

House of Commons  
Committee of Public Accounts

**MANAGING THE  
RELATIONSHIP TO  
SECURE A SUCCESSFUL  
PARTNERSHIP IN PFI  
PROJECTS**

Forty-second Report of Session  
2001–02

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Forty-second Report of Session  
2001–02

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

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*Ordered by The House of Commons to be printed Monday 24 June*

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HC 460  
Published on 11 July 2002 by authority of the House of Commons  
London : The Stationery Office Limited  
£10.00

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### Footnotes

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# FORTY-SECOND REPORT

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

## **MANAGING THE RELATIONSHIP TO SECURE A SUCCESSFUL PARTNERSHIP IN PFI PROJECTS**

### INTRODUCTION AND LIST OF CONCLUSIONS AND RECOMMENDATIONS

1. The Private Finance Initiative (PFI) is now established as a major form of Government procurement. There are over 400 PFI contracts currently in force committing departments to future expenditure of around £100 billion.<sup>1</sup>

2. These contracts are generally long term arrangements involving public expenditure over extended periods, often for 30 years or more. To achieve value for money over the life of these contracts, the public sector clients (often referred to in this context as “authorities”) will need to have a strong contractual framework allied with good relationship skills which will help them to approach projects in a spirit of partnership with their private sector partners.

3. On the basis of a Report by the Comptroller and Auditor General<sup>2</sup> the Committee took evidence from the Office of Government Commerce (OGC) and the Major Contractors Group. The Comptroller and Auditor General’s Report is based on a survey by the National Audit Office (NAO) of 121 PFI projects where contracts had been let prior to 2000. The survey results include perceptions of authorities and contractors about the early experience of how the contracts they have entered into are working out. We examined the evaluation of PFI projects in progress, how value for money can be maintained in the long term and the skills and guidance that are needed by the public sector to manage these contracts successfully.

4. This Report focuses on the early experience of PFI contracts. It is, therefore, a transitional report highlighting issues which will be important to the successful future management of these long term contracts.

5. Our key conclusions are:

- **Better evaluation is needed of PFI projects in progress.** There are 400 PFI contracts now in progress with many more contracts being negotiated. Departments need to analyse rigorously whether their PFI projects are delivering the quality of customer service and value for money expected when the contracts were let. The results of these evaluations should also be monitored by the OGC to enable it to refine the government’s approach to the development of future PFI projects.
- **Value for money needs to be maintained over the life of these long term contracts.** We are very concerned that over one in five authorities consider that value for money from their PFI contracts has diminished, with high prices for additional services an area of concern. As many as 23 per cent of authorities surveyed considered that there had been a decline in value for money in PFI projects after contract letting. It is essential that PFI contracts have appropriate mechanisms in place to ensure that value for money is maintained over the lifetime of a project. Yet only around half of the contracts surveyed had such mechanisms

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<sup>1</sup> These include all central government PFI contracts and those let by local authorities where there has been financial support from central government.

<sup>2</sup> C&AG’s Report, *Managing the relationship to secure a successful partnership in PFI projects* (HC 375, Session 2001-02)

in place. In future all contracts should have appropriate mechanisms, such as benchmarking, market testing, and open book accounting.

- **Contractors should expect to lose their investment in PFI projects when things go wrong and to be rewarded reasonably when things go well.** If contractors successfully manage the risks that have been allocated to them and deliver the required services then they will expect to earn rewards commensurate with the level of risk they have borne. But if they fail to manage the risks they have taken on then they should expect that part or all of their equity investment in the project may be lost. It will undermine an essential commercial discipline if contractors generally are given the impression that the Government will always bail them out, as has occurred in some individual cases, such as the Royal Armouries Museum or the Channel Tunnel Rail Link.
- **Staff responsible for managing PFI projects must be equipped with the appropriate skills.** Over £100 billion of public funds is committed to PFI projects, yet the OGC recognises that there are still gaps in the guidance and training on how to manage PFI projects, as distinct from how to negotiate them at the outset.

6. Our detailed conclusions and recommendations are as follows:

*On the evaluation of PFI projects in progress*

- (i) Post-implementation reviews are particularly important for projects where perceived value for money has declined since contract letting. Departments need to identify whether such a decline reflects errors of judgement by the authority when letting the contract, the contractor failing to deliver the service as promised, short term problems during the early period of the service delivery, or other factors such as high charges for additional services.
- (ii) There is very little information available on the returns which private sector contractors earn on PFI projects. It is impossible to tell whether these are reasonable in relation to the quality of the service delivery and the risks which the contractors bear. The OGC should complete its current review of contractors' returns as a matter of priority.

*On maintaining value for money in the long term*

- (iii) **As many as 23 per cent of authorities surveyed considered that there had been a decline in value for money in PFI projects after contract letting.** Yet only around half of the contracts surveyed had mechanisms for ensuring continued value for money over the lifetime of the project such as benchmarking and open book accounting. All contracts should have appropriate mechanisms in future.
- (iv) The survey showed a very low proportion of authorities, just 15 per cent of those surveyed, with arrangements to share in refinancing gains. Refinancing can give rise to excessive returns to the private sector from PFI deals, beyond even the private sector's reasonable expectations. The OGC should introduce its new guidance on refinancing as quickly as possible to ensure that authorities have contractual rights to share in refinancing gains.
- (v) PFI contracts often contain specific procedures for the parties to vary the deal, and 55 per cent of authorities with such change procedures had already used them in the early years of their PFI contracts. Long term contracts must provide room for flexibility in the face of changing circumstances. But concern has arisen over high charges for additional services, suggesting that authorities need to watch that

change procedures are not abused as a covert means for increasing the profit margins of the contractors.

- (vi) The fact that 58 per cent of authorities with a performance review process had made performance deductions from payments due to PFI contractors suggests many authorities are not getting the service they require. If bids are priced on the assumption that actual performance will fall short of the required level, then contractors may not have a strong incentive to perform well. It is up to departments to ensure that their PFI contracts do not accommodate persistent under-performance.
- (vii) The transfer of risk inherent in a PFI deal cannot protect the authority from the risk that the private sector simply fails to deliver what may be a key public service. It is essential that the authority actively manages this ultimately untransferable business risk.
- (viii) The essence of PFI deals is that the private sector contractor should take appropriate risks in return for appropriate rewards (such as the risk on volume of users in return for a share of user revenue). It is not for the public sector authority to insulate the contractor from the consequences of the risks it has been paid to take on. The public sector should certainly not reward private sector failure by agreeing to reduce the risk of the contractors losing their equity investment when the private sector has not delivered, as occurred in the case of the Royal Armouries and the Channel Tunnel Rail Link.<sup>3</sup>

#### *On skills and guidance*

- (ix) Some authorities provide little or no training on contract management and there appear to be significant shortcomings in authorities' current approach to managing PFI contracts. The OGC should introduce further guidance and training on the key principles of good contract management, on evaluating the value for money of PFI projects in progress, and on mechanisms for maintaining value for money. Drawing on illustrations from successful PFI projects, the OGC could show how to combine insistence by the authority on getting what it paid for with a partnership-based approach throughout a long-term deal.
- (x) Familiarity with the project and how the contract is intended to operate are essential requirements for any staff engaged in managing PFI contracts. Staff continuity between the procurement and the subsequent management of the contract is desirable. Where this is not possible, there should be a gradual hand-over between the staff who negotiated the deal and those who will be responsible for post-contract management to ensure that there is continuity in the authority's knowledge and understanding of the project.
- (xi) Public sector officials involved in developing and managing PFI projects need commercial awareness, and the Civil Service has taken steps to recruit staff from the private sector. Departments should consider whether such staff would benefit from training in the proper conduct of public business.

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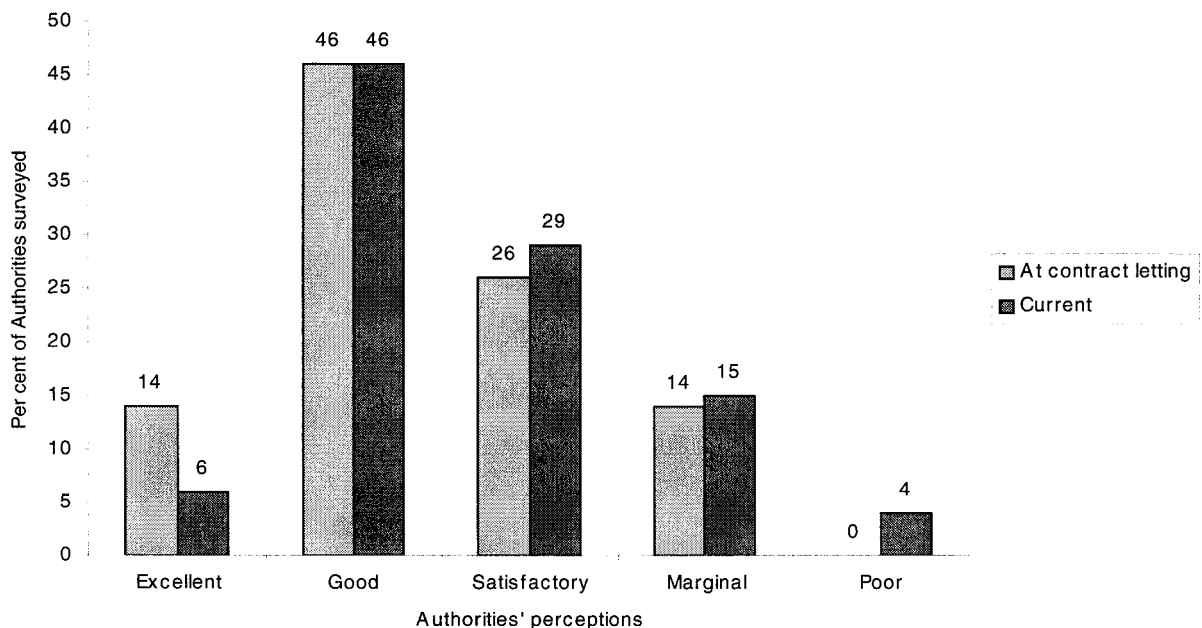
<sup>3</sup> C&AG's Reports: *The Renegotiation of the PFI-type Deal for the Royal Armouries Museum in Leeds* (HC 103, Session 2000-01); *The Channel Tunnel Rail Link* (HC 302, Session 2000-01)

## EVALUATION OF PFI PROJECTS IN PROGRESS

*Perceived value for money*

7. Responses to the NAO's survey of 121 PFI projects where contracts had been let prior to 2000 showed that 81 per cent of authorities said that the value for money of their PFI projects was currently satisfactory or better. But 15 per cent said value for money was marginal and 4 per cent said it was poor (Figure 1).<sup>4</sup> And 23 per cent of authorities who gave a perception of value for money considered that it was not as good as at contract letting.<sup>5</sup> We noted that the positive perceptions given by many authorities were based on a subjective impressions of what was happening on their PFI projects. Having entered into the contracts authorities were not likely to admit that they had got it wrong.<sup>6</sup>

**Figure 1: Authorities' perceptions of their projects' value for money**



*Based on 98 authorities who gave their perception of value for money at the time the contract was let, as well as at the time the survey was completed.*

*Source: NAO survey<sup>7</sup>*

8. The OGC attributed the fact that the majority of projects were perceived as delivering at least satisfactory value for money to competent staff applying good practice and guidance. In these projects the management of value for money was a priority, there was focus on outputs and service levels, and specialist experts such as the former Treasury Taskforce and Partnerships UK helped to keep the projects on track. However, there was no room for complacency in the level of achievement to date.<sup>8</sup> Once any project, whether PFI or non-PFI, became operational the client's perception of value for money might well

<sup>4</sup> C&AG's Report, para 7 and Figure 1, p2

<sup>5</sup> *ibid*, para 3.39

<sup>6</sup> Qs 14–15, 35, 56–62

<sup>7</sup> C&AG's Report, Figure 1, p2

<sup>8</sup> Q1

change as factors in the original evaluation related to the construction phase of the project ceased to be relevant, and other aspects of quality assumed greater importance. The client's view of the relative importance of monetary and non-monetary considerations could also change over the life of the project.<sup>9</sup>

#### *Monitoring of value for money*

9. There are 400 PFI contracts currently in force committing departments to future expenditure of around £100 billion.<sup>10</sup> But we have seen no rigorous assessment of value for money on PFI contracts in force, or empirical evidence as to whether they are good value for money or not. Every pre-contract appraisal of any substance should indicate how the proposals concerned will be evaluated after completion and how the results of the evaluation will be disseminated.<sup>11</sup> While overall responsibility for looking at individual projects rested with the relevant departmental accounting officers, OGC was obtaining feedback from a number of sources: the post-contract stage of its Gateway Review process, Partnerships UK, reports from the National Audit Office and other parties on individual projects and the OGC's networking with departmental private finance units.<sup>12</sup>

#### *Reductions in perceived value for money*

10. The 23 per cent of authorities surveyed by the NAO which considered that value for money was not as good as at contract letting gave a variety of reasons including high charges for additional services, user dissatisfaction and expected benefits not being realised.<sup>13</sup> The OGC said that in some cases a common understanding of what was really required and what each party had to deliver only became apparent after the award of the contract. In some cases the authority might have made a mistake and had selected the wrong partner. Projects such as the Armed Forces Pay and Administration Agency PFI project and RAF Mail had experienced initial difficulties, but had subsequently improved as a result of redefining the relationship between the authority and the contractor.<sup>14</sup>

#### *Contractors' rates of return*

11. The private sector participants in a PFI project may earn returns from providing services as contractors to the project or on their investment in the project. The OGC is reviewing value for money and the levels of return the private sector gets on its investments in PFI projects to ascertain whether it is commensurate with the risks in undertaking government contracts.<sup>15</sup> There is a risk that if a contractor builds high rates of return into the contract, it will be more expensive than if undertaken in the public sector. If its study shows that contractors' rates of return are excessive, the OGC will wish to look at the steps needed to introduce more competition into the market place. High contractors' returns might also reflect other factors such as the private sector putting a very high premium on certain risks which had been transferred by authorities. If this was the case, the authorities would be advised to bring such risks back into the public sector.<sup>16</sup>

12. The OGC did not know what level of returns would be highlighted by its current study but believed that shareholders' returns of 8 to 15 per cent in real terms would be reasonable.<sup>17</sup> Our Report on the refinancing of the Fazakerley PFI prison showed that the contractor had made significant extra profit as a result of refinancing, increasing the

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<sup>9</sup> Ev 22

<sup>10</sup> C&AG's Report, para 1

<sup>11</sup> *Appraisal and Evaluation in Central Government* ("The Green Book") HM Treasury, para 1.13

<sup>12</sup> Qs 2, 14

<sup>13</sup> C&AG's Report, para 3.39

<sup>14</sup> Qs 28–34

<sup>15</sup> C&AG's Report, para 1.18

<sup>16</sup> Qs 75–81, 86–87

<sup>17</sup> Qs 178–185

shareholder returns to 39 per cent.<sup>18</sup> The OGC said this was an early prison where there had been significant risk for the private sector, since in public sector procurement in areas like prisons there had been significant cost and time overruns. It would expect the private sector to make higher returns on successful early contracts. As the PFI market matured and the risks became better understood by the private sector, their rates of return might be expected to diminish towards the average returns earned in other market sectors. The OGC review was assessing whether returns were in fact declining. Even on early PFI contracts some private sector organisations had lost large amounts of money.<sup>19</sup> The Chairman of the Major Contractors Group told us that in his company, Kier Group, returns on PFI contracts were about 2.5 per cent of turnover compared with one per cent on other contracts. However, the risks were significantly greater in PFI projects and there were high bidding costs.<sup>20</sup>

## MAINTAINING VALUE FOR MONEY IN THE LONG TERM

### *Value for money mechanisms*

13. Although well run competitions will produce competitive initial prices for PFI contracts, authorities also need contractual means for maintaining value for money during the contract period.<sup>21</sup> The percentages of contracts surveyed by the National Audit Office with contractual value for money mechanisms are shown in Figure 2. The OGC expected the percentages to become much higher, as standardisation, advice and guidance affected more of the contracts. Some, such as benchmarking, might require the assistance of third parties with specialist market knowledge. The OGC did not necessarily expect, however, to see all the mechanisms used in every contract.<sup>22</sup> Gate 5 of its Gateway Review process was a formal review after the service was in operation to see whether the benefits in the original business case had been realised and to confirm what authorities were doing about the ongoing monitoring of value for money.<sup>23</sup>

**Figure 2: The use of value for money mechanisms**

Value for money mechanism	Percentage of projects including such mechanisms
Benchmarking	49
Profit and other gain sharing mechanisms	43
Open book accounting	55
Sharing of refinancing benefits	15

Source: NAO survey<sup>24</sup>

### *Refinancing*

14. At the time of the NAO survey only 15 per cent of authorities indicated that they had the right to share in refinancing benefits.<sup>25</sup> The OGC agreed that this was not acceptable. In 1999, it had alerted departments to the question of refinancing and issued further guidance in 2000. It had put out to consultation its revision of the Standardisation of PFI contracts which it proposed to publish in March 2002, and which would explicitly steer

<sup>18</sup> Qs 21–23; 13<sup>th</sup> Report from the Committee of Public Accounts, *The Refinancing of the Fazakerley PFI Prison Contract* (HC 372, Session 2000–01), para 29

<sup>19</sup> Qs 22, 79

<sup>20</sup> Qs 115, 139, 146–177

<sup>21</sup> C&AG's Report, para 1.24

<sup>22</sup> Qs 16–19, 69–71, 202–205

<sup>23</sup> Q2

<sup>24</sup> C&AG's Report, Figure 8, p13

<sup>25</sup> *ibid*, para 1.30

authorities towards a 50:50 share of refinancing gains and retaining the right to approve any refinancing. It now expected all contracts being let to include appropriate refinancing provisions.<sup>26</sup>

### *Dealing with change*

15. PFI contracts are generally of a long term nature so not all changes that may be required can be foreseen. The NAO survey showed that 55 per cent of the authorities surveyed had already used change procedures to update their contracts. Most of the changes made related to changes in services, the introduction of new services, and additional works and changes to the design of buildings.<sup>27</sup> The OGC considered that most of the changes were fairly minor while some, such as the authority and the contractor agreeing to joint testing of the service, were beneficial and showed that the partnership was working well. The Major Contractors Group also said that there were far fewer changes under PFI deals compared to a conventional building contract.<sup>28</sup>

16. One of the reasons authorities gave, however, for a decline in value for money was high charges for additional services.<sup>29</sup> A recurring feature in traditional construction projects is that departments accept lowest price tenders, but contractors then seek to increase their profit margins through variations and claims for additional work.<sup>30</sup> The OGC standardisation guidance emphasises that authorities should configure PFI contracts to satisfy themselves that change would be made on a value for money basis through the life of the contract.<sup>31</sup>

### *Performance deductions*

17. We were concerned that a contractor facing losses because it had failed to allow sufficient contingencies for risks occurring might seek to cut the level of service. The OGC said that an authority would have remedies against the contractor for failure to deliver the contracted level of service because there would be contractual payment deductions for poor performance.<sup>32</sup> 58 per cent of authorities surveyed by the NAO who had an agreed performance deduction review process had made deductions in accordance with that process.<sup>33</sup> The Major Contractors Group said that these deductions put pressure on contractors, though some cases, such as a contractor taking a hospital ward out of action for maintenance, did not arise from an assessment of the contractor's performance under the contract, and would be expected to arise during the contract period. It would be unreasonable to expect every hospital ward to be available all of the time throughout a 30 year contract. Contractors would probably have taken the likelihood of deductions into account when pricing the contract and the OGC confirmed this was normal business practice.<sup>34</sup>

### *Risk transfer*

18. The Committee has considered reports on the Passport Agency and National Insurance Recording System 2 deals, where the contractor failed to deliver the service required yet costs were borne by the relevant department, so there was a lack of real risk

<sup>26</sup> Qs 23–24, 200–201

<sup>27</sup> C&AG's Report, paras 1.37–1.38

<sup>28</sup> Q11

<sup>29</sup> C&AG's Report, para 3.39

<sup>30</sup> 2<sup>nd</sup> Report from the Committee of Public Accounts, *Improving Construction Performance* (HC 337, Session 2001–02), para 3

<sup>31</sup> Qs 228–230

<sup>32</sup> Qs 48, 88–106

<sup>33</sup> C&AG's Report, para 1.22

<sup>34</sup> Qs 47–48, 109–111, 116–122

transfer.<sup>35</sup> The OGC said that effective risk transfer was being achieved in certain PFI contracts and in some the private sector partner, having failed to perform adequately, was suffering significant financial penalty. For example, on the PRIME project the contractor had suffered a performance penalty of £5.6 million which had acted as an incentive for the contractor to improve.<sup>36</sup>

19. There was now a much better understanding among public sector clients that certain types of risk that could not be transferred, particularly the ultimate responsibility for delivering a public service. As risk management techniques were developed within the public sector, with an understanding that there were retained risks, focus was being sharpened on what sort of risks authorities could sensibly seek to transfer to the private sector and those that would have to be retained in the public sector. The public sector would always try to extend the envelope of risk that the private sector would take. What would be the optimal allocation today would not be the optimal allocation tomorrow. The Gateway Review process examined risk transfer in individual projects and it was developing enhanced guidance for accounting officers on risk management systems.<sup>37</sup> The Major Contractors' Group said the private sector had struggled significantly with the additional risks they were asked to take on board as a result of the PFI. There was now a debate, which it considered healthy, on which party was best able to manage each individual risk.

#### *Bailing out the private sector*

20. The Committee's Report, *The Renegotiation of the PFI-type Deal for the Royal Armouries Museum in Leeds*, found that the public sector had bailed out the private sector.<sup>38</sup> The OGC said that cost overruns and risks which had a high probability of occurrence and a low impact to be picked up by the private sector. But the risk of catastrophic failure to provide a public service, which had a low probability but very high impact, could never be transferred to the private sector. The public sector had to keep providing the service, and if the authority had followed standardisation of contracts, it would have rights to step in take over the running of the contract and would be able to seek other providers.<sup>39</sup> Under the standardisation of PFI contracts there were termination provisions that defined the circumstances in which an authority could terminate the contract where the contractor was in default for not delivering a public service.<sup>40</sup>

#### *Procurement times and bidding costs*

21. The OGC considered that the considerably longer timescale for putting PFI contracts into place, as compared with conventional procurement,<sup>41</sup> was offset by the better performance of the private sector in bringing assets in on or ahead of the schedule demanded by the contract. It also compared favourably with what had been seen in the past when assets had been provided late compared to original plans, and the cost of the overrun had fallen to the public sector.

22. The Major Contractors Group was concerned about the time being taken to put contracts in place. It had the impression that a lot of public sector organisations did not understand the importance of time to the private sector. The OGC said it was in dialogue

<sup>35</sup> 22<sup>nd</sup> Report from the Committee of Public Accounts, *Delays to the new National Insurance Recording System* (HC 182, Session 1998–99); 24<sup>th</sup> Report from the Committee of Public Accounts, *The Passport Delays of Summer 1999* (HC 208, Session 1999–2000)

<sup>36</sup> Qs 191–192

<sup>37</sup> Qs 10, 25, 27, 112–114, 219

<sup>38</sup> 4<sup>th</sup> Report from the Committee of Public Accounts, *The Renegotiation of the PFI-type Deal for the Royal Armouries Museum in Leeds* (HC 359, Session 2001–02)

<sup>39</sup> Qs 231–239, 246

<sup>40</sup> Qs 227–229

<sup>41</sup> Q50

with a number of departments to understand the reasons for the excessive timescales which gave rise to additional cost to the public and private sectors, and to see what could be done to shorten the timescales.<sup>42</sup>

23. The Chairman of the Major Contractors Group said that for one contract, valued at £70 million which his company, the Kier Group, had bid for and won, there had been £4 million of bid costs at risk until the deal was signed. His company was not being asked to invest £4 million up front in any other part of his business. His company had also lost other PFI contracts it had bid for after incurring costs of up to £1 million before being eliminated from the competition. In the light of this risk he considered the higher returns for PFI projects were fully justified, and believed that some prospective competitors were actually excluded from the competitive process by the high costs of entry.<sup>43</sup>

#### *Risks to the competitive process*

24. There is a risk that high bidding costs could encourage contractors to discuss with each other their approach to bidding for PFI contracts. The Major Contractors Group said that, at the level of individual contracts, its members did not discuss such practices as pricing and contingency funds for penalty clauses or any other matters which related to how they would approach individual contracts and tendering. Their members did, however, discuss issues such as risk allocation and general points of contract and bid costs where they felt it appropriate to take these issues forward as an industry for discussion with the OGC.<sup>44</sup>

#### SKILLS AND GUIDANCE

25. PFI is used to procure a wide range of public services, including accommodation, hospitals, prisons, roads, computer systems and Government accommodation. There are over 400 PFI contracts currently in force committing departments to future expenditure of around £100 billion.<sup>45</sup> It is vital, therefore, that PFI contracts are managed well and that staff responsible for managing the contracts have the appropriate skills and guidance.

#### *Training*

26. The OGC described the C&AG's Report as a useful stimulus as it focused on the importance of contract management and was a reminder that it needed to continue to maintain and strengthen the focus on this area. It regretted that contract management disciplines had not been in place earlier, and that many authorities provided little or no training in contract management skills. It also had concerns about the blend of experience and appropriate skills employed in some contract management teams.<sup>46</sup>

27. The OGC said it was taking action to improve authorities' capability to commission and manage projects through advice and guidance, the use of the Gateway Review process and a stronger focus on wider commercial skills. It would introduce new training courses and encourage people to build careers in contract management. At the operational and business level the OGC had inherited much advice and guidance from predecessor organisations. It plans to provide revised, coherent and updated contract management operational guidance by the end of April 2002. For accounting officers, the OGC had provided more focused advice on the critical issues of managing partnering arrangements and why service contracts could go wrong.<sup>47</sup> It also published a document on 15 April for

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<sup>42</sup> Qs 9, 51–55

<sup>43</sup> Qs 115, 146–177

<sup>44</sup> Qs 240–245

<sup>45</sup> C&AG's Report, para 1

<sup>46</sup> Qs 8, 12–13, 65

<sup>47</sup> Qs 3, 206, 211, 215–218

accounting officers on value for money in complex procurements.<sup>48</sup> The need for contract management manuals would feature as part of its updated advice and guidance. As part of the Gateway Review process review teams would test what methods were in place to facilitate the ongoing management of a contract.<sup>49</sup>

#### *The Gateway Review process*

28. To ensure that authorities have the capability to achieve value for money at contract award and to maintain it, the OGC had introduced the Gateway Review process in February 2000. All civil central government projects were required to go through that process and a similar process for local authority projects was under consideration. Part of the Gateway Review process is to give the OGC a much sharper insight on where good things are happening so that it can encourage other authorities to replicate them. The Gateway Review process focuses attention on the early life of projects, where the OGC considers there is greater scope for management to take corrective action. The OGC told us that accounting officers were paying a lot of attention to the recommendations that were emerging from the Gateway Reviews.<sup>50</sup>

29. Asked whether authorities were allowed to go ahead with a project unless they had been given clearance and understood the risks, the OGC told us that the Gateway Review process would enable projects to be reviewed before contracts were signed. If it felt a department was doing something which was fundamentally not conducive to value for money, then the OGC had escalation routes to draw the matter to the attention of the Chief Secretary of the Treasury or the Chancellor of the Exchequer. It preferred, however, to deal with these matters on a face to face basis with departments, winning over their hearts and minds rather than instructing them what to do.<sup>51</sup>

#### *Staff continuity*

30. 47 per cent of authorities surveyed by the National Audit Office transferred less than a quarter of the staff employed on the contract procurement team to the contract management team. A number of authorities and contractors said they had experienced problems because of the lack of staff continuity within each other's contract management teams.<sup>52</sup> The OGC said that its Gateway Review process explicitly tested what the authority's contract management plans were for an acceptable level of continuity.<sup>53</sup>

31. The OGC said it strongly encouraged continuity between those involved up to the point of contract award and those involved post contract award. If there was loss of memory about what had led to particular agreements in the negotiations, then it must increase the risk that the partnering arrangement would not get off to a good start. The Major Contractors' Group said that although it would expect some links between before and after contract award, the business skills needed to put the deal together were very different from those needed during the progress of the contract. The people building a hospital would not be those who had negotiated the contract.<sup>54</sup>

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<sup>48</sup> Ev 22

<sup>49</sup> Q214

<sup>50</sup> Qs140–141

<sup>51</sup> Qs 142, 207–213

<sup>52</sup> C&AG's Report, paras 2.11–2.12, and Figure 15, p19

<sup>53</sup> Qs 5–7, 66–68

<sup>54</sup> Qs 66–67, 144–145

*Commercial awareness*

32. Contractors responding to the NAO survey highlighted the need for authorities to understand the operations of commercial organisations.<sup>55</sup> The OGC agreed that departments had to respond to the business needs that they faced and the market conditions at the time they are doing business. It was looking at a range of factors that were necessary to ensure the successful management of the whole life cycle of a project. These included the need for specialists in procurement, project management, contract management and other key disciplines. It wanted greater professionalism and stronger capability on the part of practitioners who were involved in these disciplines, and to build up a network of people involved in contract management. Recruitment and retention of staff were affected by the fact that in a number of key skills areas there were wide pay differentials between what the private and public sectors paid for certain skills. There were also some pay differentials between departments.<sup>56</sup>

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<sup>55</sup> C&AG's Report, para 2.17

<sup>56</sup> Qs 4, 193–196

MINUTES OF PROCEEDINGS OF  
THE COMMITTEE OF PUBLIC ACCOUNTS

SESSION 2001–02

WEDNESDAY 12 DECEMBER 2001

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon	Mr Gerry Steinberg
Geraint Davies	Jon Trickett
Mr Brian Jenkins	Mr Alan Williams
Mr David Rendel	

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 Managing the Relationship to Secure a Successful Partnership in PFI Projects (HC 375) was considered.

Mr Peter Gershon, CBE, Chief Executive, Office of Government Commerce, was further examined; Mr Peter Ryan, Head of Private Finance Policy and Projects, Office of Government Commerce; and Mr Colin Busby, Chairman, Major Contractors Group, were examined (HC 460-i).

Mr David Finlay, Head of PFI Development, National Audit Office, was examined (HC 460-i).

The witnesses withdrew.

The Committee further deliberated (PFI Report).

\* \* \* \* \*

[Adjourned until Monday 17 December at half past Four o'clock.

\* \* \* \* \*

MONDAY 24 JUNE 2002

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon	Mr George Osborne
Geraint Davies	Mr David Rendel
Mr Frank Field	Mr Gerry Steinberg
Mr Nick Gibb	Jon Trickett
Mr George Howarth	Mr Alan Williams

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

The Committee deliberated.

Lorraine Constable, Assistant Treasury Officer of Accounts, was further examined.

\* \* \* \* \*

Draft Report (Managing the relationship to secure a successful partnership in PFI projects), proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 5 read and agreed to.

Paragraph 6 postponed.

Paragraphs 7 to 32 read and agreed to.

Postponed paragraph 6 read and agreed to.

*Resolved*, That the Report be the Forty-second 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.

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[Adjourned until Wednesday 26 June at Four o'clock.]



# MINUTES OF EVIDENCE

TAKEN BEFORE THE PUBLIC ACCOUNTS COMMITTEE

WEDNESDAY 12 DECEMBER 2001

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Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon  
Geraint Davies  
Mr Brian Jenkins  
Mr David Rendel

Mr Gerry Steinberg  
Jon Trickett  
Mr Alan Williams

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SIR JOHN BOURN KCB, Comptroller and Auditor General, and MR DAVID FINLAY, Head of PFI Development, National Audit Office, further examined.

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

## **REPORT BY THE COMPTROLLER AND AUDITOR GENERAL: MANAGING THE RELATIONSHIP TO SECURE A SUCCESSFUL PARTNERSHIP IN PFI PROJECTS (HC 375)**

### **Examination of Witnesses**

MR PETER GERSHON CBE, Chief Executive, MR PETER RYAN, Head of Private Finance Policy and Projects, Office of Government Commerce and MR COLIN BUSBY, Chairman, Major Contractors Group, examined.

#### **Chairman**

1. Welcome to the Public Accounts Committee. We are considering the Comptroller's Report on Managing Relationships to Secure a Successful Partnership in PFI Projects. We are delighted to welcome back Mr Peter Gershon, who heads up the Office of Government Commerce, and we also welcome Mr Colin Busby who is Chairman of the Major Contractors Group and Chairman and Chief Executive of Kier Group PLC. Perhaps I could start with a question to you, Mr Gershon. Can I refer you please to page 2, paragraph 7, where it says: "In total 81 per cent of authorities said that value for money was currently satisfactory or better". To what do you attribute this positive outcome?

(*Mr Gershon*) There are a number of factors, Chairman. There are competent staff applying good practice and guidance. There is management focus on value for money as a priority and the involvement of specialist experts to help get and keep projects on track, in other words what was the Treasury Task Force and has now become Partnerships UK. There is the discipline that PFI gives about the focus on outputs and service levels. I would also add that if you also take into account figure 36 on page 35, which shows some of the underlying trends, there is no room for complacency in that 81 per cent achievement.

2. Can I question you a bit more about that? Can you tell us a bit more about the way in which you are monitoring the extent to which the expected value for money improvements for PFI contracts are being delivered? Are you monitoring it?

(*Mr Gershon*) The overall responsibility for looking at individual projects rests with the individual accounting officers. Within the OGC we are looking at a number of sources of feedback.

Firstly, as the Gateway review process cuts in, which I have referred to on a number of occasions when I have appeared at this Committee, the so-called Gate 5 Review is a formal review post the start of operational service to see whether the benefits in the original business case have been confirmed and to confirm what the clients are doing about the ongoing monitoring of value for money. As we get feedback from those reviews that will help inform us. We also get feedback from Partnerships UK, monitor National Audit Office reports and other reports on individual projects, and there is established networking with departmental private finance units which gives us additional feedback.

3. Are you convinced that your department and, more importantly, other departments, are coping with change as these projects have very long lead times—30 years? Are you convinced that they have got their finger on what is going on?

(*Mr Gershon*) First of all, not all of them are 30 years in length. Some of them are of rather shorter duration. Am I convinced? The short answer to that question is no, I am not convinced. Through things like the Gateway process we are helping to sharpen the focus on the whole life aspects of these and other forms of complex projects in public sector procurement. I think this report has acted as a very useful wake-up call about the importance of post-award contract management. Following the discussion and agreement at the last meeting of my Supervisory Board, the OGC has now commenced a programme of work in conjunction with departments looking at what we call the wider commercial skills agenda which explicitly includes a focus on contract management, and in due course that will result in a number of measures to help improve skills and capabilities in this area, for example, the

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[Continued

**[Chairman Cont]**

introduction of new training courses and encouraging certain people to see that they can build careers in this sort of practitioner discipline.

4. Would you like to turn to page 33? I just want to open up a number of areas that my colleagues can explore further. At paragraph 3.39 you will see there that 23 percent of authorities who gave us their current perception of value for money considered that value for money was not as good as at contract letting. I want to pursue this point about value for money being eroded during the life of a PFI contract. Have you got any more comments on that paragraph?

(*Mr Gershon*) Of course this can happen in conventional procurement as well. I do not think this is unique to the Private Finance Initiative. I am dealing with one case of conventional procurement at the moment where I am very concerned about the potential deterioration in the value for money in the life of the contract. I use that as an example. What are we doing to improve client capability in this area? First, we have the introduction of the Gateway review process. As I said, there is also a greater focus on trying to get much more professionalism and stronger capability into the practitioners who are involved in disciplines like contract management. We want to build up a contract management network of PFI practitioners as the NAO has suggested in this report. Over time we will see a sharper focus about testing ongoing value for money in contracts. For example, in many long term contracts to do with property and construction, somewhere around the five or the seven year point in the life of a contract, the client has the option to go to the market again to re-run a competition for the provision of soft facilities management services. There are other mechanisms such as benchmarking, but we all have to look at how we can introduce stronger governance mechanisms through looking again at our advice and guidance to help improve clients' capability in this critical area.

5. Can I ask you about one contract for the sake of example? I am told that in the Department of Work and Pensions there is a property deal called Prime. If we look at the management team in the department, nobody involved in the management team was involved in the original deal and nobody in the private sector side was involved in the original deal. This is rather worrying. Do you know about this particular contract?

6. I am aware of that situation. We have seen some of the consequences of that. Certainly in the advice that we are giving to departments we are strongly encouraging them that there is a level of continuity between those people involved up to the point of contract award and those who are involved post-contract award. I do think that is important to help the partnering relationship get off to a good start, particularly in the early years of the contract, because if there is complete loss of memory on both sides about what led to particular agreements around the contract at negotiations, then it must increase the risk that the partnering relationship does not get off to a good start.

7. And you knew about this particular situation with Prime, did you?

(*Mr Gershon*) No, I did not. It did not go through the Gateway Review process. It was too far down the track to go through it. If it had done that issue would have been picked up because we explicitly test in these reviews for what the client and the supplier's contract management plans are in terms of resourcing.

8. Will you now go back to page 17, and if we look at paragraph 2.8 you will see there that it says: "There were, however, many authorities which had provided little or no training in contract management skills either before staff took on contract management duties or in the form of follow-up training." Are you not worried that this is putting the public sector at risk on these important long term contracts?

(*Mr Gershon*) I am concerned, but if you asked me the same question about non-PFI complex or novel projects I would give you exactly the same answer, Chairman. The key is about the actions that we are taking, some of which I have referred to already, which will lead to improved client capability to commission and manage projects which is in the area of advice and guidance, the use of the Gateway review process and the actions that will flow from a stronger focus on wider commercial skills.

9. Can I ask a question now of Mr Busby? Can you please turn to page 20? If you look at paragraph 2.17 you will see that many contractors highlight the need for authorities to understand the operations of commercial organisations. That is a fairly obvious statement. It is a bit of a naive question but in what ways would such an understanding lead to improvements in the delivery of successful PFI contracts? It is a very easy question to let you have your say about the public sector.

(*Mr Busby*) It does not sound very easy. It is in the area of risk allocation that most of the detailed debate happens in the early days of the contract negotiation side. A greater understanding in that particular area would be helpful. That is what I interpret as the commercial aspect. The particular point that concerns my organisation is one of time. Frequently during the leading up to and award of contracts, the time pressures are allowed to slip and it is an area that the private sector feels as though it struggles with. One gets the impression that a lot of the public sector organisations do not understand the importance of time to the private sector. Time is money in that area and the request that we would have would be to try and get a greater conforming to the timetable as laid down. It is in that type of area where most of these issues affect my particular members.

10. If you go back to page 8 and look at paragraph 1.11, you will see that 79 per cent of authorities thought the risk allocation was totally satisfactory but only 53 per cent of contractors had this view. Do you want to tell me why you think that contractors and authorities had differing views on how risk transfer is worked out?

(*Mr Busby*) There always will be a difference. I would suggest that the public sector would be worried if 100 per cent of contractors thought the risk allocation was ideal. The fact that there is debate in this area I would consider fundamentally healthy. I think it comes down to detail. There is the Gateway

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[Continued

**[Chairman Cont]**

process that I know Peter's office has issued various announcements on. The fundamental criteria there as I understand it is that risks should be allocated to the party that is best able to manage them. That is a principle that we agree with. The debate that happens is on which party is best able to manage each individual risk. I feel as though it is a learning process. We are talking here of PFI. It is a process that has been around for a relatively short time. There are very steep learning curves in this process and one assumes that as PFI continues the detail of risk allocation will become a procedural rather than a discussion point.

11. Mr Gershon, if you look at page 14, paragraph 1.38, you will see that 55 per cent of these authorities have already used the change procedures to update their contracts. How are you going to encourage authorities to achieve successful outcomes to any new service requirements?

(Mr Gershon) If behind that quote was that this level of change is contributing to lack of success rather than success . . . I am not worried about this level of change because one of the things that the NAO have given us in general terms about the nature of these changes is that in the main they do not reflect very substantive changes to the contract post-award. A lot of them are of a fairly minor nature. The sort of example you might expect, I know from one or two contracts, is where the contract was placed on the basis that the supplier would do a set of testing and then the customer would do a set of testing. But in the period between contract award and the asset becoming ready for service and being introduced into service, the client and the supplier agreed to a joint testing approach. That would have to be reflected in a change to the contract. That is a highly beneficial change and reflects in some sense that the partnership is working well. On the other hand you could see a scope change post-contract award because of the needs for example of the prison service, if the role of a prison is changed to include provision for under-18 prisoners who require special additional facilities to ensure their protection. That would then lead to some change to the contract which was accommodated by the contractor. The percentage seems high but the nature of change does not lead me to believe that this is worrying. It might be helpful for Colin to say on a traditional procurement contract which his company has been involved in, the sort of level of changes they would see between contract award and the handover of the asset in a conventionally procured built contract.

(Mr Busby) I think this whole area of change is a plus side for PFI. The example that Peter is asking me to relate to you was for a hospital procurement under the traditional form. My company has been involved in many of those and it is not unusual for such a traditional contract to have, say, 15,000 change orders during the construction phase of such a contract. I am sure there are plenty of examples where 15,000 is significantly under what has actually occurred. We have just finished a major general hospital in Scotland under PFI and the change orders through that process number less than 50. I am convinced that it is the PFI process that has caused that change to occur.

**Mr Williams**

12. Mr Gershon, you have described this report as a useful wake-up call. As far as I understand it we are 400 contracts and £100 billion down the road. What happened to your alarm clock?

(Mr Gershon) I described it as a wake-up call in terms of helping to focus attention on the importance of contract management, not in the sense that it is not happening today. It is, but it is a very powerful reminder that we need to continue to maintain and strengthen the focus on this area. That is entirely consistent with the remit of the OGC which was created in April 2000 to look at procurement in a whole life sense from cradle to grave, whereas historically procurement much more closely followed what happened pre-award. The Gateway process is a demonstrable example of how we have introduced a technique to support that whole life approach. I use this term in the sense that anything of this nature which helps draw to the attention of top management across the Civil Service to the importance of these disciplines I regard as being entirely helpful to my cause.

13. You do? Do you not regret that they were not there before?

(Mr Gershon) Of course I do.

14. Are you not alarmed? For example, if I look at page 11, in banner headlines in the last column it says "Value for money mechanisms are needed". How is it that they are still needed at this stage? You yourself said that you are not actually monitoring; you are getting some information, but there seems to be no scientific assessment of value for money. Indeed, in the NAO report it is impressionistic whether it is good value for money or not. There is no empirical evidence here that it is good value for money. It is just the contractor saying it is good value for money and the people who enter into the contract say it is good value for money, but neither of them are going to throw up their hands up and say, "We got it wrong", are they?

(Mr Gershon) What this report is looking at is what has happened over time between contract as contracts move into their implementation and operational service phase.

15. No, no. The question is value for money. All we have here is impressionistic analysis of the views of the authorities and of the contractors on whether it was good value for money or not. You agreed this report.

(Mr Gershon) Yes.

16. If it does say value for money mechanisms are needed you must agree with me and with the report and with your department that indeed they are needed. Why are they so slow in coming?

(Mr Gershon) As standardisation and advice and guidance affects more and more of the contracts they will include mechanisms for determining the ongoing value for money during the life of the contract. I referred to one example and, if you recollect, I was last in this room with Sir Andrew Turnbull when we looked at GOGGS. That has in it, for example, the provision at various points in the contract to re-complete the soft FM aspects of the contract which provides a real test as to whether that aspect of the contract is continuing to provide value for money.

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[Continued

[Mr Williams Cont]

17. You quoted one example out of a hundred. You have agreed that there is a need, a gap, for mechanisms. Either you agree there is a gap or you do not. If you do not agree why did you sign up to the report?

(Mr Gershon) If you look at the text that underpins this it highlights what authorities are already doing.

18. Yes. That is what they are already doing but it says more are needed.

(Mr Gershon) Yes.

19. But it is 400 contracts. You quote one example.

(Mr Gershon) You are assuming that in 400 contracts there are no value for money mechanisms in place. That is not the case. In a number of instances mechanisms such as the re-competing of the soft FM contracts may not yet have been triggered because insufficient time has passed in the life of the contract because typically that will happen at the five or seven year point.

20. That would sound more impressive if it were not for the other side of the page. If you look at page 10, second column, again in banner headlines which you have signed up to it says that further understanding is required of the returns contractors earn. If you do not actually understand the returns they earn how do you know whether they are giving you good value for money or not? It just reinforces what I have said about the value for money inadequacies.

(Mr Gershon) I am sorry, I do not agree. Firstly, this does not say that there is no understanding today of what contractors earn. It says there needs to be further understanding, but the critical test of value for money if you run a competition is—

21. You are misunderstanding me. We have £100 billion already committed and you do not even have any meaningful information to give this Committee on rates of returns for contractors. Let us give you an example we had a little while ago when we were dealing with the prisons in the last Parliament. The contract—was it for Fazakerley, or was it Parc, Sir John?

(Sir John Bourn) Fazakerley.

22. The contractor said that they required a 50 per cent premium on their normal rate of return for a prison PFI contract, 50 per cent on top of what they would normally expect with a conventional building contract. That seems somewhat obscene.

(Mr Gershon) That was a very early prison in a very novel market where for the private sector there would have been very significant risk. As the market matures that risk declines and you would expect therefore the rate of return that a contractor expects to decline. This was against a background that in the history of public sector procurement in areas like prisons there were significant cost and time overruns on which the contractor was being asked to take the risk as it moved across from the public to the private sector.

23. They were making so much profit on their existing PFI contracts that they were using the profit to invest in new PFI contracts because they were such a good deal. Let us take it a stage further. We at that time also, and this is dealt with here, discovered that they had made significant bonus profit as a result of re-financing. I tabled a question and Sir John and his colleagues very kindly prepared a memorandum

based on the questions I tabled to every department. Out of a relatively small proportion of these 400 contracts they found that in only 15 per cent<sup>1</sup> was there any understanding to share in re-financing profits. We well understand how they arise. The risk is early on—borrow short and high interest rates at the beginning. When the income flow comes in as you get to the building phase you have got the income flow and you now go to a lower rate of interest and longer term borrowing. That is predictable. It was in some of the early contracts in relation to railways but it was not in the later ones. Where was the monitoring of that? Where was the value for money there? Why did Treasury in its guidance tell departments and authorities that they were not to seek any share in re-financing windfall profits? It is in the report and it was in their guidance. They, you were told, are now re-writing that guidance. Is it re-written yet and what is the outcome?

(Mr Gershon) If I can clarify the position on that, in 1999 we alerted departments to the issue of re-financing and said it was an issue that they needed to take into account. Last year we issued further guidance to departments on the subject of re-financing. The revision of the Standardisation of PFI Contracts that is currently out for consultation, and which we expect to publish by next March, explicitly steers clients towards a 50-50 share of re-financing gains and approval of all re-financing.

24. You have got there after all this time. Oh, no, you have not got there because you still have some consultation. We do not know, as it is only out to consultation, that that is what the guidance will state at the end, do we? It is conceivable if you do not get the results you want in the consultation that it may not happen. You have not exactly been expeditious.

(Mr Gershon) It is also the case that if the OGC is now consulted by departments on the subject of re-financing and for a new contract they get a very clear steer in advance of the revision of standardisation which is 50-50.

25. There you are. It shows that some of the shouting that government departments get in this Committee does at least achieve something. Let us move to the contractual side. I am in favour of PFI but I want it to work properly. I want it to be a good deal for everyone. I want contractors to get a reasonable rate of profit but I want the taxpayer to get a reasonable deal. I have no objection in principle, unlike some people, to the PFI notion. I want it to work effectively. On risk transfer how much further ahead have we gone since we ran into the nonsenses we had with the Passport Office and so on when they incurred costs of £12.5 million as a result of the failure of Siemens, and that two weeks before a hearing here, they were only able to get Siemens to pay £2.5 million towards the losses? That did not seem much of a risk

<sup>1</sup> C&AG's Report, figure 8, p 13. An earlier memorandum, summarising the answers to Parliamentary Questions in July 2000, showed that 24 per cent of 105 PFI contracts listed by departments included arrangements entitling departments to share in refinancing gains: *The Refinancing of the Fazakerley PFI Prison Contract*, 13th Report from the Committee of Public Accounts (HC 372, Session 2000–01), Appendix 3, para 5.

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[Continued

**[Mr Williams Cont]**

transfer. The fault was mainly that of the company and its computer system and yet the costs were borne by the department. Are we advanced on that now?

(*Mr Gershon*) I think there is a much better understanding amongst public sector clients that there are certain aspects of the risk that cannot be transferred, particularly the ultimate responsibility for delivering a public service. As risk management techniques develop within the public sector—and the understanding that there is a retained risk—that is sharpening up focus as to what sort of risks you can sensibly seek to transfer to the public sector, and those that you have to be mindful to retain in the public sector and that should influence how you select and manage your private sector contractor. I am very mindful of the report that came out recently from this Committee about its hearing on the NAO report on risk management where what you advocated was that in the selection of partners (not just private sector partners but also other partners) clients need to understand and satisfy themselves about the risk management systems in their partners. That is certainly one of the things that we take on board. We do not necessarily use the same language but if you look at the guidelines around the Gateway review process that is one of the things that is tested by these independent reviews. We are also in the process of developing enhanced guidance for accounting officers about seeking value for money in complex procurements, not just PFI but PFI is a good example of a complex procurement, and we have factored in that aspect about looking at risk management systems in that advice. You would say, “Bloody slow; they ought to be doing it faster”, but—

26. In slightly more delicate language that is exactly what I would have said.

(*Mr Gershon*) In our pedestrian way we are slowly but surely trying to get to where you would have liked us to be a long time ago.

Mr Williams: I think you have successfully talked me through my 15 minutes so I give in at this stage.

#### Chairman

27. I am very sorry—I should also have welcomed Mr Peter Ryan; I am sorry, the Head of the Private Finance Policy Unit. As you have not had a chance of saying yet I would like to give you the opportunity now. Do you have any comments?

(*Mr Ryan*) Amplifying Mr Gershon’s response, there is clear evidence that in certain contracts we are seeing effective risk transfer and there are contracts where a private sector partner, having failed to perform adequately, is suffering significant financial penalty. We are learning. We are not perfect but we are doing better.

#### Mr Rendel

28. I want to start on figure 1, page 2, and also figure 36, page 35, which are obviously connected. Mr Gershon, you said earlier that figure 36 on page 35 shows that there is no cause for complacency. Clearly there are a number of areas in a lot of contracts where the evaluation of how good the contract is in terms of value for money has suffered quite a lot even within the first year. That worries me. My first question therefore

is, in those cases where the evaluation has fallen were the authorities concerned simply fooled by the contractor into thinking that they had got a better deal than they had?

(*Mr Gershon*) No, I do not think they were fooled. I think in some areas common understanding about what was really required by the contract and what each party had to deliver only became apparent after the award of the contract. That could have been a contributing factor.

29. So the authorities got it wrong, did not set up the contracts properly and as a result suffered?

(*Mr Gershon*) Partnering is a bit like marriage. You enter into it with the view of having a long term relationship and sometimes, regretfully, you discover after the marriage ceremony that the person you thought you had married does not quite turn out to be as you had expected. They have bad habits that only come to light after the wedding ceremony.

Chairman: Or vice versa.

#### Geraint Davies

30. Where is Mrs Gershon?

(*Mr Gershon*) Do not draw any conclusions whatsoever about the state of my own marriage. It was excellent on the day of contract award and remains excellent.

#### Mr Rendel

31. You say they were not fooled but something went wrong clearly. You think that what happened was that the authorities made a mistake, they misunderstood what they were letting themselves in for?

(*Mr Gershon*) Or there was lack of mutual understanding about what was really required.

32. It does not seem to me that it matters much whether the contractors understood or not. The point is that the authorities thought they were getting a good deal; now they do not. It may still be satisfactory but it is certainly a worse deal than they thought they were getting.

(*Mr Gershon*) Yes.

33. Either they were being deliberately fooled or they made a mistake and misunderstood what they were doing.

(*Mr Gershon*) Or potentially they selected the wrong partner.

34. In that case they made a mistake. Selecting the wrong partner seems to me to be a clear case of making a mistake.

(*Mr Gershon*) Yes. What do you do then to try to make the relationship work? In one instance in which I had some personal involvement helping the parties come to a revised arrangement to put the relationship on a stronger footing was the PFI contract for the Armed Forces Personnel Administration Agency where, after the contract was awarded, the relationship went through a bad period and it was necessary to reconstruct it to get to a point where the client now believes that it has the potential to start to deliver value for money. If you look at the NAO report it also illustrates RAF Mail which went from excellent

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[Continued

**[Mr Rendel Cont]**

to marginal but also records somewhere else in the report that the relationship has been redefined and the early signs following that reconstruction are encouraging.

35. Let me pass on from that if I may and say that if we again compare figure 1 to figure 36 the apparently successful outcome of PFI in the NAO view seems to depend very heavily on figure 1. In other words, as Mr Williams was saying earlier, you seem content with what is happening because most people seem to think it has gone well but this is after all a fairly subjective view of what was happening.

(Mr Gershon) I was careful not to express contentment in the answer I gave to the Chairman's questions, Mr Rendel.

36. You indeed said there was no cause for complacency. Nevertheless it seems that your general view is that on the whole most people feel that these arrangements have been at least satisfactory and yet within one year of their start in 23 per cent of cases the perception of how good the value for money is has deteriorated within the first year.

(Mr Gershon) I am slightly confused by this reference to the one year. I recognise the 23 per cent but I do not recognise the one year.

37. I think somewhere in here we were told that most of the ones that are being looked at had been in operation for about a year.

(Mr Finlay) The contracts had been let for at least a year, so some contracts had been operating for a year, some two years, some three years.

(Mr Gershon) For example, one of the projects here, which happens to be in my direct area of responsibility, was let in 1996. It was four years.

38. The point I am making is not whether it was one year, two years or three years but they are still on the whole, because PFI is a fairly new business, at the early end of their existence. Some of them may be halfway through by now. They have been three years of a six-year contract but a lot of them will be a lot longer than that. Some of them, as we know, go right up to 30 years and are right at the beginning of their term. That being the case, and given that apparently the estimation of value for money is falling away, are you confident that at the end of these contracts we will still have more than 50 per cent in the satisfactory or better area?

(Mr Gershon) As I said, we are taking a number of measures to strengthen client capability. If you take these 100 projects what could be done to improve value for money would be in the areas of looking at the skills involved with people in managing the contract, the partnering, the strength—

39. Excuse me, Mr Gershon, I do not think you are answering my question. What I want to know is, if you look at figure 1 and you take figure 1, not just at the contract letting which is the light blue and concurrent which is the dark blue, but if you were to take all these at the end of the contract time, would you get a graph which still showed more than 50 per cent in the first three blocks?

(Mr Gershon) My belief is yes.

40. How much more than 50 per cent? At present you are at something like 80 per cent; is that right? Somewhere in here I think I saw a figure of that sort.

(Mr Gershon) I am clear what number we should aim for.

41. That is not the point. What are you getting?

(Mr Gershon) What is my belief?

42. Yes.

(Mr Gershon) How many would be better than satisfactory?

43. Yes, satisfactory or better by the end of the contract. How many of the authorities will still think that these were good value for money contracts when they come to their final year?

(Mr Gershon) At least the same number who think they are satisfactory or better today.

44. Really?

(Mr Gershon) Yes.

45. Although it seems to be falling, and yet you are saying that from now on it is not going to fall any further at all?

(Mr Gershon) First you asked me a question about what would happen at the end of the contract, and that was the question I answered. As I said, I think we are taking a number of measures that will help clients' capability to manage these contracts and strengthen the ability to derive value for money from them.

46. I hope you are right. Probably neither of us will be here in the year when these contracts end.

(Mr Gershon) I sincerely hope that at periodic intervals the NAO will do similar reviews to this so that we are all able to monitor what is happening and the effectiveness of the management actions that are being taken.

47. It will be very interesting to see how this graph changes over the years, and no doubt the NAO will wish to reproduce this graph as years go by. Mr Busby, may I ask you a question? Twenty five of the firms concerned have had deductions made as a result of failure to fulfil the contract terms totally.<sup>2</sup> Are you not a bit worried about the figure? It seems to be quite a lot. Presumably if they were, as one hoped they all were, tendering for the minimum price which would nevertheless give them a reasonable return on the amount of capital employed and the workforce employed, and 25 of them have actually not got that price because they have had deductions made as a result of failing to fulfil the contract, is that not rather bad news for the contractors?

(Mr Busby) It certainly puts pressure on contractors. If I can use the example of the hospital, the contractors will get paid for two things in hospitals on the service side. One is the provision of the service and the other is the availability of the service. For example, if a ward is taken out for maintenance the authority involved would be entitled to make a deduction for that particular non-availability and would in fact do so. It is that area where I believe the deductions have been made. I do not think it is a fundamental assessment of the performance under the contract. It is a process within it that allows for deductions to happen in those terms.

48. So you are saying that this is not a case in which they are making less of a profit than they thought they were going to make?

<sup>2</sup> C&AG's Report, para 1.22.

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[Continued

**[Mr Rendel Cont]**

(*Mr Busby*) It could easily be that, yes. I would expect the deduction to reduce their profit undoubtedly.

49. I may want to come back to that later because it was not quite how I understood it. Mr Gershon, are you aware of any cases in which deductions could have been made but were not?

(*Mr Gershon*) I personally am not aware of any such cases.

50. Can I ask you now about the timescale for putting these contracts into place? It seems to me from experience, particularly in my own constituency, that very often putting a PFI contract into place takes a hell of a lot longer than going down a straightforward paid-for-by-the-government-out-of-public-funds type of contract. Is that correct, in your experience?

(*Mr Gershon*) Yes, I think that is a fair top level statement to make.

51. In that case what notice is taken of that when you are deciding to go one way or the other, because clearly if we are talking about providing public services, if you can provide a public service perhaps at a slightly greater price now or at a slightly lower price in five years' time and add on the extra time taken to set up the contract, is notice taken of that in making the decision as to whether you go one way or the other?

(*Mr Gershon*) Yes, but offsetting those delays is the better performance that we are seeing of the private sector in PFI contracts bringing the assets in on or ahead of the schedule demanded by the contract compared to what we regrettably have seen too often in the past, that through traditional procurement the assets come late, sometimes many months, sometimes years and years later than the original plan. Therefore, although yes, you may get additional time at the beginning, you have to look at what happens overall in the life of the project.

52. We are looking surely at value for money in both cases. If you have a straightforward contract and it comes in late, then presumably you have got something in the contract that says you get some money back or the price is lower.

(*Mr Gershon*) I am sorry, that is not always the case. In traditional procurement methods often the cost of the overrun fell to the public sector, both the direct cost and the consequential cost.

53. There is no reason for that, is there, if you write the contract properly?

(*Mr Gershon*) But historically most public sector contracting was not done on a prime contracting basis. It was done using more traditional procurement methods where the client in effect acted as his own prime contractor.

54. What you seem to be saying is that if you go for a traditional procurement method but you introduce into your contract some sort of penalty clause then that is very often going to be better value for money than going for a PFI scheme?

(*Mr Gershon*) No, I am not saying that at all, because there is a cost to the public sector of the asset coming in late in terms of delayed services. The point you make about the additional time is absolutely right. We are in discussion at the moment with the industry association of which Colin is the Chairman, where they have drawn to our attention a number of

areas where the time that was being taken is a matter of concern to them and I am in dialogue with a number of the departments to understand what is driving these excessive timescales which are giving rise to additional cost for the private sector and the public sector to see what we can do to shorten the timescales in PFI contracting. It is not a given. There is no fundamental law of nature that says it should take as long as it does for some of these contracts to get awarded.

55. But it has done up to now.

(*Mr Gershon*) It has done up to now and it is a matter that I am paying attention to.

### Jon Trickett

56. I do not feel comfortable with this report in some ways. Its methodology is really an opinion survey of a number of people chosen we do not know quite how. I am not sure that measuring perceptions tells us very much, especially when you are asking people, "Are you in favour of motherhood or apple pie?" Underlining some of my questions will be that general theme, that we have here an opinion survey rather than any objective study of value for money or anything else, although there is some interesting information coming out of it. Sir John, are you in favour of motherhood and apple pie? It seems to me that the culture of this place now is that PFI is the latest flavour of the month. Personally I am not particularly in favour of it but I guess if you asked the majority of civil servants, "Are you in favour of PFI and do you get value for money?", it is a bit like saying, "Are you in favour of motherhood and apple pie?"

(*Sir John Bourn*) Yes, but that of course was not what the survey was about. The survey was about the experience that people had of working the PFI contracts and the experience showed that there was a degree of satisfaction. The experience also showed that satisfaction was declining. The experience also showed that on both sides people had ideas on how to make things better. It was—and I do not claim for it any more than it was—a survey of those people who were responsible for this work and a survey of what their experience was. As Mr Gershon has said, this is the first time that an attempt has been made to provide information on this area at all and that does not mean to say that we will not do further work which examines this from other bases.

57. I have no doubt that there is useful information in here but you really are asking people about perceptions: "Do you perceive that you have had value for money?", and then we have made a table which members have made much of about whether the people who are managing accounts perceive that they have achieved value for money. I guess most people are going to say yes, and in a way it is a self-fulfilling approach. That is my view and I just want to say that some of the people of whom we have asked questions are clearly not equipped to give answers. I will demonstrate that in the questions which I am going to address to yourself and others. First of all can I ask on what basis you selected the projects? There were 400 projects altogether. You chose 121 of them. Actually you did not even manage to get some of them to reply, did you?

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[Continued

**[Jon Trickett Cont]**

(Mr Finlay) The sample that we chose was virtually all of central government PFI contracts.

58. Every one of them?

(Mr Finlay) At the end of 2000 which had been in force for over a year. That was the basis of the sample.

59. Not everybody replied though, did they?

(Mr Finlay) Not everyone replied but we did get a high proportion who replied. What I would also say is that although you have mentioned that we asked perceptions about value for money, which is absolutely true, we also asked a series of much more detailed questions to build up a very close understanding of the mechanics of what was going on.

60. We are politicians and we try to understand opinion polls and that is what this really is. We also know that opinion polls depend on accurate sampling. When you get a rogue poll it is because the sample of population that was asked was not truly random. We have only got a limited number of responses. Ninety per cent of the authorities but only about three-quarters of the contractors bothered to respond. If you look at the detail of the report many of them did not fill all the questions in, did they? They did not answer all the questions.

(Mr Finlay) Certainly in the answers on value for money we got a high proportion of responses there.

61. What steps did you take to find out whether the people who did not respond were not skewed in some way? How do you know that the people who did not respond were the ones who were most disgruntled, unhappy or confused?

(Mr Finlay) We certainly took steps to get as high a response rate as possible.

62. Yes, but I did not ask you that question, did I? How do you know that the ones who did not respond were not the examples of worst practice?

(Mr Finlay) Clearly if we have not got the response from an authority or a contractor then we do not know exactly what their view of the contract is. What I would say is that having devised the survey by reference to, as I say, virtually all central government PFI contracts which had been in force for over a year at the end of 2000, it was a virtually comprehensive sample that we started from and the list of projects at the back does show a very wide ranging list.<sup>3</sup>

63. It does. I have made the point, which you have not responded to but it is on the record because I have made it, that even the ones who responded did not reply to every question. In some cases your analysis was only based on 72 responses, in table 12, for example. If we turn to the outcomes of this opinion poll, I am surprised that anybody says we have not achieved value for money because presumably they are required by their contracts of employment to produce value for money. In a way it is back to this motherhood and apple pie thing. When we looked at the skill levels of the staff who were managing the contract I thought that that was useful information. I think it is very valuable to us. I will just turn to Mr Gershon. Are you happy with the information which was revealed, for example, in table 12, admittedly on a relatively small sample, which indicates that

significant numbers of the staff were not appropriately skilled or experienced in managing contracts, does it not?

(Mr Gershon) The contract management team should have had experience in the appropriate skills. I am happy with that but there is some cause for concern with these figures. In any team you would expect to see a blend of experience and appropriate skills. Otherwise how will young people ever become the experienced people of the future? Where you see the percentages below 50 per cent, that would be cause for concern.

64. Seventeen out of 72 were precisely less than 50 per cent.

(Mr Gershon) Yes.

65. So in 17 out of 72 cases, according to your answer just now, and this is design and build, you are unhappy with the blend of skills there.

(Mr Gershon) Yes, I am.

66. Then we note elsewhere that the number of staff who were then transferred from having designed the contract, prepared it and presumably let the contract to managing the contract, it is fascinating that significant proportions of contracts were managed by yet another group of staff who had not been involved in the preparation of the contract. Are you content with that?

(Mr Gershon) No, I am not. It is because of that that we recognised that that was a problem some time ago, which is why in the Gateway review one of the things that is explicitly tested is things like the skills and capabilities of the team at the design and build stage and that the skills and capabilities of the team at the procurement stage, and we also look at what are the plans for contract management and test what plans the department has for an acceptable level of continuity.

67. Two-thirds of the contracts were managed by staff who had no or little involvement in the procurement of the contract.

(Mr Gershon) Incidentally, we may not like these results but it does illustrate that people who answered the survey were pretty honest.

68. I am going to come back to the C&AG in a moment because this question reveals two things: firstly, contract preparation and contract management are conceptually separate from a civil servant's point of view which I would have thought you would be unhappy with; secondly, the people who are preparing contracts are not all equipped to prepare those contracts in many cases. The question then is, if that is the case, were these the same people who replied to the questionnaire because we are compounding the problem of levels of competence if we are then asking these less than competent people to respond to say whether they felt that the contract was well managed? I think it rather proves the reverse of what you were saying, does it not? Let us just stick to the question which is about levels of competence in terms of contract management and contract preparation. Are you happy with the information that has come out?

(Mr Gershon) I have just said that I was not. Ideally I should like to have seen no entries in the 0-25 per cent and the 26-50 per cent ranges. Mr Williams always

<sup>3</sup> C&AG's Report, Appendix 2.

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[Continued

**[Jon Trickett Cont]**

thinks we are a bit slow but in this area with the Gateway review process, from when we first launched it last February, we have been helping the department take a whole life approach to these forms of complex projects, not just PFI contracts but other complex projects as well, where we test explicitly for the skills in the public sector team in the procurement phase and the plans for the skills in the public and private sector teams in the design and build stage and the service provision stage. We highlight to the Accounting Officer where those reviews identify the sorts of weaknesses that this report is also highlighting.

69. Let me go on to table 8. I may not have time to get back to the C&AG. These are supposedly the ways in which VFM was guaranteed objectively according to the perceptions of the people responding to the opinion poll. It is interesting to see that large numbers of contracts do not seem to have had VFM exercises done on them, objective tests. If you take bench marking, for example, which I am not totally convinced is an accurate way of securing value for money, how convinced are you that the staff who were doing the bench marking were competent?

(*Mr Gershon*) Bench marking as far as I am aware not only involves the authority's own staff. They may well bring in third parties who have specialist market knowledge to assist in the bench marking exercise.

70. But it may well involving bringing in some extra staff.

(*Mr Gershon*) There are examples that I am aware of where I know that that has been done.

71. What guidance are you giving to the authorities and the departments as to these types of methodologies for securing VFM? Are you happy with these statistics?

(*Mr Gershon*) No, I cannot say I am happy because to say 15 per cent shared in refinancing benefits is cause for concern. I have indicated already through the revised advice and guidance we are giving departments that we have to take a much stronger position in the sharing of those sorts of benefits. The direct answer to your question is no, I am not happy with those percentages and we are doing something about it.

72. Okay. If I can just come back to the C&AG because I have been given my short term warning that time is running out. Mr Gershon is not too happy with the level of competence that has been revealed in terms of contract management and the procuring of contracts, the skill of those people. How happy are you about the level of competence of the staff who fill in your questionnaire? What steps did you take to ensure that these people were competent? I would guess that if it landed on my desk and I was the chief officer in the department I would pass it down to the person who was doing the contract to fill it in and probably make sure the boxes were filled in before it came back to yourself. Is that apple pie and motherhood and things really? What is this measuring, this document, in a way?

(*Mr Finlay*) In terms of the people who filled out our questionnaires, they were sent to the people currently in charge of the projects, whether that is on the authority side or the contractor side. Certainly from a lot of the feedback that we got, because we were regularly in touch with the people who were

completing these questionnaires, they were giving it a lot of consideration and the people at the top of the teams, even if they delegated part of the exercise to people beneath, the people at the top of the team were taking responsibility for sending it back to advisers.

73. Many of the people who were managing the contracts had not actually prepared the contracts in the first place. Let me just say this—I have to finish—you were asking them had their perception of the value for money changed and yet many of the people were either not qualified to manage the contract and/or had not even prepared the contracts in the first place.

(*Sir John Bourn*) If they had not prepared the contract in the first place they were not *parti pris* to it and were not under any obligation of previous activity to say what they did not think. It was an opportunity for them to say what they really thought.

Jon Trickett: In trying to demonstrate the dynamics of perception as they change over the lifetime of a contract, we now know from this report actually that the staff were changing. You were asking the staff at the time at which the survey went out rather than the time it was submitted. I have now received my final warning.

Chairman: You can still get an answer.

Jon Trickett: No, I would like to get the last word in.

**Mr Steinberg**

74. Page 10, paragraph 1.18, there is no need for me to quote the paragraph but if you read the paragraph it is very interesting, is it not, because really this does sum up the whole of the PFI, does it not? In fact it is the whole basis of the PFI, is it not? If the private sector do not get a big enough rate of return they are hardly likely to be interested in the project to begin with. They are only in it for the rate of return, are they not? There are no altruistic reasons why they are in it.

(*Mr Gershon*) The assumption is they are not charitable organisations and they are there to make a reasonable rate of return, as this report identifies.

75. Right.

(*Mr Gershon*) On the other hand, they are in the business, not just in terms of what they do for the public sector but with other customers as well, of providing high quality products, goods and services because if they do not do that they will not make reasonable rates of return and they will not prosper as private sector organisations. The rate of return is a consequence of taking business decisions and good management action.

76. For example, the hospital in Durham has just been completed under PFI, my understanding is the contract was based on the fact that there will be returns for shareholders of something like 20 per cent. If you are building into a contract that the shareholders are going to get 20 per cent dividends, somebody has to be paying more money than the project is worth in the first place, if we were in the public sector.

(*Mr Gershon*) I do not want to get into the deep water we did at the GOGGS hearing about the complexities of some financing issues, about what is the make up of a return and wherever a return is necessarily commensurate with a dividend.

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77. Presumably if a contractor is building into a contract the fact that he must get 20 per cent return for his shareholders, it must make the contract more expensive than it would have been if it was built in the public sector. You do not need 20 per cent.

(Mr Gershon) Mr Steinberg, let me try to explain this issue about the cost of finance. I still remember the debate we had here a couple of weeks ago. It is absolutely true that money costs the public sector less than it costs the private sector.

78. Yes.

(Mr Gershon) Typically, if you are a sort of credit worthy private sector organisation, it costs about two and a half, three, four percentage points more than it costs the public sector. You are having to fund the construction cost of a project which is, over the life time, typically around 20 to 25 per cent total project costs. That is making overall about a one per cent difference. If you take that extra to three to four per cent of 20 to 25 per cent it is less than one per cent difference. If that was the only thing then why would you do it but the whole point about having the private sector focussing on not only construction responsibility but having to take whole life responsibility is it should be able to find efficiencies that far outweigh that additional cost of money.

79. At the end of the paragraph it says: "The Office of Government Commerce is reviewing value for money and levels of return the private sector gets on its investments...". Why would it be doing that if it did not think the actual rate of return was too high in the first place?

(Mr Gershon) Because as the market matures and the risks become better understood by the private sector and the market develops, you would expect to see that the rates of return are diminishing over time more towards the sorts of averages the private sector would earn in other market sectors. That is the piece of work that I commissioned, to see whether that is happening in practice. That is what the theory says should happen and I am interested to assess whether it is happening in practice. You would expect on the early contracts that the return the private sector would make, provided the project was successful, would be higher than they would be making in a mature market. We should also bear in mind that some private sector organisations have lost an arm and a leg on PFI contracts. They have not all gone swimmingly well for the private sector.

80. That is probably an argument they should not have been built in the private sector in the first place. They should have been built in the public sector.

(Mr Gershon) No, no, no.

81. I have no great sympathy for that argument.

(Mr Gershon) The private sector have also lost money on conventional procurement as well.

82. I want to come back to that later on, to what happens when that does go wrong. Let me just continue down this track just a little bit more. The PFI and public sector development, I understand over a 60 year period would probably cost about the same but over a 30 year period the PFI is much more expensive than a public sector project, is that right?

(Mr Gershon) Are you making that statement about the particular hospital project in your constituency?

83. No, generally.

(Mr Gershon) No, that is not true. That is not true as a generalisation.

84. It is not true?

(Mr Gershon) No.

85. Is it true about the hospital in Durham, just as a matter of interest? You brought that up, I did not.

(Mr Gershon) I would very much doubt it. I do not know the detail of the public sector comparator but I would doubt it.

86. What happens if you find there is an excessive rate of return, what would you do?

(Mr Gershon) As a result of the study?

87. Yes?

(Mr Gershon) We would need to look at what steps we would need to take to introduce more competition into the market place or what other factors might be driving it. It might be that there are some particular risks we are seeking to transfer which the private sector is putting a very, very high premium on which is not justified and it might be better to advise the public sector client to bring that risk back into the public sector. There could be a variety of reasons. I cannot be specific about it. I just illustrate two of the possibilities that might be taken if the scenario that you have outlined comes to pass.

88. In your review will you be trying to discover if the project is making higher dividends than you thought in the first place and those dividends are cutting services, will you find that out in your survey?

(Mr Gershon) No, no. This is looking at rates of return, it is not an attempt to correlate that with the quality of the service that is being delivered.

89. Do you not think you should? My point is if high levels of rates of returns are being produced then they have to be paid for somehow. The only way I can see them being paid for is a cut in the service.

(Mr Gershon) Let me try to explain. When you bid a fixed price for a contract, irrespective of whether it is PFI, any sort of asset based contract where you have to bid in some way a fixed price, firstly you have to estimate what your costs are then you have to look at the risks you are taking and price those risks. You have to set aside contingency money against those risks occurring.

90. Yes.

(Mr Gershon) Firstly you have to win the contract, you have to put a price on the table, you now win the contract. If you manage those risks very well you do not use all your contingencies which will lead you to a higher than anticipated rate of return. If you have got your estimating wrong, that may erode your contingency, it may consume all your contingency, in which case you are now into a position known as loss.

91. Then you have to pay for that loss. How will you pay for that loss?

(Mr Gershon) You have only got a fixed income coming in.

92. Exactly.

(Mr Gershon) Yes.

93. That is what I am saying.

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[Continued

**[Mr Steinberg Cont]**

(*Mr Gershon*) But the client has remedies against the contractor for failure to deliver the contracted level of service because you get deductions under the contract for poor performance.

94. What you are saying is regardless of the performance of the contractor and regardless of the dividends that are made, this should not affect the service?

(*Mr Gershon*) The client has the lever to enforce the contractor to perform and deliver the contracted level of service. If he does not his losses just get worse.

95. Perhaps we are not going down the same track here. Let us just take the hospital as an example. If that hospital has to pay the contractor a certain amount of money per year, let us say £12 million a year, whatever it maybe.

(*Mr Gershon*) For a contracted level of service?

96. Right. That is for the building.

(*Mr Gershon*) No.

97. Not for the service?

(*Mr Gershon*) No, no.

98. They do not provide services?

(*Mr Gershon*) They will provide hard facilities management.

99. Yes, they will provide, perhaps, the car parking and the portering.

(*Mr Gershon*) No.

100. They do not provide the clinical services?

(*Mr Gershon*) No, no, no.

101. The point I am trying to make, if you will listen, is if the hospital has a certain budget and they have to take from that budget to pay for the contract, at the end of the day that contract is more than was anticipated because they then have to find extra money to pay the extra payments, where will that money come from?

(*Mr Gershon*) The extra payments are not triggered by the contractor making losses. I am sorry, although it is true in the hospitals clinical services are not within the scope of PFI, the contractor will probably have an obligation about the maintenance of the ambient temperature inside the building.

102. Right.

(*Mr Gershon*) He will provide soft FM services like catering, laundering, portering, i.e. the non clinical services.

103. Absolutely.

(*Mr Gershon*) Right. He contracts. There are key performance indicators in the contract which define the contracted level of service. If the contractor does not achieve that he gets debits off his payments for failing to meet the contracted level of service. If he has already made losses, because he got it wrong on the building, that is tough luck, you do not get extra money, that is one of the great benefits of PFI.

104. I hope that is right. My understanding and information that has perhaps been given to me, it might be biased information, is that at the end of the day if the hospital, out of its budget, has to increase its payments to the contractors —

(*Mr Gershon*) Because the contractor has made a loss?

105. Yes. Then they have to find that money from somewhere else and that means cutting services.

(*Mr Gershon*) Mr Steinberg, if you pass me that information, I am very happy to follow that up and personally come back to you on that.

106. Okay. We will move on. I am almost out of time. That cannot be right. Is it not a fact, the way I look at it, that the track that Jon was going down is absolutely right? Basically you are bound to say, if asked, it is value for money because at the end of the day you have no other option but to say that because there is no other avenue you can go down, therefore you have to justify it. At the end of the day there is only one way that a major capital project can now be built and that is through PFI.

(*Mr Gershon*) Sorry. It is not the case that is the only way of building capital projects.

107. Can you tell me a hospital that is now being built under a public sector contract?

(*Mr Gershon*) There are one or two traditionally procured hospitals.

108. Where?

(*Mr Ryan*) Can I just clarify. I cannot give you the names off the top of my head but I know that very recently on four hospitals in the NHS which had been due to be built under PFI it was concluded that after careful examination it was better to do it through conventional procurement. That is what is being done. That illustrates the fact that the public sector comparator is used properly.

(*Mr Gershon*) Mr Busby has just mentioned in my ear that he thinks that the one on the Isle of Sheppey is being done through traditional procurement, not PFI.

(*Mr Busby*) It fits the definition.

Mr Steinberg: I had six pages of questions I wanted to ask you, I have asked one and a half.

Chairman: You can come back at the end if you want to. Mr Rendel, unusually, has now found his reference to the question he was asking Mr Busby so he wants a very brief question to him before he leaves.

#### Mr Rendel

109. If I may, Chairman, because I am afraid, I have to apologise, I have to leave in a moment. Mr Busby, when I was asking you earlier about these ones that had deductions, you gave me an answer which I was surprised about. You may remember at the time I said I would look up the reference and come back to it. I have now been helped to find the reference which is paragraph 1.22 on page 11 where the report says that "... 58 per cent of authorities who had an agreed performance and performance deduction review process told us they had made performance deductions in accordance with those processes. 25 authorities told us that they had made deductions totalling £10.3 million". As I understand it, that is when the contractor's performance—as it says in the very first sentence there—falls below certain contractually defined standards. In other words, it is something that is in the contract. When a ward goes into maintenance for a period you do not get the payment during that period, that is in the contract. What we are talking about here are

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deductions for when the performance falls below certain standards. Now it seems to me if that is true and if this amount of money is being removed from your contractors, given that—as I mentioned earlier, I would hope the contractors were basing their tenders on the lowest possible price to get anything like a reasonable rate of return—then presumably in the end all these 25 contractors had failed to get a reasonable rate of return and I would have expected that to be pretty worrying from your point of view.

(*Mr Busby*) I can only repeat what I said earlier. As far as I am concerned, the ones I am aware of, the deductions were made in accordance with the processes which are contained within the contract. There are two fundamental ways on which a contractor is paid: availability of the service is clearly one of them. In the event that there is a problem with that availability, and that can come in all sorts of forms, then a deduction will be made.

110. Are you saying—let me get this quite straight—that in your view the contractors would have taken into account the likelihood of this level of deductions before they fixed the tender price to give them a reasonable rate of return?

(*Mr Busby*) I think they probably would, yes, because it is totally unreasonable to expect every ward to be available for 30 years 100 per cent of the time.

111. Can I just ask the C&AG, is that how you understand the PFI is supposed to work or perhaps Mr Gershon would like to answer this? Is that what you understand, they are expected to set up their contract prices with an allowance for the fact that they probably will fail to do what they said they will do in the contract?

(*Mr Gershon*) Can I put it this way. When I was on the other side and we were bidding for a PFI contract, you would make probably an allowance that certainly in the period immediately following what you describe as the start up phase of the contract, you would probably make some contingency against meeting the contractually defined levels.

Chairman: I am going to stop you there.

Mr Rendel: That is fine. I am appalled, but that is fine.

### Mr Jenkins

112. Mr Busby, it is a strange set up, is it not? We go through all this system and I bet you must wish for the bad old days or the good old days again. When we were building hospitals in the good old days, we would start off with a price of £200 million to build a hospital in two years.

(*Mr Busby*) Yes.

113. Then by some miracle we would find things go wrong or things not up to standard, we suddenly found the floor was not good enough, we would call the architect and say: “That ward there would look much better if the floor was wood or the doors would look much better in glass and if they had gold handles on it would be much better, you know”. The architect was trying to keep costs down because he was paid a percentage of the final price. He would say “Oh, no, all right” and we would get this extension and it

would take three years to build and cost £300 million and you use the three years and the £300 million and then suddenly you got cut back to produce this building in two years for £200 million. Do you not rue the day anybody thought of this scheme? Yes, is the answer.

(*Mr Busby*) It was a considerable shock to the industry when the scheme was initially suggested by Government. The industry struggled significantly with the additional risks that they were asked to take on board as a result of PFI but there is no doubt that the good old days—as you describe them—did a number of things. It certainly in the main, if you use hospitals as the example, did not provide value for money to the public sector, of that I am absolutely convinced.

114. It was awful.

(*Mr Busby*) It was awful, yes.

115. They were all part of the same gang.

(*Mr Busby*) The returns that the contractors get, I am fascinated by some of the comments that have been made around the construction industry shafting the public sector. The reality is that my industry probably makes a return on average of about two per cent of turnover, that is the return that we as an industry on average will get. My company has been very proud to announce for the first time it has managed to get one per cent profit margin on its turnover. There are industries which I know contract to the public sector, Mr Gershon, where margins of, let us say, ten per cent are thought to be more appropriate. That does not happen in this industry.

116. IT Companies are 15 and 20 per cent.

(*Mr Busby*) Fine, yes.

117. Construction is quite well known and recognised. Schedules and rates, for example, you can work these things up reasonably simply and easily. Here is the old building, you have a chance to maintain it, taken over a 30 year lifespan where you have a responsibility—

(*Mr Busby*) Absolutely.

118. You have to make sure it is built right to start with.

(*Mr Busby*) Absolutely so.

119. I am surprised you find it amazing you have to take wards out. You have to take wards out to paint them.

(*Mr Busby*) Yes.

120. To put new windows in to them, new lighting systems in, ten years you have to refurbish the ward as you go through the hospital. This is a normal maintenance programme.

(*Mr Busby*) That is the point I was trying to make but clearly failed. As far as I am concerned if you, for example, do not paint a ward every, say, two years, I do not quite know when but say every six years, I think that is wholly unacceptable to the patients. Are we going to paint the ward whilst they are in it? Is the ward available during the process? If it is not then it is right that the deductions should be made for non availability. I think that is healthy.

121. When you set out these schemes, if you stay on this theme of hospitals for the moment.

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(Mr Busby) Yes, I am happy to talk about hospitals.

122. If you sat down and wanted a good deal, and the good deal was "We can build this, not with the 15,000 changes which we used to do to push the revenue over a three year period, but we can build with 15,000 changes over a two year period and then maintain it" if you sat down with an open book and said "This is what I am going to do. This is what it will cost me. This is how it will turn out", then we had a contract where if things did go wrong, through no fault of anybody's, you could not predict the risk, there was some variation of contract to take this into consideration and if it cost more the contract could be altered and if it cost less it would go down. Did you ever approach this sort of stance?

(Mr Busby) There is a considerable number within here who do operate on an open book basis, not the hospitals, I would suggest, but other parts, other types of PFI would come into that category. The way it is set up is that we have to assess risk on day one of the contract. If we get that wrong, and we often do, then we end up paying for it. That is part of this process. That is why I said when the idea was first promulgated the industry really did take two steps back and worried considerably about whether it was in a position to cope with these risks.

123. I have not seen any figures on this. If I was going to try and defend PFI and say "Under the old system this hospital has cost £300 million, it came in a year late, there was a 30 year maintenance contract on it. I had to pay £300 million or X million at a discount of six per cent. This has now cost us £200 for 30 years", it would not make a hell of a lump sum difference as to why we should not go into a PFI contract or not, let alone transfer risk. I have never seen the figures. Have you worked on these figures?

(Mr Busby) They exist.

124. They exist?

(Mr Busby) I am sure they do.

125. Can I ask the Treasury, do these figures exist?

(Mr Glicksman) I think the bit of the Treasury which would see them would be more likely to be the Office of Government Commerce, which is a part of the Treasury.

126. Mr Gershon, do you have the figures?

(Mr Gershon) We have the public sector comparator. You talked about the maintenance, what the contractor is obligated to provide is a service environment in which he has to do maintenance.

127. Of course.

(Mr Gershon) He is contracted to provide service levels. He has to make decisions then about the maintenance, and the frequency of it, and that can influence his decision about what equipment he has. He may spend a lot more money to buy equipment that needs much less maintenance.

128. I accept all this. I went through all this with Mr Busby just now. I said do we ever do the comparators, the figures, as to why PFI is a good deal?

(Mr Gershon) In every PFI decision there is a comparison made as part of the process, not exclusively but as part of the process of the

determination of value for money over the life of the project there is comparison made with the public sector comparator.

129. Why do we not get them? Do we have to ask about them?

(Mr Gershon) In some cases in the NAO report the NAO has commented on the comparison between the chosen alternative and the public sector comparator.

(Sir John Bourn) Yes. We have produced reports on particular projects and one of the items included in those reports is exactly that kind of information, yes.

130. Let us move on. Mr Busby, it said 20 authorities thought there would be no innovation, according to the contract, and 30 per cent said no innovation afterwards. Is there anything in PFI which stops the private sector from innovating? Can you think of any illustration?

(Mr Busby) Inevitably if you are defining a level of service it imposes restrictions on you so I suppose I have to answer yes to that. I feel the environment that it creates is far more conducive to innovation and cost savings and sharing than any other process that, certainly, I have been involved with in the past.

131. You do not agree with the 30 per cent who feel there had been no innovation at all during the PFI system?

(Mr Busby) If you look at the contractor's view of innovation it is a much higher percentage, I think, if I am on the same paragraph as you.

132. Yes.

(Mr Busby) I think that is encouraging because there is clearly an attitude prevailing within the contracting side to innovate. I think this is still a learning process for everybody and the fact that there is quite a high proportion within the public sector which believe that innovation is there on the agenda every day is heartening. I am sure if you ask the question again in 12 months' time you will end up with a higher percentage than you presently have, it will evolve.

133. This is a perception which is different from the contractor actually.

134. It is bound to be. I have seen the statistic, which might be amusing, today somebody told me that 38 per cent of women have sex every day but only 26 per cent of men do. I cannot work out where the difference is. The perception between contractor and supplier would be different. Maybe it is a matter of time, maybe more openness.

(Mr Busby) There is no doubt that there is considerable innovation in the early stages of PFI.

135. Yes.

(Mr Busby) If you take the prison process, for example, prisons historically were built in situ, on site, concrete, each one bespoke. Now, to be quick about it, it is like lego. These things are produced in a factory, they come on site and are slotted together. I am simplifying it too much but that is it.

136. They should be.

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(*Mr Busby*) Absolutely. That came out of PFI. The consequence of that is lower construction costs, shorter construction periods. I am told by my prisoner friends that they would much prefer one of those prisons than the traditional form.

137. What about the amount of damage in prisons?

(*Mr Busby*) That is why they are made out of pre-cast concrete. You have to be quite determined to damage a prison.

138.

There is still an appalling level of repairs and maintenance in prisons.

(*Mr Busby*) Mostly on the older ones, I think, the brick built ones, Victorian design, for example, but inevitably there is, that is the inmates, I think. I hope it is the inmates anyway.

139. When you have these different schemes bolted together and we get some good ones and some more difficult ones, either way we are going to fail on some of them.

(*Mr Busby*) That is true.

140. Where are we passing the good ones on? Where is the source? Where is the centre? Is that Mr Gershon's remit? Do you pass on the good news and say "This is a good scheme. It is a good PFI. This is how it is set up. This is how it is run. These are the check points to abide by"?

(*Mr Gershon*) Yes. Part of the Gateway Review process is to get a much sharper insight on to where we see good things happening where we can encourage other clients to replicate them.

141. You use this term "encourage". Why do we not insist they pass through the process, the procedure, before they are allowed to PFI?

(*Mr Gershon*) I am probably going to get this wrong in constitutional terms, still as a relatively lay person. At the end of the day accountability for what goes on within a department rests with the individual Accounting Officer. He is the ultimate authority. He is accountable to you and to Parliament for the decisions that he makes. Now, with the Gateway Review process, my experience has been because of where we have deliberately focused the attention on the early life of projects where there is the greater scope for management to take corrective action, the accounting officers are paying a lot of attention to the recommendations that are emerging because much to my surprise most of them do not seem to like coming here defending what has gone wrong in the past. They seem to welcome the recommendations that we are providing to them to help try to get projects on to much stronger foundations in the future.

142. I think we try to be as helpful as we possibly can. One of the things I try and do is to explain that. When a person comes here as an accounting officer and says "I have put a PFI through the system. I took no advice. I did not put it through the guidelines.", they can expect to get roasted. You can take that message back. I am surprised as a Government we have not stopped them from going ahead with any scheme unless it is given clearance and they have gone through a set procedure, understood what the risks are and how to overcome the possibility of a risk. You say it is left to each individual authority or each individual accounting officer?

(*Mr Gershon*) It is still very early days yet. It can only have real benefit on projects which are still very much in their gestation period. With the Gateway Review, my experience has been that the Accounting Officers respond to the recommendations very positively.

143. If I can go on, very quickly. I think you did answer this. I noticed declining enthusiasm for PFI but I thought as the projects become less appropriate with PFI, as the risk was much more difficult to transfer, you said "Yes, there were one or two which now we have scrutinised we have decided to pull back from because there was recognition that you cannot transfer risk."

(*Mr Gershon*) Mr Ryan said that in a number of NHS hospital projects the client felt that there was better value for money to be obtained by going down a non PFI route than a PFI route. Therefore he went down the route which provided better value for money.

144. Mr Busby, quickly. How do we stop—this is almost impossible—the contracting team from your particular company or any other company having stitched up a deal, a very good deal, then moving off to stitch up another one? How do we ensure the contractor leaves his team in place for the duration of the contract?

(*Mr Busby*) I had a slightly different view to what was expressed with regard to this continuity because on my side of the business the skills needed to put the deal together are very different skills from those that are needed during the progression of the contract. Yes, there will be undoubtedly in any organisation some links but fundamentally the people that are building the hospital, for example, are not the same ones who will negotiate the contract to build it. This requirement for continuity from our side of the fence is somewhat different.

145. And impossible to maintain?

(*Mr Busby*) Always. If we felt that we would like to do that then I am afraid the market forces would obviously prevent us from achieving it, I suspect.

Mr Jenkins: Thank you very much.

#### Geraint Davies

146. Mr Busby, the Kier Group that you are in charge of turns over one billion pounds a year.

(*Mr Busby*) Yes.

147. Can you tell me what proportion of that is PFI?

(*Mr Busby*) In turnover terms last year less than 50 million of it.

148. Is that all? Okay. So there is 50 million in turnover. I think you said you expected over two per cent return on turnover, that you were hoping to reduce it to one per cent. I hope the shareholders are not listening to that. Can I ask how your expected rate of return between PFI and non-PFI compares?

(*Mr Busby*) PFI returns, on the experience to date, are higher.

149. How much? What are the figures?

(*Mr Busby*) About 2.5 per cent, I would estimate.

150. On PFI?

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**[Geraint Davies Cont]***(Mr Busby)* On PFI.

151. What is your normal rate?

*(Mr Busby)* One per cent on other contracts.

152. Right.

*(Mr Busby)* But, if I could add to that?

153. No, do.

*(Mr Busby)* The risks involved in this process are significantly greater. For example, the contract that such a return made, because it is really largely one contract, required us to invest £4 million before we had a signed deal. Right up until a minute to midnight that deal could have aborted and we could have lost £4 million, and that is more than we made on the job.

154. You invested £4 million before signing a deal?

*(Mr Busby)* Yes.

155. In preparation with solicitors and all the rest of it to get the contract?

*(Mr Busby)* Yes.

156. For a contract of what value?

*(Mr Busby)* Just under 70 million.

157. Seventy million?

*(Mr Busby)* Yes.

158. I thought you said a moment ago your total turnover was only 50 million for all PFI projects.

*(Mr Busby)* Last year that 70 million contract was of two and a half years duration.

159. So what value of contracts have you established with PFI extending into the future if you brought all that cash flow together?

*(Mr Busby)* In contract terms I have not got that. Can I come back to you on that?

160. You are a fairly small player because we are looking at something like—

*(Mr Busby)* We have about half a dozen contracts under PFI.

161. In the generality of this report, on the 400 projects the Government do they have already committed £100 billion and you are a very, very small fraction of that, you are talking about millions of pounds, or are you into billions?

*(Mr Busby)* In total it would be 150 million-ish on construction work over the half a dozen that my group has.

162. It is small beer in the totality of things. Basically in ballpark terms, and I know from what you say this is being distorted by this one contract, you are looking at, say, 2.5 per cent return versus one per cent on normal activity, so two and a half times the level. You think that is a reflection of inherent risk, yes?

*(Mr Busby)* Yes, I do.

163. If there is inherent risk, risk goes both ways so you would expect in the wash that it comes out at the same level, one per cent, because you win some and you lose some.

*(Mr Busby)* No, I do not. I am not being asked to invest £4 million up front in any other part of my business.

164. Do you think 2.5 per cent return is normal or below average?

*(Mr Busby)* I am sorry?

165. Do you think 2.5 per cent return is normal or below average, because it seems a bit low from the figures I have heard before?

*(Mr Busby)* We are in a competitive marketplace. Every contract that we have been awarded under PFI has certainly been in competition and I would be surprised if our returns—

166. Have you lost a lot of bids?

*(Mr Busby)* Yes, of course.

167. Okay. You think it is rational from the point of view of your shareholders to put forward £4 million bidding for a contract, paying solicitors or whatever you did, for a £70 million contract?

*(Mr Busby)* There are times when we questioned it, but yes.

168. If you had not won the bid then that £4 million would have been lost money. Would that have been factored into other PFIs?

*(Mr Busby)* That is why I believe the returns that we are getting are fully justified. We have lost contracts.

169. In this example, what was it for incidentally?

*(Mr Busby)* A hospital.

170. Presumably there were competitors who also spent £4 million and did not get the deal, is that correct?

*(Mr Busby)* No, I think that is wrong. There could well be competitors who spent up to, say, £1 million.

171. £1 million?

*(Mr Busby)* We have certainly incurred £1 million of costs on a project that we have not got.

172. If you are running, as you are, a successful private sector enterprise then you need to stay in business. In the global analysis of PFIs, if each PFI is four companies bidding, for argument's sake, and they all put forward in this sort of contract between £1 million and £4 million up front for the bid then we are talking about a net loss in this sort of industrial system of three or four million through that competitive activity that you have to recover from prices if all these companies are to keep going. That is true, is it not?

*(Mr Busby)* Your numbers are not correct.

173. They were your numbers, with respect.

*(Mr Busby)* Taken out of context.

174. Let me give you it again then. You said in this example you put £4 million and other competitor companies were putting £1 million up front. Is that an abnormal situation, is that what you are saying? That was the situation because that was the evidence you have just given.

*(Mr Busby)* Yes, that was the situation, but you said that, in fact, there were typically four bidders, all four bidders would not be spending at least £1 million. There is a process here.

175. How many bidders would there be?

*(Mr Busby)* Typically four, but in the early days of getting down to the final two the costs are much lower.

176. Is there a sense in which some prospective competitors are actually excluded from the competitive process by the very high entry costs in terms of lawyers and all the rest of it?

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**[Geraint Davies Cont]***(Mr Busby)* Yes.

177. If I was running a company and knew that you were bidding and you were going to spend £4 million even though I could do a better contract, I would think, I would not be prepared to bet £4 million, I would go elsewhere.

*(Mr Busby)* Yes.

178. Could I ask Mr Gershon just on this narrow line really. You are in the midst of reviewing the rates of return for PFI deals, are you not, or rather your organisation? That is correct, is it not?

*(Mr Gershon)* We have commissioned a review, yes.

179. Tell me the spread of rates of return you are picking up?

*(Mr Gershon)* The review is under way, it has not concluded.

180. I know that but I asked you to give me an indication of the spread of return or do you have no information at all?

*(Mr Gershon)* We do not have that data, as yet.

181. You have begun that review but you have no information at all having begun the review, is that correct?

*(Mr Gershon)* I do not expect to have until the external reviewers are ready to report against their assignment.

182. Have you any idea, a rule of thumb, of the sort of rate of returns you would expect or have you simply no idea what the review will generate? You are a man of considerable business experience, I know that, so what is reasonable, do you think?

*(Mr Gershon)* I do not know what the review will highlight.

183. When you get the figures you will have no idea how to evaluate whether it is fair or not?

*(Mr Gershon)* I can only tell you from my own experience, which is largely not to do with PFI, what one might consider to be acceptable rates of return if you were looking at an investment.

184. Precisely. So what sort of rates would be reasonable for the private sector?

*(Mr Gershon)* If you were using the shareholders' own money as opposed to using debt, if you were using equity to find an investment, if it was an investment in a piece of capital not just in a contract, in terms of internal rates of return, post tax, in real terms, you would normally be looking at something in the range of somewhere between eight and 15 per cent.

185. So eight to 15 per cent. So Mr Kier is not doing very well for his shareholders, is he?

*(Mr Gershon)* No, what Mr Busby talked about—

186. Mr Busby, sorry.

*(Mr Gershon)*—was a margin which is looking at a profit to sales ratio, which is not the same as looking at the return on investment.

187. Fair enough. What is your return on investment actually, Mr Busby, so we are not talking apples and pears?

*(Mr Busby)* The targets within PFI, and I think that is the relevant here, are in line with Peter's estimate.

188. So eight to 15 per cent?

*(Mr Busby)* Post tax it is maximum 15.

189. I will move on, I do not want to get too bogged down in this. Can I just ask the NAO something. I do not want to dwell on this because Jon picked it up, but am I right to say that this report is not really a test of value for money and the like but simply, as has been put, a questionnaire and one of the questions that emerges out of this is when are we going to have a consistent methodology for measuring value for money and PFI projects? This almost masquerades, so I was fooled, but basically it is just asking a lot of people what they think, is that right?

*(Sir John Bourn)* It is a report that does what it says it does. It is a report that looks at the replies to a series of questions on 121 projects. It shows what the people who were responsible for the management of those projects believed to be the case on the level of satisfaction as they saw it. It is not less and it is not more than that.

190. Obviously there are all sorts of bias in terms of who responds and all this as to whether they think it is good or bad, but alongside that, given that PFI is the political menu of the day, there will be a propensity for people to feel they should say "this is great, we get a lot of added value".

*(Sir John Bourn)* I do not think there is any greater incentive to say that than if they were people responsible for a traditional procurement, because if that was what they were working on and if you say because they are working on it and in a way their careers are going to be judged on it, there will always be a propensity to say that what you are doing is going well, whether it is PFI or anything else.

191. Can I ask Mr Gershon, you mentioned you did not know much about the PRIME project, did you not? I was surprised by that.

*(Mr Gershon)* I am aware of the NAO report and what I know is based on the NAO report.

192. I only mention my surprise because I understand from the report that half of the total value of penalties paid for failures of contract, half of £5.6 billion, on page 11, 1.22, was in this PRIME project. I would have thought you would have found out quite a lot about the failures of that but you did not, did you?

*(Mr Gershon)* That was an example of where the contractor was contracted to do a defined level of service and in the initial period—I think it was a year—of operation after hand over he clearly struggled with great difficulty to meet the contractual levels, fell short and paid a whopping penalty which then acted as an incentive for him to sort out what he had to do. It had exactly the desired effect in the eyes of the client.

193. More penalties mean good contract management. Can I ask you about your wider commercial skills agenda. The situation is that in the 1980s and 1990s we had the then Government bringing in skills market testing and a huge exodus of procurement managers from the Civil Service, a valuable asset, went to the private sector. Alongside that we have got a situation now where different people can enter different departments at the same

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level at widely different salaries and there are big differentials between departments, which stand as pillars, and that undermines the opportunity for you to move procurement managers, contract managers, around the system between departments. Is that a fair summary?

(*Mr Gershon*) It is not just looking at procurement specialists in a narrow sense. It will look at things like project management, contract management and other key disciplines that are necessary to ensure the successful management of the whole life cycle of a project. Yes, part of that is because departments have to respond to the business needs that they face and the market conditions at the time. If you have to go and recruit people today —

194. Are you paying them enough, these people, to match their private sector counterparts?

(*Mr Gershon*) I think I have been asked that question on a previous occasion by this Committee when I was examined on the management of the procurement of professional services. I said at the time in a number of key skills areas there were big pay differentials between what the private sector paid for certain practitioner skills and what the public sector pays.

195. Are there differentials between departments as well?

(*Mr Gershon*) There are also in some areas differentials between departments.

196. Are there incentive systems?

(*Mr Gershon*) They have to be careful. In some instances departments need people at a higher grade than other departments and that clearly also drives salary.

197. Can I ask you something about figure 8. It says in figure 8 we have a situation that only 55 per cent of accounts are open book accounting. We cannot see profit transparency. Only 49 per cent have benchmarking, so if unit costs go down in the market place we cannot track down our costs. Only 15 per cent are arrangements for sharing of refinancing gains. Do you not think all those are very profound indications of failure to deliver optimum value for money in PFI contracts across this sample?

(*Mr Gershon*) I did not catch the question.

198. Yes. All these indications, namely half the people do not bother with benchmarking so if the unit costs of what they are providing slips down they do not track that. Only 15 per cent have arrangements for refinancing. Somebody comes along and says “This is the cost” and they go off after they have shown there is no risk, it was all a pretence or misunderstanding. They refinance and lower costs of capital, make lots of money, there is no arrangement for refinancing in 85 per cent of cases. In 45 per cent of cases there is not transparent open book accounting, as it is called, so both sides know how much money is being made out of the deal. Do you not think that is a disgraceful situation in terms of delivering value for money for the public sector? What is your response to that?

(*Mr Gershon*) I think I have been asked that question before.

199. You keep saying that. Can I have an answer, not the answer “I have been asked that before”. What is the answer?

Chairman: I am afraid in this Committee Permanent Secretaries get the same question over and over again. You have to give the same answer.

(*Mr Gershon*) Right. Well, I will give exactly the same answer as I gave before...

200. I am not talking to somebody in the Department now.

(*Mr Gershon*) This is not good. 15 per cent showing in refinance is clearly not acceptable. I have already indicated, the action we have taken is to move the position that it will become the norm in PFI contracts that there are explicit refinancing gains in all contracts for 50:50.

201. Okay. Just very quickly. On figure 8, the 15 per cent refinancing benefit within a year, that will be near 100 per cent?

(*Mr Gershon*) We cannot retrospectively do that.

202. I know that.

(*Mr Gershon*) If you took a sample of contracts going forward, let today, you would expect to see that number become 100 per cent.

203. Open booking accounting, 55 per cent now, is that going to move to 100 per cent?

(*Mr Gershon*) There are a range of other techniques to establish ongoing value for money. I would not necessarily expect to see open book accounting used in all contracts. I would expect the percentage to become much higher. I would not necessarily expect to see all VFM mechanisms used in all contracts.

204. No, but if you have a target. This cloudy language means people think they do not have to do it. I am talking about your focus on benchmarking, open book accounting, and you have already said about sharing of refinancing.

(*Mr Gershon*) Yes, and the Gateway Reviews explicitly test how the department is planning in the pre-contract phase to secure ongoing value for money in the post-contract phase.

205. You would expect benchmarking and open book accounting in the future, is that true, just so we are clear where you are going and where you have been?

(*Mr Gershon*) Yes.

Mr Davies: Thank you.

Chairman: That is a good way to answer on that. Thank you, Mr Davies. Mr Bacon.

**Mr Bacon**

206. Mr Gershon, it is a pleasure to see you, although I feel on this occasion you will be singing to me rather than the other way round. The question which interests me is this question about whether the public sector is “managing the contracts well”. You have said a number of times that you are taking specific steps to improve the ability of the public sector to manage these processes well. Can you just expand on the specific steps a little for us?

(*Mr Gershon*) Yes. Take, firstly, the Gateway Review process. That is testing various points in the life cycle of the project, from the very earliest stage.

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[Continued

**[Mr Bacon Cont]**

You could relate that to the earlier comment about women and sex, I am not sure I would use it, to describe the very earliest stages of conception of a project through into the operational phase, whether the departments are taking account of best practice using sound management techniques, how they are planning to resource the teams and whether they are resourcing the teams with people of the appropriate skills and experience. As we get a body of projects that have been through that process, and given the period of time it takes for projects to move from conception through to operational service, is going to take a number of years before we see the full benefit of that but we will see a growing body of projects that are on much stronger foundations than a number of public sector projects which have come in front of this Committee all too often in the past. That is one of the steps we are taking. We are looking in a number of areas to provide better advice and guidance, that is both at what I describe as the operational and business level where the OGC inherited an enormous volume of advice and guidance from its antecedent organisations, and we are going through a process of updating it and making it more coherent. Some of the advice which came from different origins was inconsistent and in some cases in conflict with each other. As an example of that, we are planning that by the end of next March we will have provided revised operational guidance in the area of contract management because we have looked at our contract management guidance and it is inconsistent and it needs updating to take account of helpful reports like this and other reports which have shown the need for better contract management advice. We have also identified that there is a need to provide much more focused advice for accounting officers and their management boards because in my experience it is very difficult to expect a very senior busy manager to read a 50 or 100 page advice document that is designed for middle management and practitioners. We have produced these fold out two page documents which are trying to help Accounting Officers focus on critical issues. We have done three of those, two of which I think are relevant to this hearing, which are about managing partnering relationships and why service contracts can go wrong. We have another one on the stocks, as I alluded to earlier, which is about how value for money can be assessed and determined, the sorts of factors that need to be taken into account in identifying value for money. Whether it is PFI or non-PFI the generic issue is the same.

207. Can I interrupt you because it is all very interesting and actually you have raised a couple of other questions but I know I am going to run out of time if I do not interrupt you. It leads on to a question I was going to ask later about the position of the OGC in the firmament. One of the things you said much earlier was if the OGC is consulted by departments they get a very clear steer. To what extent is your job about getting the attention of Accounting Officers and to what extent can you invoke powers to require them to do what you want?

(Mr Gershon) I said that I want to win hearts and minds because I am great believer that if you have people's hearts and minds you can achieve far more change than if you instruct them what to do.

208. I am asking the Lenin question "who whom". Machiavelli said given the choice between having someone fear you and having someone love you he would go for fear.

(Mr Gershon) My minister is the Chief Secretary of the Treasury responsible for public expenditure and above him sometimes sits Gordon Brown, the Chancellor, and it is known within departments that if I feel they are doing something which is fundamentally not conducive to value for money that I have escalation routes to draw the matter to their attention. I would hope to win that argument on a face to face basis with the departments but if I cannot I have resort to that weapon.

209. You keep a little button under your desk.

(Mr Gershon) And I hope I never have to use it because I would regard it as the nuclear option.

210. The Gateway Review process, as it is now set up, is it something through which every project now goes as a matter of course?

(Mr Gershon) Yes.

211. It is not an option for departments, they have to go through it?

(Mr Gershon) In central civil government.

212. That brings me to paragraph 2.9. Presumably you are referring to health authorities or local government that do not necessarily go through that Gateway process, is that right?

(Mr Gershon) At the moment that is the case, yes.

213. Is that likely to change?

(Mr Gershon) I do not know. For example, the Byatt review on local government procurement recommended the adoption of a Gateway-like process for big capital projects in local authorities and ministers are considering that recommendation. We are in discussion at the moment with the NHS about how the Gateway process could be used on some of their projects.

214. Considering the *Sunday Times* ten days ago reported that between 16 and 20 per cent of all the health service budget is wasted through fraud or inefficiency, I hope you are right and something happens. In paragraph 2.9 it talks about contract management manuals and how useful they can be but "only a minority of authorities had produced such manuals" whereas in actual fact where they were produced people were very likely to regard their relationship as very good. It is basically saying that if people have a very clear idea what they are supposed to do because there is a contract manual then it is much more likely that things will go very well. Plainly that being the case, manuals being a very good idea, yet only a minority of authorities having contract manuals, can you say when it is going to change so that it is utterly standard to have a contract manual?

(Mr Gershon) What I can tell you is that in the revised guidance that I referred to earlier about contract management, this will feature in that as part of the updated advice and guidance. I would certainly expect in Gateway Reviews that the review team would be testing what methods were in place to facilitate the ongoing management of the contract. Part of the evidence they would be seeking would be a plan to produce a contract manual of the type described here.

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AND MR COLIN BUSBY

[Continued

**[Mr Bacon Cont]**

215. When do you think you will promulgate your updated advice and guidance?

(*Mr Gershon*) On contract management we are targeting to get that out by the end of next March.

216. So how long after that would you expect local authorities and health authorities to have taken it up and done something about it?

(*Mr Gershon*) As I have just said, my remit does not extend either to local government or to the NHS at the moment.

217. Nonetheless, this is advice that you are issuing which will be taken up throughout the public sector, will it not, in some form or another?

(*Mr Gershon*) Yes. What I have said is we would then see to what extent some of that we could then embody in terms of advice that we do provide to the wider public sector through PFI and encourage that to flow out across the wider public sector.

218. All I am saying is that I would find it disappointing if we were reading a report like this in a year's time where contract manuals were only issued in a minority of cases even though plainly they have a good effect.

(*Mr Gershon*) I would agree. The experience to date is where we have produced updated advice and guidance there is an encouraging level of appetite in the wider public sector to take our revised advice and guidance, even though there is no mandate for people to do that, to take advantage of it. I think it is encouraging that Sir Ian Byatt thought the Gateway Review process had sufficient value to recommend it in his own review.

219. Can I ask you a specific question about the transfer of risk. In paragraph 1.13 it talks about authorities being tempted to transfer inappropriate risk. Mr Busby earlier said the issue of risk is one where it ought to lie with whoever is the most appropriate holder of that risk. What is the mindset of the negotiator going into a negotiation? Is it, and one might expect it to be, intuitively one would think it would be, "let us offload as many risks as we can" and the commercial provider trying to commercially accept as few risks as possible, or is it in the minds of authorities, do you think, in negotiating consciously to think about keeping risks themselves rather than transferring them because of the consequence down the road?

(*Mr Gershon*) In the light of the experience that has been gained, and as risk management processes become more mature within departments, there is a greater awareness about what risks are sensible to transfer, or to seek to transfer, to the private sector and which ones need to be retained and plans put in place as to how those risks should be managed. Catastrophic type risks, like where you still have to provide a public service or the supplier goes bankrupt, have to be thought about. Having said that, however, the public sector will always be trying to extend the envelope of risk that the private sector will take, what may be the optimal allocation today may not be the optimal allocation tomorrow. As the private sector gets a better understanding of the market they may be willing to take more risks. So you would expect the negotiators to be trying to push out the envelope, but to try to do that within a

framework that they are not trying to transfer risk which can never be transferred wholly to the private sector.

220. That is a very helpful answer, thank you. I would like to ask you about the position of PFI in the firmament generally. To what extent do you think PFI is understood by public servants, by politicians, by the public, by journalists?

(*Mr Gershon*) I think there is still some way to go, particularly in the wider public, to communicate the real benefits of PFI and to try to clarify some of the conceptions that people have around PFI. I think amongst public sector procurers there is recognition that PFI is a powerful acquisition tool to use in some, but not all, circumstances and can be a powerful way of getting value for money, but not the only way; it has to be considered on its merits. I think the perception of the tool is rather different from the reality of the tool and we have to do further work to change perceptions.

221. Your answer is incomplete. You mentioned the public and you mentioned public sector procurers but perhaps wisely you did not mention politicians. The impression I have is that it is not particularly well understood by large numbers of people in all sorts of facets of life. Would you say that is totally unfair?

(*Mr Gershon*) Not well understood. You said do I think that is totally unfair, no, I do not think that is totally unfair.

222. Right. I will not press you further on that.

(*Mr Gershon*) I think we have to demystify some of it. Some of the language we use to describe it does not help improve understanding of it. When we talk about it in terms of complex financial engineering I do not think it is reasonable to expect normal human beings to understand what things like net present value and internal rates of return and all that stuff mean.

**Chairman**

223. Do not go into it now.

(*Mr Gershon*) I have no intention of doing so, Chairman. I do not think we help ourselves in communicating what the benefits of this are about.

Mr Bacon: Chairman, I asked the clerk for a seminar on net present values and rates of return.

Chairman: You can go to it.

**Mr Bacon**

224. That being the case, there is plainly a big communication job to do and you are the adviser and guider for Government departments on how they should assess the value of these projects and whether to go ahead with them, but as with many things the communication is very much part of the answer. What steps are being looked at by your office or others in terms of improving the level of communication and understanding about PFI?

(*Mr Gershon*) With which community?

225. With the wider public. They were the first people you mentioned in your earlier answer.

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[Continued

**[Mr Bacon Cont]**

(*Mr Gershon*) In that area I think we have to look for direction from ministers as to what they would like to see done and I do not regard that as something I can do off my own bat.

226. But you accept there is a need to do something?

(*Mr Gershon*) We clearly input. I just said I think on the clarity of understanding of the benefits and some of the currently held conceptions there is always room to do better. That is my personal opinion, which I may get shot for when I leave.

Mr Bacon: I think that is absolutely right. Thank you very much.

### Geraint Davies

227. A general question about risk transfer, in particular for longer contracts. Can you just comment on this suggestion that basically if you go into one of these long contracts and the public sector has a duty under all circumstances to deliver a public service, to what extent is there a real opportunity to actually exit and either provide another provider or provide something directly? Do you want to make a general comment?

(*Mr Gershon*) Under the standardisation of PFI contracts there are termination provisions included in the contracts that define the circumstances in which a client can terminate, which include termination where there is contractor default.

228. For argument's sake I will not carry on. If I have a contract with you and you are the supplier, as it were, and you provide a standard service over time and in the future unit costs go down but the balance to the consumer goes up and the whole specification begins to change and I try to negotiate with you because I want to change, how easy is it for people in the future to exit—this is public sector—without facing massive penalty clauses? I am just wondering what your view is down the line, whether Government agencies will find themselves in a situation where with new consumer demand alongside lower unit costs and very clever lawyers they will find themselves in a position where they provide sub-standard above cost.

(*Mr Gershon*) That is why standardisation places great emphasis about what authorities now need to do in PFI contracts to configure the contracts to cope with change and satisfy themselves that change will be delivered on a value for money basis through the life of the contract.

229. You are satisfied we can deliver that?

(*Mr Gershon*) We have the standardisation route and those sorts of issues are things which are tested during the Gateway Review process. We have a number of mechanisms in place now which are helping authorities get a very clear focus on this important aspect of PFI.

230. See you in a couple of years.

(*Mr Gershon*) Does that mean there may be scope to take further action in the future? There may be. We need to keep the matter under review.

Geraint Davies: I will leave it there.

### Mr Steinberg

231. It struck me that really we are talking about risk and transfer of risk but at the end of the day if anything goes wrong you are going to bail it out, are you not?

(*Mr Gershon*) No, I am not.

232. You are not?

(*Mr Gershon*) No.

233. That is what it says here.

(*Mr Gershon*) Which one is that?

234. The renegotiation of the PFI for the Royal Armouries Museum in Leeds. The Department for Culture paid £10 million to bail it out. You are not going to let a hospital close, are you?

(*Mr Gershon*) You made a general statement to which I answered.

235. You answered no.

(*Mr Gershon*) I answered no to your general statement. Things do go wrong, costs overrun, things like that, which are costs which are picked up by the private sector.

236. The answer was not right, it was not accurate, because there is one which has been bailed out and if my hospital closed you would bail it out. You could not let a hospital close, could you?

(*Mr Gershon*) I made it very clear that there are some risks which the public sector can never transfer to the private sector. One is the risk that in the ultimate you have to keep providing public service. Let us suppose your hospital closed because the contractor went bust. In that contract, if it followed standardisation, the client will have step-in rights to take over the running of the hospital.

237. That is my point.

(*Mr Gershon*) You are looking at catastrophic failure.

238. Was that a catastrophic failure?

(*Mr Gershon*) That was catastrophic but many failures are not catastrophic and the tab is picked up by the private sector. The risk of catastrophic failure can never be transferred to the private sector if there is the provision of public service involved. Whether it is passports, hospitals, whatever, we all have the responsibility to continue to deliver a public service. That is a catastrophic failure which has low probability but very high impact. There are other risks which may have a high probability of occurrence and a lower impact which will be picked up by the private sector.

239. If you had been sitting there three or four years ago and somebody had said that the Royal Armouries would need £10 million to bail it out, you would have said that was a catastrophic failure and it would never happen, would you?

(*Mr Gershon*) Where there is demand risk involved, which there was in the Royal Armouries, the number of people who would actually come through it, there is no doubt that both the public and the private sector have learned from those sorts of experiences about how much demand risk the private sector can sensibly take in a PFI.

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[Continued

**Jon Trickett**

240. One of the things which I always think about is the possibility of collusion between various people who ostensibly are not related to each other. I am interested in the MCG, the Major Contractors Group, because in questions which were posed earlier by Mr Davies we learned there are some financial barriers to bidding. The preparation of contract documents and tender documents can be a very expensive process and as a consequence many contractors are priced out of the market before they even get to stage one, as I understood Mr Busby's responses. As it turns out Mr Busby is also the Chairman of the Major Contractors Group, which is probably a comprehensive list of every contractor who can afford to get over the contract barriers you have just been describing. I just want to ask you, Mr Busby, in relation to the PFI do you and your colleagues discuss such practices as pricing and contingency funds for penalty clauses or any other matters which relate to agreements within the industry as to how you will approach contracts, tendering? These are supposed to be your competitors but, in fact, they turn out to be your colleagues.

(Mr Busby) If you attended our meetings I do not think you would describe the process as sitting with colleagues.

241. It sounds like the Labour Party. We are supposed to be comrades. I did ask you the specific question because I think we all fall out from time to time amongst friends, and even families fall out from time to time, but have you ever discussed any matters which could be regarded as—collusion is too strong a word—discussing industry's views as to how to tender?

(Mr Busby) There has been absolutely no discussion at the level of individual contracts. There are one or two industry moves with regard to risk allocations and general points of contract that we do feel that it is appropriate to take forward as an industry. All of our meetings are minuted and we certainly do not break any of the competition rules.

242. I do not think I asked you about specific contracts because probably that would be very close to fraud or something like that.

(Mr Busby) Precisely so.

243. Therefore, I did not ask you that question and I do not expect you to give me any answer other than the one you gave me.

(Mr Busby) I did also add that we do take certain standard contract conditions up as an industry and take them up with certain people.

244. Have you discussed tendering practices in the generality? It sounds as if the answer is yes to that.

(Mr Busby) In the generality?

245. In the generality.

(Mr Busby) I am not sure I fully understand the question but I suppose the answer has to be that we have because we have taken up some things, like bid costs with Peter, as an industry.

**Chairman**

246. Thank you very much, gentlemen. We have just published a report on the Royal Armouries and we used some fairly strong language about how we felt that the public sector client was naive in their handling of this matter. That was the point Mr Steinberg was making very powerfully to you. We are talking about contracts committed to a sum of £100 billion, this is an important subject. We are very grateful to you, Mr Gershon, Mr Busby, Mr Ryan, for coming here this afternoon. I am afraid when you come back you will have to learn the mannerisms of a mandarin, that when we keep repeating questions to you you have got to assume that they are all very intelligent questions.

(Mr Gershon) I will try harder next time.

Chairman: Thank you.

**APPENDIX 1****Supplementary memorandum submitted by the Office of Government Commerce**

At the Committee's hearing on 12 December into the C&AG's report on *Managing the relationship to secure a successful partnership in PFI projects* there was some discussion of the changing assessment of Value for Money (VFM) over time and the nature of its measurement.

As the Accounting Officer responsible for the Government's overall procurement policy I felt it might be helpful to the Committee to send a supplementary memorandum on this important matter.

Successive Governments have firmly based their procurement policy on Value for Money being defined as the optimum combination of whole life cost and quality to meet the customer's requirement. While whole life cost should be assessed wherever possible in an objective and quantitative manner, there could be a degree of subjectivity in cost estimates where these are dependent on changing circumstances. Some aspects of quality also involve a degree of judgemental assessment by the public sector client. Furthermore, the determination of the optimum combination of these factors in any individual procurement requires judgements to be made about the relative importance of monetary and non-monetary considerations that have arisen during the tender evaluation process.

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Once any project, whether PFI or non-PFI, becomes operational the client's perception of Value for Money may well change as factors in the original evaluation related to the construction phase of the project cease to have any relevance and other aspects of quality assume even greater importance. The client's view of the relative importance of monetary and non-monetary considerations may also change over the life of the project.

The OGC is planning to publish this quarter a document aimed at Accounting Officers to provide best practice guidance on Value for Money in complex procurements.

*Mr Peter Gershon CBE*  
Chief Executive  
Office of Government Commerce

*January 2002*

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SESSION 2001–02

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2	Improving Construction Performance (HC 337) . . . . .	05/12/01
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ISBN 0-215-00420-5



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