal run-of-the-mill departments who do this sort of work?

(*Sir Andrew Turnbull*) That is why we have set up PUK to make sure it is, but it may not have always been in the past.

158. That is what I wanted to clarify. Is there anything that is comparable to this in the way in which the financing of PFI has been undertaken? I am trying to clarify just how unique this is.

(*Sir Andrew Turnbull*) It was a first. There is one other project currently going down this track, an MoD barracks refurbishment. There have not been all that many projects which it is suitable for. The MoD project was signed slightly before this but the interesting thing about this report is it will change perceptions and what will then be the response to the consultation document.

159. Is this the way things will be in the future?

(*Sir Andrew Turnbull*) I think the Chairman was trying to manoeuvre us into the position of saying this was going to be a minority taste. I do not know I want to accept that it is for just a few projects here

[Mr Davidson Cont]

and there. It could become the norm for large projects which are not too complicated, as discussed somewhere in Chapter 2.

160. On the question of the advisers which cost £2.6 million for the Treasury in all of this, how much cost would it have been had it just been a normal Government procurement? What I was not clear about was whether or not this was an additional cost or the total cost.

(*Sir Andrew Turnbull*) I do not know that figure but I think I would have said we would have spent too little on advisers and probably would not have done it well. That has been the historical experience.

161. That is not quite as precise as I was looking for.

(*Sir Andrew Turnbull*) I have not costed an option we did not follow.

162. No, but I am genuinely unclear as to whether or not you would have normally spent 100,000 or 2.5 million on a normal procurement and therefore how much of a difference there is in all this in terms of the advisers.

(*Sir Andrew Turnbull*) I may be able to find a figure. It certainly would not have been as little as £100,000.

163. It would have been as much as 2.5 million?

(*Sir Andrew Turnbull*) Probably not because the £2.6 million included the—

164. You can understand why I am keen to explore this because much has been made of the advantages of PFI and so on, and 2.6 million for advisers does seem a lot but I am not quite clear what the costs were anyway.

(*Sir Andrew Turnbull*) I am not either. All I know is, this is not very much money compared with the project going 10, 15, 20 per cent over budget.

165. I understand that. Why, in that case, would you not normally spend enough money on these things?

(*Sir Andrew Turnbull*) Because we are also bringing in not just our critical scrutiny of the project but what we have been talking about, the due diligence of the funders, which is also raising the questions.

166. I do understand that, but you said earlier on, when I asked about how much you would spend on that, not enough, and that would seem to display a lack of due diligence simply by yourselves, would it not?

(*Sir Andrew Turnbull*) There is an OGC chart which shows where projects go wrong, and the answer is, they go wrong very early on. The message which is now being given to departments is, whether you are procuring this by PFI or conventional means, invest heavily in getting the project right, specified right, in its early days.

167. I accept and understand that, but I am slightly puzzled by this. One of the great advantages you have been telling us and others have been telling us with PFI is the due diligence and expertise it brings in and so on. Yet, when I was asking about an alternative route, you admitted you would not have spent enough money on it. That seems to be a circular argument and it seems to be a rigging of the ballot in

favour of the PFI route, if by definition you are geared to make mistakes had you done it the other way.

(*Sir Andrew Turnbull*) This is the argument which says that all this risk transfer, contract performance, we could have got anyway without involving the F bit of PFI. The only thing is that the experience is completely against it.

168. Can I clarify the bond issue? Could you explain to me in words of one syllable why, if it is such a great idea for this, it is not a good idea for London Underground?

(*Sir Andrew Turnbull*) That is a process which is going on at the moment. There were originally three projects, now down to two because two merged, and it could well have a very large bond element in it.

169. I do not quite understand the point you have been making in response to some of my colleagues about the question of funding it yourself, providing it by gilts rather than a commercially-obtained bond. It seems to me if you were agreeing you were going to have somebody managing the money as well as managing the project, and they were operating the bond and you gave them the money, not only would you have gained in the interest rates, you would also have a gain presumably on the bond arrangement fee since there would be no risk, and you would also have removed completely the risk of not having raised the money at all, but you could still have the bond financier holding the money as it were and using their expertise to lay off the money they were not using at any particular time. Would that not have been an entirely reasonable way of combining the best of both worlds?

(*Sir Andrew Turnbull*) That is assuming that the public sector could develop as good a credit inspection, as good a due diligence—

170. The private sector could do all that. There comes a point, as I understand it, in bond raising when you actually go out and say to people, "Give us your money", and they come in with bags over their shoulders, put it on the counter and then it goes—

(*Sir Andrew Turnbull*) What does that then do to the performance of the contractor? The contractor has a relationship direct with the market place, and that is incentivising them—

171. No, I would not change that. I would have you as the Treasury representatives on earth taking the money along and giving it to the banks—

(*Sir Andrew Turnbull*) We give the money in your scheme to Ambac and they manage it.

172. Yes. As I understand it, you are not buying from the bond arrangers the money, you are buying the due diligence, the expertise, the ability to make the best use of the money when it is not being used and so on, and you would still access that and have these other gains surely by supplying the money yourselves. If you re-worded the terms so that was available to everybody, so anybody who won a contract would get that, that would presumably overcome the competition rules?

(*Sir Andrew Turnbull*) The money we had lent, if it was properly risk-adjusted, would be lent with a risk premium in it, so the price we would get it for at the end, the £14 million, would still be the same, because

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if we were lending this money to a contractor and not making a proper allowance for risk, we would be taking an unpriced risk.

173. I am not convinced by that but you have managed to baffle me so I will move on to something else. Can I ask you about the competition that took place not producing any benefits in the price of the bond arrangers' fee. Does that not suggest that there is no competition for this sort of work?

(Sir Andrew Turnbull) Actually what it says is that three people came in with the same price. What it does not say is that there were five others who came in with a different price.

174. That is in the report you agreed? Why did you not raise that?

(Sir Andrew Turnbull) What is there is the fact that the three best bidders offered the same fee which suggests there is a standard fee for this work and the competition did not provide any savings in this area. The reader is led to think there were only three bidders and they all bid the same, but actually there were eight of them.

175. This reader certainly thought that. The reader who gave us the question thought that as well. You saw that, why did you not correct that?

(Sir Andrew Turnbull) I confess I did not see that until we were doing the homework for this hearing.

176. I was under the impression that part of the homework was you actually checked the report.

(Sir Andrew Turnbull) We do. This is one of those questions where, if it is true, you do not necessarily change it.

177. If I have not been able to catch you on anything else, I have caught you on that one. Societe Generale was going to be compensated 100,000 if they did not provide part of the financing. Why was that compensation agreed?

(Sir Andrew Turnbull) I think I explained that about an hour and a half ago.

178. Sorry, time flies when you are enjoying yourself.

(Sir Andrew Turnbull) This was an offer to provide this level of financing which they made originally in 1996. We did not know whether the people providing the senior debt would also bid for this mezzanine type debt, so it could have ended up with a situation where we had no competition for the mezzanine debt at all, we only had someone doing the senior debt. What this meant was that we at least had in our back pocket someone who was prepared to offer at the terms originally agreed the funding of this kind of debt, which meant we could wheel it out if we got no other bid from someone for that debt. So that was an option and therefore there was a commercial negotiation about what we should pay for it, and that was the result.

179. That is pretty much similar to the answer you gave us an hour and a half ago. Finally, can I ask what circumstances are there that would make you want not to have a funding competition? To reverse it slightly: if this had been successful, from now on will we always have funding competitions?

(Sir Andrew Turnbull) Going to paragraph 2.7, "Relatively simple projects in mature PFI sectors . . ." are likely to be suitable; 2.8, "More complex

projects . . ." raise doubts, in particular where the allocation of risk, in the sense at the commercial stage when you took it to the funders, the funders might say, "We will lend against if it is constructed in that way but not in precisely the way you have constructed it", so you get an iteration backwards and forwards, and you end up with paragraph 2.25, you have to negotiate a contract that was commercially viable and bankable. In this case we were fairly sure that the project we had got was not going to change in any substantial way and that the lenders would fund it. What is going on in London Underground, which you raised before, is a much more complicated thing. You cannot simply define the engineering characteristics of that and then go and fund it and be sure that the funders will not take the thing back, you have to have iteration, and that is where having a competition where everybody has to put in a certain time is much more difficult to do.

180. I understand it is much more difficult to do but it seems to me that the iterative process is one that has an enormous amount to contribute to the public sector, in the sense you are then able to gain all the benefits of the expertise out there. It is undoubtedly more complex, because the nature of the projects for which it would be unsuitable by definition are the ones potentially where there is the greatest gain from it if it works. Is that not something you would want to gradually move along?

(Sir Andrew Turnbull) If you are saying, in big complex projects you simply allow the funding to take its course and do not take an active interest in it, no, obviously not. We take a very active interest in that kind of funding, but we would not do it on a straight forward competition which assumes that the terms of the competition are known, people enter it and then there is a result, because you get a lot of bids back saying, "I would bid this if it were that and something else if it was something else." You would not be able to have a competition and judge it.

Chairman: There is a division in the House so the sitting is suspended for ten minutes before your final two questioners.

The Committee suspended from 6.01 pm to 6.09 pm for a division in the House

Mr Steinber

181. I am delighted to say that all the questions have been asked because, I have to be quite honest with you, I do not know whether it is a good deal or a bad deal, I could not understand it. I looked at page 16 and paragraph 1.42 and that graph there, and when I got to that I gave up! . . . it is therefore possible to suggest that the Treasury building bond was priced at LIBOR plus 30 basis points", what the hell does that mean? It is double Dutch!

Chairman

182. Sir Andrew, you can answer that question if you want. You have not got to where you are now without being able to answer that!

(Sir Andrew Turnbull) You are looking at Table 6, is that right?

Mr Steinberg

183. It is very clear. "Margin movement (deviation from base case bp) LLCR = 1.270x."

(*Sir Andrew Turnbull*) This relates to Appendix 3, which is effectively the working where the NAO are displaying to you and the market and the technicians their working documents. I have drawn the conclusions from this—but I have not gone absolutely to the depths of it. That is what they used in drawing up this report. I looked at the conclusions they drew, so I share your problem.

184. Somebody said they were a capitalist, I am glad I am a socialist because I could not understand that. It seems to be simpler being a socialist than a capitalist! When I first read the report and listened to the debate and the National Audit Office were saying it was a good deal, I thought it must be, but having listened to you this afternoon I think it is not that good. It is a gimmick. It is nothing but a gimmick we have here. And it is a gimmick at a cost to the taxpayer. The poor old taxpayer. Everybody is making a fortune out of this except the poor old taxpayer. Money is raised, you have 35 years to pay it back, there is no risk to anybody, but at the end of the day it is going to cost a lot more than if it was done in the public sector.

(*Sir Andrew Turnbull*) The report does not say that.

185. You have just said it.

(*Sir Andrew Turnbull*) The report says that the funding competition, which is the comparison between the private version by one method and the private version by another, saved £974,000 on the annual payment or £13 million in net present value terms, so that is the saving achieved through the funding competition process. The net present value compared with the public sector comparator is £20 million less.

186. I went out to make a phone call at one stage so I might have missed this, but what is the total cost of the refurbishment?

(*Sir Andrew Turnbull*) The total cost, that was a figure of £128 million of bond, £6 million of this mezzanine debt and about another £7 million of equity, so £141 million.

187. We are going to pay back £14 million a year, which is index linked, over 35 years. I am not very good at sums but that seems to me to come to something like £490 million over 35 years.

(*Sir Andrew Turnbull*) You are not making a relevant comparison. The relevant comparison is the net present cost of this thing is £169 million, that is when you discount these payments, some of which are going to be made 35 years hence.

188. But the Treasury has borrowed money to give to itself, when it could have borrowed £150 million and done the refurbishment.

(*Sir Andrew Turnbull*) Yes, but we would have gone on paying the interest on that debt for 35 years, that has to come into the calculation.

189. But the interest is not going to be £14 million a year, is it? You were not going to pay back £490 million, were you?

(*Sir Andrew Turnbull*) We believed the cost of the project would have been higher had we done it as a public sector contract.

190. I took a little exception to you when you said that the public sector had failed and the proof of the pudding was in the eating at Marsham Street. That is in the design of the building, that is nothing to do with the financial arrangements. That was some architect who had not been given the correct instructions by Prince Charles and that was the development we got. That is not the fault of the financial deal.

(*Sir Andrew Turnbull*) The whole thing was a disaster in every sense, the design of it, the way the project was managed —

191. But that is nothing to do with PFI.

(*Sir Andrew Turnbull*) PFI is trying to produce a better method of procurement against a background in which the public sector has had a poor record in delivering construction contracts.

192. Is the taxpayer any better off?

(*Sir Andrew Turnbull*) We believe the taxpayer is better off.

193. So you reckon after 35 years the taxpayer will have a better deal than if it was done in the public sector?

(*Sir Andrew Turnbull*) Yes.

194. Well, we will come back in 35 years and find out hopefully. I am not the only one who thinks it was not a good deal. Listening to you there is no risk to anybody, no risk to the Treasury, certainly no risk to those gentlemen sitting there, they will make a nice profit out of it at no risk to them—

(*Sir Andrew Turnbull*) There is a risk —

Mr Steinberg: It was very lucrative for the 19 bidders because having sat here over a number of years on most PFI contracts they have been lucky to get two or three bidders, but here we have 19 who were very keen to get their paws on the deal, were they not? So they must have seen it as very lucrative.

Chairman: A very interesting question but unfortunately there is another division in the House. We will come back as quickly as possible. I apologise, Sir Andrew.

The Committee suspended from 6.16 pm to 6.22 pm for a division in the House

Mr Steinberg

195. As I was saying, everybody seems to be wanting to get their fingers into this very lucrative deal because 19 bidders were very interested. If it was not such a good deal for them, why were they interested in it?

(*Sir Andrew Turnbull*) There was a lot of interest in it, the result of which the unitary payment as a result of this competition reduced by £974,000. That is how we exploited their interest in this deal.

196. One point which springs to mind, and I have just been talking to Mr Bacon on the way back from voting, is this 35 year pay-back period. I do not know whether it is against the law, perhaps it is, I do not know, but presumably the Treasury are the best people in the world to be in a position to pay back

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[Mr Steinberg Cont]

this very quickly. Why does it have to be over 35 years? If you do public sector work, why does it take 35 years to pay it back?

(Sir Andrew Turnbull) Because what we were buying was serviced accommodation, we wanted to know we had a place to live.

197. Why not pay it back more quickly?

(Sir Andrew Turnbull) Why should we pay it back more quickly?

198. Because it costs less.

(Sir Andrew Turnbull) I am not sure it would if you pay it back quickly.

199. If I have a mortgage and take it out over 25 or 30 years and then pay it off in 20 years, I pay a lot less than if I paid it off over 35 years.

(Sir Andrew Turnbull) It depends how you pay it back. Here you have a project—

200. Come on! Come on! Answer the question. “It depends how you pay it back” is not a sensible answer. If I borrow £50,000 over 35 years but then pay it back over 25 years I pay it back for a lot less than if I had taken 35 years.

(Sir Andrew Turnbull) In cash terms, yes, but not—

201. I am talking about cash.

(Sir Andrew Turnbull) We are doing this on a discounted—

202. What we are here for is to see if the taxpayer gets a good deal, and the taxpayer could get a much better deal than I think this has given them. We could save money for the taxpayer. We could save them millions of pounds.

(Sir Andrew Turnbull) I am not going to agree with you.

203. We could not save them money?

(Sir Andrew Turnbull) We have compared a refurbishment which gave us a right of occupation for 35 years—and we assume there will be a Treasury in 35 years—and what that cost us by this route compared to if we had done it as a public sector project.

204. As I say, everybody seems to have a good deal except the taxpayers. Let’s go on to paragraph 1.14, this has been mentioned before, and I picked this out and so has everybody else. Societe Generale was appointed by the partnership to run the funding competition. Mr Stewart used to work for them, did he not?

(Mr Stewart) I did.

205. They got a hell of a good deal as well. They got a £100,000 sum in compensation if somebody got a better deal than them. That is great, is it not?

(Sir Andrew Turnbull) I have explained that twice already.

206. You have but at the end of the day try giving a justification. Justify it, because I do not think you have justified it. Here is a deal where you say, “If somebody can come up with a better deal than that, we will give you £100,000 in compensation.” Did you declare an interest at the time, Mr Stewart?

(Sir Andrew Turnbull) What we got was the assurance that there would be in place at least one mezzanine level debt provider against the possibility that the senior debt providers did not want to provide the mezzanine level debt as well.

207. Nobody is liable here. They are all doing very well. Paragraph 2.29 on page 23, I was surprised when I read this particular paragraph and I will quote it here. It “... should include all forms of financing to ensure that the best type of funding is being considered by contractors and their financiers.” That implies that is not already done and I would have thought it should automatically be done. It does not matter what deal is being done, it should not just be thought about now.

(Sir Andrew Turnbull) I do not think it is doing that. It is a statement of good and best practice. I do not think it is implying it has never been done and people have not cared at all what the funding cost was and how it was—

208. So why does the report say that? Why does the report suggest that it has not been done? I got the impression it would not be said in the report if the—

(Sir Andrew Turnbull) It is suggesting (a) you should do it but (b) with a degree of rigour and how you can do it better. I do not think it is suggesting no one has ever done this in the past.

Mr Steinberg: Okay. Thank you.

Mr Williams

209. Sir Andrew, like Mr Steinberg, I think virtually everything has been covered and I do not want to re-cover the same ground but just a couple of points, jumping around the place. In answer to Mr Davidson you made two points. You said you did not know the cost of a conventional public sector contract for this project and you also said subsequently, and this may have been a statement of conviction, that the public sector if they had taken it on would not have spent enough. Do you remember saying that? That is what you said because I wrote it down at the time. The only question which occurs to me is, and I am sure there is an obvious answer to it, in that case if you do not know the cost of a public sector contract and if you recognise it would not have been enough, how can you say the public sector comparator is £20 million more?

(Sir Andrew Turnbull) There was a calculation by a team which was different from the one working on this project of what the public sector comparator would cost. The reference to not investing enough in terms of examination advice was a remark about public sector construction contracts in general, and that was a finding which has been made in numerous Government reports on public sector construction projects.

210. If your public sector comparator were a genuine comparator, the point you made would not have applied. May I say I found this a very interesting project, I am not knocking the project, I am just interested. We have had problems before in public sector comparators where we have found them as low as £1 million higher, and we have the feeling the books get cooked a bit in the comparator process. I am interested to know how you reconcile the £20

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million plus with the fact you would not have spent as much and you do not know the cost of a public sector contract.

(Sir Andrew Turnbull) I think the way you reconcile the two is that not being rigorous enough in the definition of a project in its early stages is reflected in the historic performance of public sector contracts, and an allowance was made for that in the calculation of the public sector comparator.

211. So what do you do, think what it would have worked out at if it was done in a conventional way and then add an X on top to get the comparator? Where does the comparator come from on the basis of what you said to Mr Davidson?

(Sir Andrew Turnbull) If the thing overran in the private sector version, we would not pay for it. If the standards of the service which are provided during the life time of this contract do not meet the contract, we do not pay for them in the private sector contracts, so we are not at risk of under-performance of delivery. These are important risks which we have transferred off. In order to make the relevant comparison, you have to allow for those in establishing what you think would have happened in the public sector case.

212. In fairness, you did say very early on and repeated subsequently referring to Mr Gershon's organisation's chart that most risks occur when opening the building up, at the early stage of the project in other words. When you arrived at your 189, and you threw out that figure, you said, "That is 189 million allowing for risk." What did you allow for risk?

(Sir Andrew Turnbull) That allows an overrun of about 15 per cent. It also made an allowance of about one point something for latent defects and allowed for the fact that the cost of the services provided would rise by half a per cent more than the rate of inflation.

213. Mr Stewart, you assessed risk at the same time. In their allowance for risk in their comparator they arrived at £189 million, how did your assessment for risk differ from their assessment for risk and why?

(Mr Stewart) I do not work for Exchequer Partnership.

214. I do not mind who answers it. My apologies if I went to the wrong person.

(Mr Lewis) When we analysed the project and looked at the work which would be required to satisfy the requirements of the project, certain risks had to be taken on. We had to assess commercially how we approached those risks, how we might dispel them during the course of the job, and how to price them, bearing in mind we were in a competitive position and had to make sure it was the right price for the job.

215. But if they were right and you were wrong, you would have been £20 million out and you would not be here now as a witness, putting it bluntly. Why were you able to get it so right and why did they get it so wrong in assessing the risk?

(Mr Lewis) I am not suggesting Sir Andrew's team got it wrong.

216. They got it different?

(Mr Lewis) I am not suggesting we got it right yet either. We have several months to go before the construction element of the job is completed, so we are not yet sure but we had to make certain assessments. Bearing in mind the private sector expertise and the advisers we had on our side and in our consultancy team, we believe we assessed those risks properly and priced them properly.

217. You, I assume, would have to get external expertise to advise you on the early stage risk, why did you go where you got the risk and why did you not go where they went to get the risk?

(Sir Andrew Turnbull) I am not sure I understand. They are making an assessment of the risks they face and we are making an assessment of the risks we think we would have assumed compared with giving the job to them. We were not making an assessment of their risks; that was for them and then the people backing them financially.

218. You did make the point when you were refuting the odd balance sheet argument that the main reason for PFI, which we understand—we hear it constantly, it just never arises in performance up until now—is to transfer risk. We have had a whole series of glowing examples like the passport computer, the immigration computer and various other things where the risk was passed but the public still ended up paying when things went wrong. How sure are you that you have transferred the risk?

(Sir Andrew Turnbull) In this case I am quite confident we have transferred risk.

219. Tell us why.

(Sir Andrew Turnbull) Where people have reopened the thing and come back, first of all, they have only done so after they and their equity have probably been used up and possibly some of their banking borrowings have been forfeited, so there has been some loss, but when it gets too great they say, "Sorry, we would rather hand you the keys back than continue with this project" and we have renegotiated it. That has happened in a number of IT projects and you have examined a number of those. This is a building refurbishment. Now there are risks in that but we are past the point where if something was going to go wrong it would have gone wrong, but there are still nevertheless some risks left although I would be very surprised if it turns out they were such that the contractors came along to us and say, "We would rather forfeit all these payments than carry on with it."

220. One of the reasons refinancing has been successful is for this same reason, that in building a prison or a hospital the risk is in the early period and therefore you borrow at higher rates and short, and then you refinance at lower rates once you have got on to a steady income stream minus the problem.

(Sir Andrew Turnbull) Yes.

221. But that still has not solved the problem as far as the customer, the public, is concerned. Let us say 25 years down the line, just so you can tell me how it is covered—what I am getting at is how strong is your contract and is there a system of penalties and so on—something happened and half the building had to be closed down for six months. What is the public protection?

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[Mr Williams Cont]

(Sir Andrew Turnbull) We would not pay the rent.

222. That is not much good, you have not got anywhere to live, have you? That is not much of a protection. There should be a penalty. This is what happened with the Passport Agency. What happened there was that they thought they had the risk covered, and this came out clearly in the hearing, but in fact all they had covered was the extra cost to the Government of taking on the staff, there was no penalty for the inconvenience or loss to the public, so when there was a loss of 12.5 million the contract was not even strong enough to stand up to that in court, and it ended up with the Government paying £10 million of it and the financier only paying £2.5 million, and he only agreed that two weeks before he came here because he did not want to come here saying he had not paid anything. How are you covered? I am not talking about not paying rent, what protection have we got for things which go wrong which make a significant difference?

(Sir Andrew Turnbull) It depends how seriously they go wrong. If there is a requirement to maintain the temperature to at least 22° and over a period they fail to do that, there is a schedule which says what is knocked off if various standards like that are not met. You are saying, what happens if the thing becomes uninhabitable. I think the answer is that we can terminate this contract meaning that the future payments we would have made we do not make.

223. But then you have an unusable building for a while.

(Sir Andrew Turnbull) Yes, but we also have all that future rent which we are not going to pay.

224. But there is no penalty clause as such?

(Sir Andrew Turnbull) It is a pretty severe penalty to them if they have invested in it. They still have the bonds to service. If we say after 25 years, "Sorry, this is so unsatisfactory, we are terminating this", that is a pretty severe penalty.

225. Our problem has been that we have run up against several risk problems where the public has lost out, and it is where we are most concerned—and I think you can pick up the pattern of the questioning—whether risk transference has been as real as you genuinely, obviously, feel it is. This is a new system, who came up with the idea? Whose idea was it? Was it yours?

(Sir Andrew Turnbull) To separate out the funding element?

226. Yes.

(Sir Andrew Turnbull) That was developed in the Treasury Taskforce which was set up after May 1997. Adrian Montagu was the guy leading that and Dougie Sutherland. This was a set of ideas they worked on.

227. It is very ingenious, I am impressed by it as a concept, but I do not impress my colleagues by saying that. Can I then take up one final question and go back to Mr Stewart. I see from your CV that your responsibilities include the origination and execution of PPP transactions in Europe and the rest of Europe. Are the rest of Europe ahead of us in any way in the development of this kind of contract and, if so, in what way?

(Mr Stewart) There is not a simple answer to that. The rest of the world and Europe are catching on to this concept. Some countries are further ahead than others. Probably the furthest advanced in Europe are the Dutch and the Irish, who have established a taskforce like the Treasury Taskforce as a centre of excellence and they are pursuing projects. One of the key differences between the European market and the UK market is that the European markets tend to be much smaller so that those countries are focusing on a smaller number of projects which, if you go back, is probably the case in the UK.

228. Are there any notable lessons we could learn on project development and safeguards and so on?

(Mr Stewart) They certainly come and talk to a lot of people in the UK to learn lessons from here and I think there are lessons for the UK to learn from them. So there is a constant dialogue going on.

229. Which country would you go to if you wanted to learn from them?

(Mr Stewart) I would talk to the Irish, who I think have some interesting ideas. They, for instance, have made great efforts to involve all the stakeholders—unions and so on—in the process from day one. The jury is still out on whether it is going to work. I would also talk to the Australians, right on the other side of the world, who have extensive experience of these projects and a slightly different approach.

Mr Williams: I think the Public Accounts Committee had better reconsider its decision not to go to Australia, in that case. Thank you very much.

Mr Bacon

230. May I first, Sir Andrew, ask you a question on behalf of Mr Gardiner who had to leave and it is concerning bank versus bond finance. He asks, "James Stewart just agreed that because the term was 37 years it was longer than the banks' longest lending period and therefore the banks could not compete." He goes on to say, "Earlier you had said there was no factor which precluded the bank from bidding successfully, in particular you said you had not set out it must be done by bond finance, yet in fact the time period meant it had to be done by bond finance, so effectively the banks were excluded."

(Sir Andrew Turnbull) The banks did not take that view, otherwise why did they bid. They thought, despite this natural disadvantage, nevertheless they could come up with something competitive.

231. That was Mr Gardiner's question, perhaps I can now come on to my own. I would like to return to the question of the cost of running the Treasury building. You said they would do the maintenance, the running costs of the building, for £9 million a year, and then I think you sought to correct yourself. First, I would like to take up something you mentioned earlier in answer to another question about serviced accommodation. You said you are buying serviced accommodation which is why you are paying a different rate. Would I be right in thinking that the services you are buying are including things like cleaning, window cleaning, maintenance, security, that sort of thing?

(Sir Andrew Turnbull) All those things.

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232. So would it be a correct analogy then if I borrowed the money to buy a house on a mortgage and Barrett said to me, "Not only will you get this house for the money you are giving us but you will get a cleaning lady once a week", essentially that is a correct analogy is it not? I would not be paying any extra on top of my mortgage payments, I would be getting the cleaning lady, it says in the Barrett contract, included—

(Sir Andrew Turnbull) I would not expect it to be for exactly the same price.

233. I am not suggesting for one moment it would be, but I am asking is the analogy correct.

(Sir Andrew Turnbull) The analogy is correct up to a point.

234. So if you say you are buying serviced accommodation, you are paying interest payments on the serviced accommodation. It is equivalent to my borrowing the money over 25 years, or in your case 35 years, to pay my cleaning lady, is it not?

(Sir Andrew Turnbull) No, we are not borrowing the money, they are borrowing the money and then charging us, to pay for the capital cost. They are also having a current cost—and I think the figure given was split between £10.6 million as the capital cost and £3.4 million as the services.

(Mr Gershon) Can I just add that it is not directly equivalent because when you buy the house from Barrett, first, you only get a warranty against defects for ten years, not for the whole life you are going to live in the house, you get no warranty from Barrett about keeping up the quality of the interior decoration, the quality of maintaining the external fabric. It is different.

235. Yes, I see that. Nonetheless, you are paying interest payments on it effectively over a 35 year period?

(Sir Andrew Turnbull) No, I do not think we are. We are paying interest on the money they have had to borrow up-front to do the work. The £14 million covers the £3.4 million for services, leaving £10.6 million to pay back the capital. I do not think we are paying interest—

236. The point I was trying to get to earlier was this, if I have a rubbishy building and it is costing me, as you said, £9 million a year to keep it going, plainly one of the reasons it is costing so much money is because it is falling down, I have to spend a lot on maintenance and so on, and you yourself said you would have had to spend £50 or £60 million quite shortly. I would expect, if I spent a sum of money on doing a building up, that my annual running costs would go down, not up, because I am then in a position where I have a brand new, spanking new building which actually does not fall down. In fact, if it had been cleverly designed like some modern buildings are, the body heat of the people inside means the net energy cost of running the building is zero.

(Sir Andrew Turnbull) This would be a BREEAM, a 'very good' rating at least,⁵ so it is designed to be an efficient, low cost building.

237. Can you go back to this question of £9 million, what actually is the running cost per year of the Treasury building?

(Sir Andrew Turnbull) That was the figure I said I did not know and I would provide. The £9 million is equivalent to the £14, not to the £3.4.

238. The point I am trying to get to is this, Chairman. If you are spreading the cost of this over 35 years, including the capital cost—I take it the £14 million is index linked so it is actually going to be more than £14 million when it comes down to it. That is right, is it not?

(Sir Andrew Turnbull) Yes.

239. My concern is, at the end of the day you are going to pay a lot more than if you had just gone to a contractor and said, "Do this building up for us and then we will have a series of annual maintenance running cost payments which will be lower because we have a brand new building which is not falling down."

(Sir Andrew Turnbull) The two things are not comparable. We would have had the risk of maintaining those standards ourselves. What we have done is we have a pre-commitment to maintain those standards, that is written down in the contract, for 35 years. We have no guarantee, as I said to some hilarity, that we would actually get the money to do the maintenance. This time we are sure we have.

Jon Trickett

240. I do not feel satisfied we have got to the bottom of all this but I want to come to the indexation of this £14-odd million. Earlier you said it was RPI, is that right?

(Sir Andrew Turnbull) Yes.

241. It is just that costs vary around RPI, do they not? For instance, building costs do not increase at the same rate as retail prices, nor do wages costs and nor do interest costs either, and they seem to be the three elements. There are building costs, labour costs of the people maintaining the building, and interest rates.

(Sir Andrew Turnbull) Yes.

242. Why did we settle on RPI rather than some other complex index?

(Sir Andrew Turnbull) That was a product of the negotiation. I think we said RPI minus X, and it turned out X was nought. In the negotiation we could have ended up negotiating a different figure but that was the figure.

243. Some of this RPI index goes to the funding institutions and some of it goes to Exchequer. It seems to me the increasing cost year on year falling upon the contractor and then the people providing the money will shift, will it not? It will never be, unless there is a coincidence, RPI, it will vary around RPI, sometimes higher, sometimes lower, according to interest rates, labour costs and other building costs.

(Sir Andrew Turnbull) Yes.

244. Is there any claw-back? Have you negotiated a claw-back supposing there is movement favourable towards the contractor, leading to, not a super profit exactly, but you could envisage large amounts of money coming back to the contractor if

⁵ Note by witness: It has now been assessed with an "Excellent" rating.

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[Jon Trickett Cont]

for several years the index of RPI is substantially less than the additional cost which the contractor is facing?

(*Sir Andrew Turnbull*) The cost of their capital is also indexed to RPI. You are then assuming that there is some major break in the historical relationship between all the other costs, and that we would then say, "The wages, the services you buy, the suppliers you need, electricity, would be substantially different from the RPI." Given there is quite a wide basket of goods going in to service the building, we would not expect it to diverge very much.

245. I am not sure that is an accurate assumption. I was in the building trade and I used to price jobs and I know that building prices are calculated by different indices, and I also know that wage inflation is different from retail goods inflation. I wondered whether that calculation had ever been done.

(*Sir Andrew Turnbull*) We have kind of fixed this price. You can always say, "I would have done better if I had picked and chosen and then renegotiated after 5 or 2 years", but if it turns out these costs went up faster than RPI then you lose out. We have the benefit of fixing those costs so we, as the Treasury, know that is a major element of risk in our forward budgeting which we have eliminated.

Mr Gibb

246. Of the 9 million, presumably an element of that is rental for the property. Will an element of that continue to be paid in addition to the 14 million in the future? If so, how much?

(*Sir Andrew Turnbull*) It may include these things called CILOR contribution including rent, but I would have to look at that.

247. Can that be in your note?

(*Sir Andrew Turnbull*) The note will be what is in the £9 million and what is maybe in the £9 million which would nevertheless still continue, because it is probably a cost we bear and continue to bear—

248. For the freehold bit of the building which is already there?

(*Sir Andrew Turnbull*) Yes, there may be things which we are paying now which we will continue to pay. We will look at that.

Chairman: May I thank you, Sir Andrew, and your colleagues for spending the best part of three hours with us. I think this is an important issue. Although we are only talking about one building it has major implications for future PFI projects. As Barry Gardiner says, may I congratulate you on the first line of the contents, which says, "The Treasury competition was a success." Thank you very much.

APPENDIX 1

Supplementary memorandum submitted by HM Treasury in response to additional questions from the Committee

Q1: *Assuming no inflation, what would be the total amount of cash paid by the Treasury to Exchequer Partnership over the lifetime of the Treasury Building PFI deal?*

The Unitary Payment (UP) is set at £14.037 million per annum in March 1999 prices, to be indexed annually by the RPI. Assuming no inflation, therefore, the Treasury would pay £491.3 million over the 35 year contract term.

Q2: *What assumptions have been made about inflation in the Treasury Building PFI deal?*

The Base case assumption was a constant 2.5 per cent annual increase in the RPI All Items index.

Q3: *Using these inflation assumptions, what would be the total amount of cash paid by the Treasury to Exchequer Partnership over the lifetime of the Treasury Building PFI deal?*

£838.154 million. This equates to £169.3 million in Net Present Cost terms, discounted at 6 per cent in real terms and assuming 2.5 per cent inflation.

Q4: *What would be the total amount of case paid by the Treasury to Exchequer Partnership over the lifetime of the Treasury Building PFI deal, assuming a constant inflation rate of: (i) 2 per cent, (ii) 2.25 per cent, (iii) 2.5 per cent, (iv) 2.75 per cent, (v) 3 per cent, (vi) 4 per cent, (vii) 5 per cent?*

These calculations have no bearing on the value for money assessment since the project appraisal is conducted in real terms and the real terms value of each calculation is the same as that given in the answer to Q3.

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[Continued

Q5: Prior to the PFI deal, how much has the Treasury paid in annual rent (notionally or otherwise) for the Treasury Building?

See answer to Q7 below.

Q6: When the PFI deal ends, how much at current prices will the Treasury have to pay in annual rent?

At the end of the PFI deal in 2037 ownership of the building reverts to the Treasury. We then have a choice whether to negotiate a new deal with Exchequer Partnership, or another supplier, or to take responsibility for running the building ourselves once again.

Q7: What were the total annual operating costs for the Treasury Building in each of the four years prior to the PFI deal?

The Treasury Building is a Crown freehold so has not been subject to conventional rents. For the four years prior to the PFI deal a capital charge (an intra-Government transfer payment) has been payable on the Treasury Building. The Treasury has another building—Allington Towers (AT) in Victoria Street—which is a leasehold building so subject to rental payments to a landlord. The intention is to surrender the Allington Towers lease when the staff there have moved into the refurbished Treasury Building this summer. While the refurbishment of the west end of the Treasury Building is going ahead, some two thirds of our staff remain in the east end of the building while the remaining third are housed at Allington Towers. The total costs of running the two buildings are set out in the table below.

	1996–97 £m	1997–98 £m	1998–99 £m	1999–00 £m
Items including in Unitary Payment:				
(i) Rent/Capital Charge	4.71	4.91	4.69	6.66
(ii) Cleaning/Security/maintenance	2.1	3.03	2.62	2.21
Items not included in the Unitary Payment:				
Rates, Utilities' costs, copying, furniture and fittings	3.114	2.861	2.897	2.985

Q8: What are the total refurbishment costs of the Treasury Building? (please provide a breakdown and a total)

As at financial close (5 May 2000), the total projected costs to the start of operations were:

<i>Funding Requirement</i>	<i>Total</i> £m	<i>Total</i> %
Net VAT paid/received	0.115	0.1
Construction cost	118.659	84.2
Pre-operating costs	7.578	5.4
Senior debt service reserve	4.392	3.1
Change in law reserve	2.419	1.7
Cash	0.608	0.4
Interest and fees:		
Mezzanine Debt	0.800	0.6
Bond (net of interest received)	6.394	4.5
Total	140.965	100

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[Continued

Q9: What are the total operating costs for the refurbished Treasury Building? (please provide a breakdown and a total)

The annual service costs payable to EP form part of the single Unitary Payment payable by HMT. These costs are expressed in March 1999 prices and are subject to indexation:

	£'000s	
Hard Services	1,504	
Soft Services	1,930	
Total Services		3,434
Capital Charges		10,603
Total Unitary Payment		14,037

Q10: What was the total capital sum involved in the Treasury Building PFI deal? (Please provide a breakdown into equity and the different layers of debt)

Sources of Funding	Total £m	Total %
Ordinary Shares	0.500	0.4
Shareholder Loan stock	6.425	4.5
Mezzanine Debt	6.250	4.4
Bond	127.790	90.7
Total	140.965	100

The equity comprises the ordinary shares and the shareholder loan stock, a total of £6.925 million, of 4.9 per cent of the total funding.

Q11: What were the gross proceeds from the Exchequer Partnership bond issue?

£127.790 million.

Q12: What were the net proceeds from the Exchequer Partnership bond issue?

£123.639 million.

Q13: What were the total fees paid to banks and to professional advisers in relation to the Treasury Building PFI deal? (please provide a breakdown showing each amount and the payers (ie HM Treasury, Exchequer Partnership etc) and the payees—and also an overall total)

(i) Fees paid by EP up to and including financial close (May 2000), as shown in the financial model, were:

		£m
SG	Financial advice to EP	1.250
SG	Mezzanine underwriting	0.100
Chesterton	Property/letting advice to EP	0.900
PwC	Tax and accounting advice to EP	0.100
Ashurst Morris Crisp	Legal Advice to EP	0.800
C E Heath	Insurance advice to EP	0.060
Marsh Bankrisk	Insurance due diligence for funders	0.030
Faithfull & Gould	Technical due diligence for funders	0.150
Allen & Overy	Legal due diligence for funders	0.532
PKF	Model Audit	0.070
Rating Agencies	Bond rating costs	0.200
UBS Warburg	Bond arrangement fee	0.799
Ambac	Initial credit enhancement premium	1.845
Ambac	Mezzanine arrangement fee	0.132
		6.968

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[Continued

(ii) Fees paid by HMT up to and including financial close were:

		£m
GTMS	Project Management and technical advice	0.462
Berwin Leighton	Legal Advice	1.355
Dresdner Kleinwort Benson	Financial Advice	0.645
Cecil Denny Highton	Advice on Accommodation requirements	0.101
CB Hillier Parker	Specialist property-related advice	0.013
Roger Preston & Partners	Mechanical and Electrical Engineering Advice	0.043
Willis Corroon	Insurance Advice	0.006
PricewaterhouseCoopers	Accountancy Advice	0.012
		2.637

Q14: *Under the terms of the Treasury Building PFI deal who owns the freehold Treasury Building?*

The Building remains a Crown freehold throughout the term of the deal. Exchequer Partnership plc will be granted a headlease for the whole site on completion of the refurbishment of the Treasury accommodation at the west end in the summer. They will then grant the Treasury a sub-lease for our accommodation for the 35 year operating period. Once the eastern end is refurbished, Exchequer Partnership will grant similar sub-leases to the tenants there.

Q15: *Other things equal, what would have been the total net present cost of the annual unitary payments by the Treasury to Exchequer Partnership over the lifetime of the Treasury Building PFI deal if the discount rate had been: (i) 3.75 per cent, (ii) 4 per cent, (iii) 4.25 per cent, (iv) 4.50 per cent, (v) 4.75 per cent, (vi) 5 per cent?*

Under current Treasury guidance to Departments on the carrying out of investment appraisals (the "Green Book") the discount rate to be used is 6 per cent in real terms. Were the guidance to be changed in the future, other parts of the methodology might also vary. So simply changing one variable, in this case the discount rate, is not valid.

Q16: *Other things equal, what would have been the total amount of cash paid by the Treasury to Exchequer Partnership over the lifetime of the Treasury Building PFI deal if the discount rate had been: (i) 3.50 per cent, (ii) 3.75 per cent, (iii) 4 per cent, (iv) 4.25 per cent, (v) 4.50 per cent, (vi) 4.75 per cent, (vii) 5 per cent?*

See answer to Q15 above.

Q17: *At the time of issuing the bond, what would have been the total extra cash paid by the Treasury to Exchequer Partnership over the lifetime of the Treasury Building PFI deal for every change of 0.1 per cent in the bond spread?*

The total additional payment over the lifetime of the project would have been £6.568 million per 0.1 per cent increase in the bond spread. The NPC impact of 0.1 per cent increase is £1.329 million (discounted at 6 per cent real), and the annual increase in the Unitary Payment would have been £110,000 as at 31 March 1999.

Q18: *By how much would the bond spread have had to widen before the project had become unviable?*

The contract with EP provided for a cap of £14.2 million on the Unitary Payment (ie 13.981 at the time the contract was signed in August 1999) if funding was subsequently secured through the bond route. If the cap had been exceeded, then it would have been for the Treasury to decide whether a new, higher figure would still have provided good VFM.

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