House of Commons
Committee of Public Accounts

HM Treasury: Making changes in operational PFI projects

Thirty–sixth Report of Session 2007–08

Report, together with formal minutes, oral and written evidence

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The Committee of Public Accounts

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Summary

Under the Private Finance Initiative (PFI), the public sector enters into a long-term contractual arrangement with private sector companies to design, build, finance and operate an asset such as a hospital or school. There are now over 500 operational projects with a combined capital value of £57 billion and future payments amount to £181 billion (a present value of £100 billion).

It is inevitable, over the course of 25 to 30 years of operation, that changes will be needed to the services and assets provided under operational PFI projects. In 2006, some £180 million was spent on changes, but there were large variations in the extent of management resource both for PFI contracts of a similar size and for making changes of the same cost. Furthermore, a third of contract managers at PFI hospitals and one in six contract managers of PFI schools surveyed by the National Audit Office described their teams as under-resourced, and 15% of PFI projects were not being managed on a full time basis, which is a clear risk to value for money.

Major changes costing £100,000 or more accounted for 90% of the total value of changes to PFI projects in 2006. Nearly 30% of major changes which could have been competitively tendered, were not.

The companies involved in a PFI deal establish a separate company, known as a Special Purpose Vehicle (SPV), to manage the project, including any competitive tendering for new work. For most small changes, SPVs simply act as conduits, passing requests for changes from the public sector authority to the facilities management provider and back again. However, many SPVs charge additional management fees for processing change requests. These fees have ranged from 2% to 25%, adding an estimated £6 million to the cost of changes made in 2006.

On the basis of a Report by the Comptroller and Auditor General,[1] we examined the staffing and management of changes, the reasons for not putting larger changes out to competitive tender, the charging of management fees by SPVs and the value for money of small changes, the cost of which varies substantially for similar work.

1 C&AG's Report, *Making Changes in Operational PFI Projects*, HC (Session 2007–08) 205

Conclusions and Recommendations

1. **In 2006, changes to operational PFI projects totalled £180 million, but many operational PFI contracts are under-managed.** Negotiating good deals is important but managing them well afterwards is key to value for money. Yet there are wide variations in the level of resources used to manage PFI deals, and many schools and hospitals consider that they do not have enough staff to do a good job.

2. **There are limits to the Treasury's capacity to control the allocation of resources to contract management at a local level.** The Treasury should identify and disseminate examples of where, in handling change, PFI projects have benefited from sufficient resourcing of contract management.

3. **There is insufficient central support for contract managers.** The Treasury, Departments and Partnerships UK should increase the roll-out of training programmes to support contract managers when changes need to be made to PFI projects.

4. **At present, only 29% of project changes over £100,000 are subject to competition.** The arguments for handing additional work to an incumbent contractor are not persuasive nor do they hold sway in every project. Public sector authorities should raise this percentage so that alternative bidders compete to undertake the work whenever possible.

5. **Management fees cost the taxpayer over £6 million a year, despite Treasury guidance issued in March 2007 which advised against the payment of management fees in new PFI deals.** Hundreds of operational deals are still paying unjustified management fees. The Operational Taskforce, run by Partnerships UK on behalf of the Treasury, should require existing operational deals to remove management fee charges from existing contracts.

6. **There are large differences in the cost of making similar minor changes to PFI projects, but the effort put into checking that costs are reasonable varies widely from project to project.** Public sector authorities need to validate the value for money of changes to PFI contracts. By the end of 2009, Partnerships UK should draw up guide prices for common minor jobs, based on existing cost information from the Royal Institution of Chartered Surveyors and others.

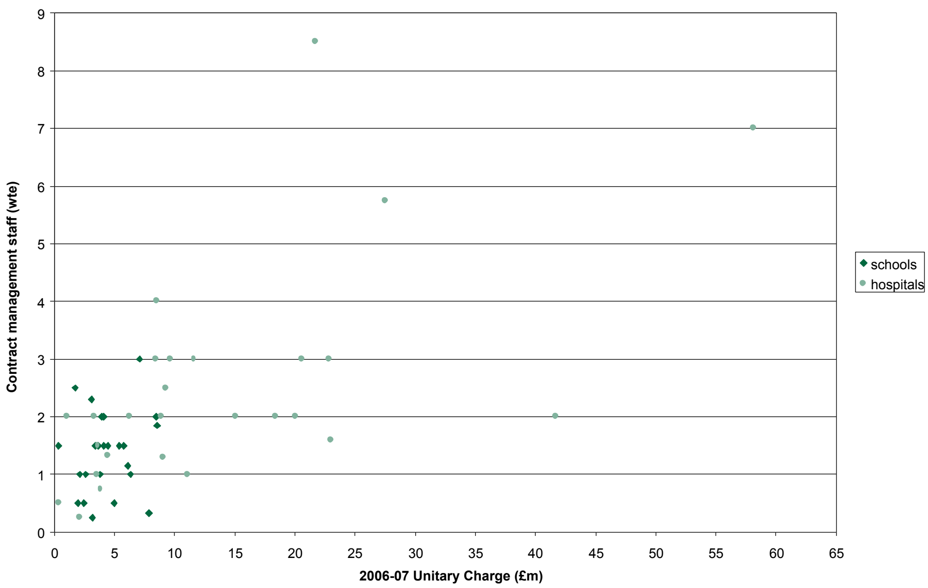
1 The staffing and management of change

1. Under the Private Finance Initiative (PFI), the public sector enters into a long-term contractual arrangement with private sector companies to design, build, finance and operate an asset such as a hospital or school. There are now over 500 operational projects with a combined capital value of £57 billion and future payments amounting to £181 billion (a present value of £100 billion).

2. Operational PFI projects cost the taxpayer nearly £5 billion each year. The public sector must ensure that value for money is maintained during the operational life of PFI projects. Value for money largely depends on the deployment of adequate contract management resources.[2]

3. There are large variations in the level of resources devoted to the management of PFI contracts of a similar size (**Figure 1**). One in three contract managers at PFI hospitals and one in six contract managers of PFI schools that were surveyed by the National Audit Office described their teams as under-resourced.[3]

Figure 1: Staff resources vary between individual projects of similar size



Source: C&AG's Report, Figure 13

4. Recent guidance published by Partnerships UK, an organisation set up by the Treasury to provide support and advice to the public sector on Public Private Partnerships, and 4ps, an advisory body for local authorities, states that PFI projects should have a full-time contract manager. There is a need for some flexibility to suit local circumstances. For example, smaller PFI projects might not need a full-time contract manager. Yet over 15%

2 C&AG's Report, para 1.3

3 C&AG's Report, para 3.8

of PFI projects surveyed by the National Audit Office were not being managed on a full-time basis.[4]

5. At a local level, successful long-term PFI contracts rely on establishing and maintaining professional relationships between the public and private sectors. This is helped when the public sector retains staff of the right calibre in contract management roles for a reasonable period of time, typically, of around five years. The public sector also needs to adapt its staffing of PFI projects to changing workloads. More staff are needed, for instance, at the time of a benchmarking or market testing exercise or a large contract change. Public authorities have yet to budget with sufficient flexibility to enable this to happen.[5]

6. The Treasury believes that public bodies should have discretion over how they manage their PFI contracts. The Treasury explained that the balance between the role of central Government and the responsibilities of local procurement bodies had shifted over the last 20 years. While responsibility and accountability for decisions on individual projects now rests with local bodies, the Treasury has nevertheless sought to assist public authorities who have to manage changes to their PFI projects.[6]

7. The Treasury set up an Operational Task Force in 2006 to provide assistance and training for operational projects. The Task Force is operated for the Treasury by Partnerships UK. By February 2008, the Task Force had held nine regional workshops, each attracting 40 to 50 attenders, which were followed with training courses running at around one a month and attracting on average 20 to 25 people. In addition, the Task Force's helpdesk has received 461 calls from 206 public sector organisations seeking assistance in managing their PFI deals. Major government departments have also established their own Private Finance Units to provide similar services.[7]

8. The Treasury also supports the efforts of the Office of Government Commerce to improve the public sector's procurement performance. In response to this Committee's previous report on tendering for PFI deals, the Government agreed that there was a continuing lack of experience and skills within public procurement teams across the public sector. To address the issue, the Office of Government Commerce has begun the process of reforming the Government Procurement Service with complex procurement and PFI as priority areas for improved training packages.[8]

9. The exchange of procurement experts between different areas of the public sector is another important way to raise the quality of procurement. Exchanges are now being encouraged by providing information on relevant vacancies and opportunities to members of the Government Procurement Service. In addition, the Treasury is now working to try

4 Qq 7–10, 60

5 Qq 43–48, 54, 76

6 Qq 33, 41–42

7 Qq 25–27, 62, 106

8 Committee of Public Accounts, Sixty-third Report of Session 2006–07, *Tendering and benchmarking in PFI*, HC 754; *Update on the Treasury Minute to the Thirty-fifth Report, together with the Fifty-seventh to the Sixty-fifth Reports from the Committee of Public Accounts 2006–07*, February 2007, Cm 7322

to raise the standard of procurement expertise across Government, for instance, through procurement capability reviews of every government department.[9]

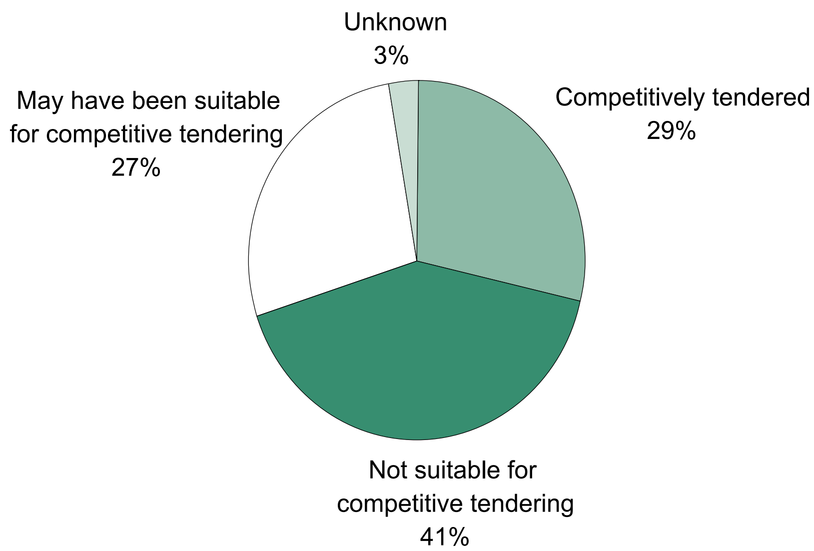
9 Qq 43–45; 48–49, 61, 67–68

2 Competition for larger changes to projects

10. Over the course of 25 to 30 years of operation, it is inevitable that changes will be needed to the services and assets provided under PFI deals. In 2003, our predecessors recommended that Departments should insist on competitions for the provision of additional work after a PFI deal becomes operational.[10]

11. In 2006, major changes costing £100,000 or more accounted for 90% of the overall cost of changes to operational PFI projects. 27% of these larger changes might have been suitable for competitive tendering but were let without competition (**Figure 2**). The value of these non-competed changes was £84 million.[11]

Figure 2: High-value changes were not always competitively tendered



Source: C&AG's Report, Figure 7

12. The Treasury has a strong presumption in favour of competition. There can, however, be sound reasons why procuring authorities decide not to put changes to PFI projects out to competitive tender. For example, of the three largest changes that took place in 2006, two were prisons requiring additional prisoner accommodation. As the prisons had to remain in use while building work was underway, the Prison Service judged that the existing contractor was better placed than an outsider to manage the risks involved. The prices offered by the existing contactor had been benchmarked and the Prison Service decided that awarding the work to the incumbent contractor was the right thing to do on operational and price grounds.[12]

10 Committee of Public Accounts, Thirty-fifth Report of Session 2002–03, *PFI Construction Performance*, HC 567

11 C&AG's Report, para 2.4

12 Qq 1–2, 46, 63

13. The companies involved in a PFI deal establish a separate company, known as a Special Purpose Vehicle (SPV) to manage the project, including any competitive tendering for new work. Operational issues have to be considered carefully, but they are not necessarily a block to competition. For example, East Riding of Yorkshire Schools PFI project has introduced a framework for competitive tendering of changes to PFI contracts. Under the framework, work can be carried out by contractors from the SPV's partners or those from the Local Authority's own list of approved contractors. The SPV also agreed to follow the Local Authority's recently revised requirements for tendering, depending on the value of the work to be undertaken (**Figure 3**).[13]

Figure 3: East Riding of Yorkshire Schools

In the early years of the contract, the Local Authority accepted that the SPV would implement any changes using its own sub-contractors and procurement procedures. The Local Authority would verify that the proposed cost of a change was reasonable and in line with benchmark prices, before work was approved. As the project developed, it became apparent that there were opportunities to enhance value for money where work was being sub-contracted. The Authority, therefore, sought to introduce more transparent competition, if necessary using contractors from the SPV's contract partners or those from the Local Authority's approved contractor list. The SPV has now agreed to follow the Local Authority's recently revised competition requirements as below:

Up to £2,000:	One oral quotation (confirmed in writing where over £500)
£2,001—£30,000:	Three written quotations
£30,001—EU Threshold:	Invitations to tender to at least three suppliers
Above EU Threshold:	EU procedure

Source: C&AG's Report, Case Example 6

14. In some cases, changes requested by the public sector have reinstated requirements that were excluded from the original contract for affordability reasons. One in five project managers stated that work requested as a change had been considered previously for inclusion in the original deal. In just under half of these cases, work was taken out of the original specification for reasons of affordability. In 2006, such changes ranged in value from £17,000 to £17 million.[14]

15. Reinstating previous requirements does not appear to be good value for money. Value for money depends, at least in part, on whether changes are essential to the delivery of the service and were required when the contract was being negotiated. In such circumstances it would not be good value for money to remove work from the original contract when potential suppliers are in competition with one another, but then order the same work later, when the project is being run by a single provider. On the other hand, public authorities may be uncertain at the outset whether they will definitely need an additional service. In such circumstances, authorities will need to be sure that there are mechanisms in place to ensure value for money, such as benchmarking and agreed rates for undertaking changes.[15]

16. The Treasury considered that public authorities needed to be careful when making large changes in the absence of competition. The fact that changes were being made

13 Q 23

14 C&AG's Report, para 1.10

15 Q 32

demonstrated the flexibility of PFI deals, which is needed in contracts typically lasting decades. This needs to be balanced, however, against getting good value if the taxpayers' wider interest is to be protected.[16]

16 Q 4

3 Management fees and the pricing of small changes

17. In addition to changes over £100,000, public sector authorities pay for a large volume of smaller changes. Such changes often attract management fees. Special Purpose Vehicles (SPVs) are paid out of the unitary payment agreed when the deal was signed for the day to day management of PFI projects, including staff and other administrative costs. The company providing facilities management for a PFI building will implement most changes, especially small ones, while the SPV usually manages the process.[17]

18. For most small changes, SPVs simply act as conduits, passing requests for changes from the public authority to the facilities management provider and back again. SPVs have, however, increasingly sought to charge additional management fees for processing change requests. These fees ranged from 2% to as much as 25% of the value of the changes, adding up to an estimated £6 million to the cost of changes made in 2006.[18]

19. In most cases the costs of processing changes are small and come within the functions that an SPV carries out under the original contract. For instance, where only small changes have been made, public authorities should not require the re-running of the financial model for the PFI deal. Nevertheless, it is one of the reasons put forward by SPVs for charging management fees.[19] On occasions, however, SPVs have acted unreasonably in trying to impose management fees for small changes, employing spurious arguments and not relating fees to work done. SPVs should only be entitled to recover the cost of additional work done where this cost is actually incurred.[20]

20. The latest Treasury guidance on PFI contracts, published in March 2007, recommended that the proper payment of contractors for providing an effective change management service should be part of the original contract. There should then be no need for additional SPV fees on individual changes unless these are particularly complex. The Treasury's current guidance makes it clear that such fees are unjustified and should be removed from existing deals. The Treasury could not guarantee that every public authority would comply, but it expected the March 2007 guidance to have a major effect across PFI deals.[21]

21. Partnerships UK is now working with public sector authorities managing existing PFI deals that were agreed without the benefit of the latest Treasury guidance. It is too early for Partnerships UK to say how far their actions will reduce or eliminate SPV fees, although the Comptroller and Auditor General's Report identifies one instance where this has happened (**Figure 4**).[22]

17 C&AG's Report, para 1.1

18 C&AG's Report, paras 2.20, 2.21

19 Q 24; C&AG's Report, para 2.21

20 C&AG's Report, paras 2.20, 2.22

21 Qq 11–18

22 C&AG's Report, para 2.24

Figure 4: Changes made to the structure of management charges

A fee of 8.5% was charged by the SPV on all changes at the PFI hospital in Blackburn, which became operational in 2005. In 2007, the hospital began implementing its "meeting patients' needs" programme, which involved considerable changes to the estate. The hospital used this as an opportunity to renegotiate the SPV fee. Changes over £5,000 now attracted a fee based on a sliding scale from 4% to 8.5% and the hospital is seeking to bundle changes together, thus attracting the lower fee. In addition the SPV had agreed that it should never have charged fees on changes under £5,000 and has repaid £17,000 to the hospital.

Source: C&AG's Report, Case Example 4

22. As well as management fees, the public sector incurs direct costs for small changes. For approximately half of small changes, contract managers were using a schedule of rates, agreed at the time the contract was signed, to validate costs. In many cases, this was seen as an efficient way of ensuring costs were reasonable, although such schedules could only anticipate the most common jobs. Public sector contract managers considered that there was a trade-off between seeking to challenge the costs of changes and avoiding delay.[23]

23. In a small number of projects, public sector contract managers had not sought to validate the cost of minor changes, either because there were too many changes, or because their low value could not justify the time. Overall, there were striking variations in the cost of carrying out similar small changes, such as the installation of additional electrical sockets and data points, across PFI projects.[24]

24. Treasury guidance now makes it clear that a schedule of rates for small changes should be agreed between the public sector and the private sector, and the schedule should be revisited at the beginning of each year. Even if schedules of rates have been agreed, the guidance stresses that public authorities should bear in mind that some changes may fall outside what is defined in the schedule and that a separate negotiation will then have to take place.[25]

25. The Treasury aims to encourage sharing of knowledge and expertise between public authorities. However, the Comptroller and Auditor General's Report draws attention to the need for wider guidance than is currently available. Around half of the contract managers surveyed by the National Audit Office in 2007 called for practical guidance on a variety of areas relating to the change process. In many cases, contract managers were looking not for formal guidance but for examples of good practice and indications of what other projects were paying, for instance in management fees.[26]

23 C&AG's Report, paras 2.12, 2.13

24 C&AG's Report, para 2.15

25 Q 24

26 Qq 55–59; C&AG's Report, para 3.3

Formal Minutes

Monday 23 June 2008

Members present:

Mr Edward Leigh, in the Chair.

Mr Richard Bacon
Mr Paul Burstow
Mr Ian Davidson
Mr Philip. Dunne
Mr Austin Mitchell
Geraldine Smith
Mr Don Touhig

Draft Report (*HM Treasury: Making changes in operational 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 25 read and agreed to.

Resolved, That the Report be the Thirty-sixth Report of the Committee to the House.

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

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Wednesday 25 June at 3.30 pm.

Witnesses

List of written evidence

List of Reports from the Committee of Public Accounts 2007–08

First Report	Department for International Development: Tackling rural poverty in developing countries	HC 172 (Cm 7323)
Second Report	Department of Health: Prescribing costs in primary care	HC 173 (Cm 7323)
Third Report	Building for the future: Sustainable construction and refurbishment on the government estate	HC 174 (Cm 7323)
Fourth Report	Environment Agency: Building and maintaining river and coastal flood defences in England	HC 175 (Cm 7323)
Fifth Report	Evasion of Vehicle Excise Duty	HC 227
Sixth Report	Department of Health: Improving Services and Support for People with Dementia	HC 228 (Cm 7323)
Seventh Report	Excess Votes 2006–07	HC 299
Eighth Report	Tax Credits and PAYE	HC 300 (Cm 7365)
Ninth Report	Helping people from workless households into work	HC 301 (Cm 7364)
Tenth Report	Staying the course: the retention of students on higher education courses	HC 322 (Cm 7364)
Eleventh Report	The compensation scheme for former Icelandic water trawlermen	HC 71 (Cm 7364)
Twelfth Report	Coal Health Compensation Schemes	HC 305 (Cm 7364)
Thirteenth Report	Sustainable employment: supporting people to stay in work and advance	HC 131 (Cm 7364)
Fourteenth Report	The budget for the London 2012 Olympic and Paralympic Games	HC 85 (Cm 7365)
Fifteenth Report	The Pensions Regulator: Progress in establishing its new regulatory arrangements	HC 122 (Cm 7365)
Sixteenth Report	Government on the Internet: Progress in delivering information and services online	HC 143 (Cm 7366)
Seventeenth Report	Foreign and Commonwealth Office: Managing Risk in the Overseas Territories	HC 176 (Cm 7366)
Eighteenth Report	Improving corporate functions using shared services	HC 190 (Cm 7366)
Nineteenth Report	BBC Procurement	HC 221 (Cm 7366)
Twentieth Report	HM Revenue & Customs: Helping individuals understand and complete their tax forms	HC 47 (Cm 7366)
Twenty-first Report	The Carbon Trust: Accelerating the move to a low carbon economy	HC 157 (Cm 7366)
Twenty-second Report	Improving the efficiency of central government's use of office property	HC 229 (Cm 7366)
Twenty-third Report	Report on the NHS Summarised Accounts, 2006–07: Achieving financial balance	HC 267
Twenty-fourth Report	The privatisation of QinetiQ	HC 151
Twenty-fifth Report	The cancellation of Bicester Accommodation Centre	HC 316
Twenty-sixth Report	Caring for Vulnerable Babies: The reorganisation of neonatal services in England	HC 390
Twenty-seventh Report	DFID: Providing budget support to developing countries	HC 395
Twenty-eighth Report	Government preparations for digital switchover	HC 416
Twenty-ninth Report	A progress update in resolving the difficulties in administering the single payment scheme in England	HC 285
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Thirty-first Report	Progress in Tackling Benefit Fraud	HC 323
Thirty-second Report	Reducing the cost of complying with regulations: The delivery of the Administrative Burdens Reduction Programme, 2007	HC 363
Thirty-third Report	Ministry of Defence: Major Projects Report 2007	HC 433
Thirty-fourth Report	Increasing employment rates for ethnic minorities	HC 472
Thirty-fifth Report	Housing Market Renewal: Pathfinders	HC 106
Thirty-sixth Report	HM Treasury: Making Changes in Operational PFI Projects	HC 332
First Special Report	The BBC's management of risk	HC 518 (Cm 7366)
Second Special Report	Evasion of Vehicle Excise Duty	HC 557 (Cm 7366)

Oral evidence

Taken before the Committee of Public Accounts

on Wednesday 6 February 2008

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon
Mr Paul Burstow
Nigel Griffiths
Keith Hill
Mr Austin Mitchell
Dr John Pugh
Mr Alan Williams

Mr Tim Burr, Comptroller and Auditor General, and **Mr James Robertson,** Director, National Audit Office, were in attendance and gave oral evidence.

Ms Paula Diggle, Treasury Officer of Accounts, HM Treasury, was in attendance.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

MAKING CHANGES IN OPERATIONAL PFI PROJECTS (HC 205)

Witnesses: **Mr John Kingman,** Second Permanent Secretary and **Mr Gordon McKechnie,** Head of PFI Policy, HM Treasury and **Mr James Stewart,** Chief Executive, Partnerships UK, gave evidence.

Chairman: Good afternoon, welcome to the Committee of Public Accounts where today we are looking at the Comptroller and Auditor General's Report, *Making Changes in Operational PFI Projects.* We welcome John Kingman and Gordon McKechnie from the Treasury and James Stewart from PUK. You are all very welcome. Before we start, it is a pleasure to welcome a new Member to our Committee, Paul Burstow. We have to ask you whether there are any changes from your declaration of interests in the register of the House.
Mr Burstow: No, none whatsoever.

Q1 Chairman: You are very welcome to the Committee. Mr Kingman, would you like to look at paragraph 2.4 on page 13 of the Comptroller and Auditor General's Report? You will see there that there is a criticism that about 30% of large changes worth £84 million had not been competed for, even though they might have been. Why is that?
Mr Kingman: I believe it is the case that the great bulk of the 27% described here was accounted for by three very large projects. We operate a very strong presumption in favour of competition but there are sometimes reasons why procuring authorities can legitimately decide not to compete things. In this case there were two prison projects and one hospital project. In those three cases, there were reasons that were thought by the procuring authorities to be good reasons not to compete.

Q2 Chairman: Is this a problem to do with existing projects? Would new projects not have this kind of difficulty? Would you be more on the ball with new projects?
Mr Kingman: The principle is the same for any project, that is there is a strong presumption in favour of competition, but there may sometimes be legitimate reasons why a project is not competed. In those cases we would certainly very strongly expect the project to be compared with a public sector comparator. We would also expect prices to be benchmarked.

Q3 Chairman: Can we look at paragraph 2.13 and figure 9? This has received considerable publicity in the press and one can understand why but there is a serious point behind it. If you look at figure 9, you can see the cost of comparable jobs carried out in 2006 often varied substantially across and within projects; supplying and fitting an electrical socket, for instance can vary from £30 to £302. There is clearly something wrong with your benchmarking, is there not?
Mr Kingman: I think there is a striking degree of variation but there is going to be variation. My understanding is that, if one looks for example at the most expensive socket here, which was at the top of a 30-foot high ceiling in a school requiring scaffolding and all sorts of things, that will sometimes be the case. From our point of view, we would certainly want to see procuring authorities procuring these things cheaply.

Q4 Chairman: But it is an extraordinary variation and even if you have to go to the top of a very high ceiling, it seems a lot of money to pay, does it not? What strikes me about this whole Report—and this is a general comment but you can reply to it—is that a great deal of time and effort goes into drawing up these contracts originally, but sometimes money leaks away because you do not have the staff to keep an eye on these projects. Is that a fair criticism? You take your eye off the ball in other words.
Mr Kingman: That can be an issue and it is certainly something that procuring authorities need to be careful about when they go into a PFI deal. A lot of people have a sense that PFI is inflexible and it is

interesting that when the NAO went in to look at this, their overall conclusion was that PFI can be flexible, that these deals are responsive but there are also reasons to be careful about value for money and we agree with the Report on that completely.

Q5 Chairman: Because the contractors have always got their eye on the ball have they not? They are always going to be looking at maximising their profit, so the public sector has to be as good as they are all the way through the contract.
Mr Kingman: Yes.

Q6 Chairman: Are you instilling that ethos across the public sector? You cannot just put all this time and effort in at the beginning and then walk away from a project and expect it to look after itself.
Mr Kingman: I do entirely agree with that, though I would add that it is just as much of an issue in relation to a conventional procurement, where we have very major challenges, to raise the public sector's game as a procuring authority. PFI is particularly complex, but we have challenges across the piece.

Q7 Chairman: This point is highlighted in paragraph 3.8 where we see that over 15% of PFI projects do not have a full-time contract manager. It is not surprising that these contracts get themselves into a position where they cannot be well managed, if they do not have a full-time contract manager, given the amount of money often involved.
Mr Kingman: I would certainly want to see PFI contracting authorities having the capability. I do not know whether it is necessary in every case to have a full-time contract manager, maybe one of my colleagues may want to comment on that.

Q8 Chairman: It seems to be just good practice and something that perhaps you would want to insist on in the future in all large projects.
Mr Stewart: The guidance is clear that people should have a full-time contract manager.

Q9 Chairman: So why are they not doing it then?
Mr Stewart: It is ultimately the decision of procurement bodies as to how they contract manage.

Q10 Chairman: But it is all public money. As a result of this hearing, what steps are you going to take to try to improve your hands-on management in the public sector of these projects?
Mr Kingman: As James says, we have guidance and that guidance is clear. We do not have the power to buy all these things ourselves nor would that be sensible. We are dependent on the decisions of procuring authorities and local authorities but we are doing a lot to try to raise the standard of procurement expertise across Government, we are doing procurement capability reviews of every government department, we have a new Head of OGC who is bringing a new energy to this drive. It is very serious issue for us.

Q11 Chairman: Can we look at special purchase vehicles mentioned in paragraph 2.20 and it is really summed up by the heading there: "Management fees charged by SPVs vary widely, are mostly unjustified and cost the public sector approximately £6 million a year"? What are you doing to get rid of them?
Mr Kingman: We are getting rid of them. We completely agree with the NAO about this. We have clear guidance which says that these fees are not justified.

Q12 Chairman: So you are getting rid of them?
Mr Kingman: Yes.

Q13 Chairman: And if we were to come back to you in a year or two's time, we would see that they were no longer on the radar screen.
Mr Kingman: We are categoric in our guidance. I cannot guarantee that every public authority will follow our guidance but I would expect to see this having a major effect.

Q14 Mr Bacon: You just said that guidance is not always followed because it is ultimately up to the authority to decide how to manage these things. I would like to continue where the Chairman left off on the subject of management fees because it says in paragraph 2.20 that SPVs, special purpose vehicles, are paid for the day-to-day management of PFI projects, including staff and other administrative costs. You would expect they had already been remunerated for this and that this had been priced in at the beginning and that essentially is your position, is it not?
Mr Kingman: Absolutely.

Q15 Mr Bacon: I take it the guidance you and I are talking about is this new SOPC4 that came out last year, is it?
Mr Kingman: March 2007.

Q16 Mr Bacon: Is that the one that says: "Thou shall not have management fees"?
Mr Kingman: Yes.

Q17 Mr Bacon: Why did it take so long to come up with this brilliant idea that since you are paying them to do it anyway, they should not be allowed to charge and get away with charging on top?
Mr Kingman: What the Report says, which is correct, is that this has been a growing phenomenon over time and what we have done is respond to that with the guidance.

Q18 Mr Bacon: They have just been creaming it basically, have they not?
Mr Kingman: There are fees which we would certainly agree are not justified.

Q19 Mr Bacon: I would like to go back a bit actually. I want to ask you a question about the report in the *FT* yesterday about PFI because it quotes Ken Wilde, a partner of Deloitte who is a member of the Financial Reporting Advisory Board, on the subject of that proportion of PFI which is not on balance

sheet saying that while no-one can yet claim to know the exact proportion, pretty much everyone now thinks that all of it, or pretty much all of it will be coming back on. You very kindly responded in correspondence with the Committee in answer to queries of mine about the total outstanding annual unitary charges which on a net present value basis are £91 billion. The *FT* refers to an extra £30 billion. Presumably the difference is accounted for by the fact that it is not all capital. As you said in your reply to us, to add PFI unitary payments together and say that all of this should be added to the public sector net debt would be akin to adding up the electricity, gas, cleaning and food bills for a family home over the next 30 years and saying that this amount is part of the mortgage debt on the house. So when you add on, as presumably is likely to happen, the stuff that is off balance sheet at the moment, it will not include the facilities and management element of annual unitary charges, but will include all of the capital. Is that basically the gist of it?
Mr Kingman: Your understanding of my letter is absolutely correct. What comes on balance sheet depends on what the ONS decide and depends on what the new accounting standard is. We have said that we will move to international financial reporting standards in 2008-2009. We are in the process of discussing draft guidance with the Financial Reporting Advisory Body and with others, but until that standard is in place, until the ONS have decided how they are going to take that into account in what they decide for the national accounts, it is not possible to say what will come on balance sheet.

Q20 Mr Bacon: Presumably though, if some extra goes on balance sheet, then there is going to be an effect on department budgets and for people who have a PFI project where they are already paying an annual unitary charge which includes capital, when it goes on balance sheet they are going to get a double-whammy, are they not, because they are also going to have to pay a capital charge?
Mr Kingman: We have made clear to departments that we strongly support the present programme of PFI procurement. If there were to be any balance sheet change that had a budgetary impact, that is something we would discuss with departments, but we have made clear to them that they should continue to progress projects that are currently in the pipeline.

Q21 Mr Bacon: If there is a threshold, which I think is 40% at the moment, would you just move the goalposts slightly? At the end of the day, it is only an accounting change, is it not?
Mr Kingman: Firstly, what happens to the fiscal position depends on what the ONS conclude. Secondly, the Chancellor would have to decide at the time anything that relates to the fiscal rules.

Q22 Mr Bacon: You are being admirably cautious Mr Kingman.
Mr Kingman: Indeed; it is my job.

Q23 Mr Bacon: I would like to ask you about competition and in case example 6 on page 21, this was the East Riding schools, a local authority project, it points out: "As the project developed, it became apparent that there were opportunities to enhance value for money outcomes where the work was being sub-contracted. The Authority therefore sought to introduce more transparent competition where changes are sub-contracted, if necessary using contractors from the SPV's contract partners or those from the Local Authority's approved contractor list. The SPV has now agreed to follow the Local Authority's recently revised competition requirements". Why do all projects not follow that example which seems to be rather a good one?
Mr Stewart: As a general point, it is interesting to say: "Where are the incentives both for the public sector and the private sector to change what is extant in existing contracts"? Slightly surprisingly, you may be surprised to hear that the private sector is sometimes as incentivised to change some of the variation protocols as the public sector and particularly that is true on small changes. On small changes, if they are not handled properly, it becomes a complete pain in the neck for both private sector and the public sector. What we have seen is a willingness from both sides to put in place variation protocols. As you probably know, we put in place recent guidance, but part of that guidance is not actually saying that no-one has put in place a variation protocol for the last five years because that is just not true. People have put in place new variation protocols and what we are trying to do now is to get a standard variation protocol right across the piece. We would support what is said in the East Riding case as good practice and in fact it is consistent with the guidance that has come out.

Q24 Mr Bacon: I am quite surprised to hear you say that the private sector have been supportive of those changes as well. Figure 11 is a description of how the private sector make extra money out of changes and how they justify extra charges. They say, for example, that they have to take account of the cost of tendering out the work to the sub-contractors, although as the NAO points out, that is done for the vast majority of cases. They say they have to consider the change and make sure it can be implemented under the project agreement, although in practice that is hardly ever an issue. They say they need to evaluate lifecycle and risk implications, but actually in practice few special purpose vehicles need to consider it for small works and they need to bear in mind the cost of re-running the financial model, although they should be re-running the financial model anyway. The point is that for each of these things they have been making money, between 5% and 25% on top of all the other charges.
Mr Stewart: What the guidance does now, is distinguish between small changes, medium-sized changes and large-sized changes. For instance, for small changes it is quite explicit that no-one should be even considering re-running a financial model. The guidance does differentiate as to how both the public sector and the private sector should behave

for small, medium and large. I would say your comments are definitely true for the large changes, perhaps true for some of the medium-sized changes but not true for the small changes where a different procedure is needed. What we have talked about in terms of the small changes, is agreeing a schedule of rates between the public sector and the private sector and that that schedule of rates should be revisited at the beginning of each year. Even if you have a schedule of rates, you have to bear in mind that some of these changes will fall outside what is defined in that schedule and therefore a discussion has to take place.

Q25 Mr Bacon: Could I ask for your comments on a quote from a focus group on page 22? At the top there is says: "Early on we had a proper project director, we had commissioning teams, a commissioning nurse—we had a full range of people. And, as soon as the contract was at the operational stage, the director of facilities disappeared, they all disappeared". Going back to the Chairman's point about not having full-time contract directors, my sense is you have a group of people, mostly in London, mostly working either for investment banks or law firms or accounting firms or, like yourself, for a sort of hybrid or for the Treasury, who all know each other, so a fairly small world, who are in many cases extremely highly paid and whose great interest is in the next deal. Once it is done then you get on to the next deal and there is less interest in the ongoing operational contract side. I can see someone behind you nodding; the last time I said that the person rapidly stopped and he has as well. It is interesting to see that nod because it just reinforces my suspicion that what you have is this group of people going round drinking each other's champagne in London and some poor soul in a prison up in the north of England is trying to run a contract without enough help, without enough guidance and without enough support.
Mr Stewart: I suppose my only response to that can be that we did take the initiative and, under the auspices of the Treasury, set up the operational taskforce in March 2006. For example, to deal with the regional point, we have run nine regional workshops right around the country and that is right across the UK, inviting all the contract managers from projects to attend those workshops. We have probably had between 40 and 50 people at each of those workshops. We have now followed that up with training courses which are running at around one a month where we have got, on average, 20 to 25 people coming to those training courses. So we have made an effort to go out and talk to people. I checked the stats this morning on our helpdesk and we have had 461 calls and, as of today, that represents 206 different public sector organisations who have contacted our helpdesk.

Q26 Mr Bacon: Phoning you up and saying: "Help. What do I do here?".
Mr Stewart: Yes, that is what we are here for.

Q27 Mr Bacon: I am glad you have a helpdesk. You are not all too busy signing off new deals then?
Mr Stewart: No.

Q28 Mr Bacon: I would like to ask Mr McKechnie a question. You are Head of PFI Policy. I have always been slightly worried about the fact that the Head of PFI Policy in the Treasury always appears to be a secondee. I take it your predecessor, Mr Abadie, has gone back to PricewaterhouseCoopers, has he?
Mr McKechnie: Yes, he has.

Q29 Mr Bacon: And you are from Deloitte, is that right? Is your salary paid by Deloitte?
Mr McKechnie: I am a partner of Deloitte and I am paid by them.

Q30 Mr Bacon: You continue to be paid by Deloitte so your being inside the Treasury is not a burden on the public purse, so to speak?
Mr Kingman: There is a contractual arrangement between us and Deloitte, as you would expect. I am surprised that you are surprised. From my point of view it is absolutely vital to have in the Treasury people who have done this and really know where the bodies are buried.

Q31 Mr Bacon: It is just that the phrase "PFI policy" kind of suggests that it is being driven by outsiders.
Mr Kingman: It is not driven by outsiders at all, but we do need to formulate policy in a way that is savvy. I honestly think this Committee would be the first to criticise us if we just had a bunch of bright young Treasury civil servants doing their best; we would be skinned alive.

Q32 Chairman: On this question of changes, what is your response to what is said in paragraph 1.10? There does not seem to me to be value for money. "One in five projects responding to our survey stated that work requested as a change since they became operational had been considered for inclusion in the original deal. In just under half of these cases, work was taken out of the original deals for reasons of affordability . . . It is likely, however, that these projects will have paid more to introduce this work after they were operational".
Mr Kingman: I would agree with you Chairman. On the face of it, it does not appear to be good value for money but it does slightly depend. If it is something you knew you were going to need, then it is obviously silly not to put that in the original contract rather than pay a price for it later. If it is something that you might or might not need, then it may be sensible to bring it into the contract later.

Q33 Nigel Griffiths: A lot of money is expended in political commitment on PFI and this Report gives the impression that you have a team that works on guidance, protocols and how it should operate. It then gets shoved out to the deliverers of projects that are very high cost; I am not saying they are not value for money. Then you almost step back and if they start messing up, you say: "Oh well, that is the price of local democracy". Is that account an accurate one?

Mr Kingman: I do not believe we have a political commitment or we are operating under a political commitment as it were to pursue PFI for its own sake. We are quite studiously neutral as between PFI and more conventional forms of procurement. Our view is very clearly that you should only pursue PFI if it is better value for money. We require every project to be compared against a public sector comparator. It is true that the Treasury cannot and does not have the capacity to second guess every procurement judgment that is made out there. I do not actually believe we are expert to do so and individual accounting officers are responsible for those decisions. For the very largest, we obviously take a close interest. We do have policies and, as James has described, one of the reasons we set up his organisation was so we could actively go out and hold people's hands out there.

Q34 Nigel Griffiths: You made a statement which is not in the Report but which certainly raised my eyebrows and that was that the impression given is that PFI is inflexible on the ground. Whose fault is it if that is the impression?

Mr Kingman: I am sorry. My comment was that I feel that people do have that perception.

Q35 Nigel Griffiths: Well whose fault is that?

Mr Kingman: I do not know whether it is anyone's fault, but people do have that perception.

Q36 Nigel Griffiths: It is the perception.

Mr Kingman: I think it is unfortunate that people have an inaccurate perception; yes I do.

Q37 Nigel Griffiths: Whose job is it to give them an accurate perception?

Mr Kingman: Ours and others, including the NAO. That is one of the reasons this Report is helpful.

Q38 Nigel Griffiths: So it has been a failure which is being addressed which is why the Report is helpful.

Mr Kingman: It is not a good thing if people have an inaccurate perception.

Q39 Nigel Griffiths: How have you dealt with that?

Mr Kingman: We are out and about all the time trying to put the case for intelligent approaches to procurement. As I said earlier, we are not in the business of proselytising for PFI for its own sake. We do think that it has a place.

Q40 Nigel Griffiths: This is not about proselytising for PFI: it is making sure that the right guidance is being implemented and what sanctions you have when it is not.

Mr Kingman: If you are the Department of Health or the Home Office or whatever, you have an accounting officer, you have procurement people, that is quite properly the affair of the department. What we do actively do is go in, with the help of OGC, and look at the procurement capability in departments and where that is weak we seek to persuade the department to strengthen it.

Q41 Nigel Griffiths: What about the capability in schools? The Report mentions that one in six PFI schools do not have enough staff for their PFI contracts and a third of PFI hospitals do not have enough staff to manage the contract properly. Is that not an indictment?

Mr Kingman: As I said earlier to the Chairman, it is essential that people who are running complex contracts have the capability necessary to do that.

Q42 Nigel Griffiths: But that is another failure then, because a third do not in hospitals and a sixth do not in schools.

Mr Kingman: It would be a good thing if those projects had stronger capability.

Q43 Nigel Griffiths: We are in agreement then. It would be a good thing but it is your job to make sure it is done. What are you doing to make sure it is being done?

Mr Kingman: It is certainly our job to try to make sure it is done but it would be wrong for the Treasury to convince itself that it can somehow take over procurement. The Government spends hundreds of billions a year on procuring services. The Treasury is a small institution, we set policy and we try to strengthen capability but we cannot run everyone's procurement for them.

Q44 Nigel Griffiths: We are not asking that. What we are asking is why in every PFI hospital—and we are dealing generally with many hundreds of millions of pounds in a PFI hospital case—it is not a requirement that there is someone there to manage PFI contracts properly? Why is it left to local health authorities, or PCTs or whomever?

Mr Kingman: We have guidance, as James said earlier, that encourages people to have a full-time contract manager but hospitals take their own decisions, that is how it works.

Q45 Nigel Griffiths: You are responsible and so are we for the use of public money and that is frankly not a good enough statement to say they take their own decisions. If they decide to waste money, we presumably rely on someone in Whitehall to try to avoid that.

Mr Kingman: We certainly do have a clear role which is about challenge and I believe we discharge that.

Q46 Nigel Griffiths: Is it not desirable to convert guidance into mandatory practice?

Mr Kingman: It can be and in some cases we do. Going back to the example about competition, we have a very strong presumption in favour of competition, it is widely understood, it is enshrined in our guidance, it is enshrined in *Managing Public Money* and accounting officers fully understand that. I am not going to say that I know that there are no circumstances in which it is inappropriate not to have a competition because there are legitimate circumstances in which it is.

Q47 Nigel Griffiths: I am sure that is right. The case that was given of the East Riding school that is in here seems to be a good case. I am just wondering why people are allowed to get away with sloppier practice. Why are they not required to adopt best practice, rather than too often ignoring guidance which is voluntary?
Mr Stewart: On your specific point on contract managers the important thing is that they are put in place before the contract is actually finalised. So there is now very clear guidance in SOPC4 that says up to six months before a contract is signed, please put in place your contract manager.

Q48 Nigel Griffiths: That is a nice way of putting it. Why do you not say: "You must put in place a contract manager"?
Mr Stewart: It is not my decision to say "must".

Q49 Nigel Griffiths: Who should be saying that they must then?
Mr Stewart: Speaking for PUK, one of the things that we struggle with at the moment is continually the balance between the role of the centre and the responsibilities of the local procurement body. That balance has shifted over the last 20 years, but currently absolute responsibility and accountability for decisions sits with local bodies. We understand that, we tell them what we feel is right, we spread best practice, we give them guidance, we give them help.

Q50 Nigel Griffiths: Because we provide the money from here, I think certain things should be a requirement and that is one. That does not seem an unfair assumption, does it?
Mr Stewart: That is a matter of government policy that is not for me to comment on.
Mr Kingman: It depends what kind of body you are talking about.

Q51 Nigel Griffiths: Staying with the example that we have just been given.
Mr Kingman: I assume that you would not contend, for example, that we should have the power to require local authorities to do things.

Q52 Nigel Griffiths: Oh, I think so. If you are spending £50 million pounds on a school or something like that, there should be a certain requirement that you have a contract manager, otherwise you get what we are getting at the moment and that is that in one sixth of the cases they do not.
Mr Kingman: There is local democracy; we do not have the authority to require local authorities to do things.

Q53 Nigel Griffiths: Well you require local authorities to go for the PFI option.
Mr Kingman: No.

Q54 Nigel Griffiths: Yes, if they want the funding—and I have to say I am a supporter of PFI—and you are entitled, since the money is coming from you, to say whether the terms are reasonable. It seems to me to be reasonable to have a contract manager.
Mr Stewart: There are two issues that local authorities and hospital trusts have to deal with. These are long-term contracts and they rely on good partnerships between the public sector and the private sector, that means good relationships. A continual challenge is to retain people in those contract management jobs for a reasonable period of time. When I say "a reasonable period of time", I think five years plus is a reasonable period of time. That is a challenge in this environment. The other challenge they have is that the workload of the management contract does go up and down, so by the time of benchmarking, market testing, which this Committee talked about a few months ago, obviously more resource is required and if there is a big variation, again they have to supplement their resources.

Q55 Nigel Griffiths: You have thrown up something interesting there. Obviously, yes, it can be difficult getting people up to capacity on projects that they have never dealt with before. Why then do we not have a central group of people, peripatetic, who have the expertise that can go in?
Mr Stewart: We do have those central groups. For the larger departments there are private finance units, so, for instance, the Department of Health has a private finance unit which is probably a first port of call for support in those situations and if more specialist expertise is needed, then someone like PUK might also offer support. One of the primary roles of the helpdesk is not actually to provide the help, but often to identify the source of where that help might be.

Q56 Nigel Griffiths: Do you have a list of contract managers that the helpdesk can suggest people hire?
Mr Stewart: We do have knowledge of all the contract managers. As you say, we might often say: "Why don't you talk to so and so who has just been doing this before".

Q57 Nigel Griffiths: Can they hire that person?
Mr Stewart: Normally those people are within a public sector environment and will hopefully offer that help for nothing. We are talking about one local authority potentially talking to another local authority who has been through a similar situation.

Q58 Nigel Griffiths: That is what has led us into the problem though. Unless they can hire that person who is the contract manager—and that generally does not happen but you may be able to give me a case—is there not a case for having a central pool of contract managers on these multi, multi million pounds projects?
Mr Stewart: You cannot say there is a general rule that one should create a pool of contract managers. The first port of call is the existing support which comes from within departmental units. They have

the ability to come to PUK. What we are certainly encouraging is sharing of knowledge and expertise and help between authorities.

Mr Kingman: James is being bashful. One of the reasons we set up Partnerships UK was precisely to provide that kind of service, so that public sector procuring authorities could hire PUK to help them, so that they could actually manage these things properly.

Q59 Nigel Griffiths: Right. But we are in the position where a third of PFI hospitals do not have contract managers and you seem to be pooh-poohing the idea that you might supply them and, given that these are usually more than £100 million as contracts, if I am not mistaken, I am surprised that health authorities, perhaps previously starved of funds, not used to procuring new hospitals, have any expertise at all in-house of that order; indeed that is what they tell me.

Mr Kingman: What we are saying is that we would very strongly encourage them to hire an ongoing contract manager.

Q60 Nigel Griffiths: Why do you not make it a requirement is what I am asking and then instead of having two thirds complying with that not unreasonable request, you would have the whole show?

Mr Kingman: There is a tension between our desire to promote good practice and not actually hamstringing the whole of the public sector by saying the Treasury knows best about everything and there are no circumstances in which you can do something different.

Q61 Nigel Griffiths: You are making an exaggerated sweeping statement that the Treasury knows best. I am not suggesting the Treasury knows best: I am suggesting that it would be very good if there were a pool of contract managers. Forget "knows best on everything else". I would hope you do know best on this.

Mr Kingman: If I may, there may be, for example, a small PFI project where actually they do not need a full-time contract manager. I do not know whether that is justified or not. It is a reasonable judgment for someone to make. Our role is to say that it is a very good idea to have a full-time contract manager and you have to have a good reason if you want to do something different.

Q62 Nigel Griffiths: You have an operational taskforce. Why did it take half a decade of PFI to set that up?

Mr Stewart: We set it up at what we thought was the most appropriate time when there was some operational experience. That is not to say no support was available before then. We were providing ongoing support: we just formalised that and set up a formal OTF in March 2006.

Q63 Mr Williams: Only a couple of quick points. We are told that competitive tendering has not always being undertaken where it would have been possible. Why is that? Are they advised they should undertake competitive tendering or not?

Mr Kingman: They are very strongly advised that they should and we have a very strong presumption in favour of competition. There are three big projects where this did not happen. Two of them were prisons and the procuring authority took a judgment that operationally they could get the existing contractor to manage the risk within the prison context much better than they could getting an outside contractor to do it. Then they benchmarked that price against what they could get and they made a judgment that that was the right thing to do. I certainly would not exclude the possibility that that is a reasonable judgment for a procuring authority to make, but it should absolutely go through very clearly why it is not having competition, whether it has a good value for money reason for not having a competition.

Q64 Mr Williams: I see new guidance has been issued in 2007. PFI has been around since 1992. Why has it taken so long to produce new guidance?

Mr Kingman: We continually improve the guidance and there is a sort of archaeology of bits of guidance that we have issued over the years which I hope has continued to improve, learning the lessons as we learned them. PFI has in some form been around since 1992 and the great bulk of PFI projects really started coming on stream at the beginning of this decade.

Q65 Mr Williams: So what were the principal lessons the new guidance was intended to address?

Mr McKechnie: The standardisation of PFI contracts has been around for some time. The first one was issued in 1999 and it was version four that was issued in 2007. The two main improvements, with respect to the operational phase, were that it dealt with management fees, which have already come up in discussion, because they were also becoming an increasing problem over the previous years. As James mentioned earlier, it made a distinction between how to handle small changes, medium changes and large changes. The concern had been until then that some of the small changes were being handled in somewhat too bureaucratic a way and it was much more sensible to streamline that.

Mr Williams: Following on the point Nigel has been dealing with, the fact that a third of the hospitals and one in six schools do not have enough staff to manage their contracts properly, I am as bewildered as Nigel was, as to why you tolerated such a situation. How long have you been aware of the scale of this failure?

Q66 Chairman: I am amazed Mr Kingman that you do not know the answer. You have had to turn to somebody who has been imported from the private sector. I have to say Mr Kingman I have found your whole attitude during this hearing arrogant and

lackadaisical and I hope in the remaining few minutes you will try to do better and try to take this Committee more seriously.
Mr Kingman: I am sorry Chairman; I certainly do take this Committee seriously.

Q67 Chairman: You have been asked a direct question and you can perhaps now give us the courtesy of answering it. It says in your biography that you are responsible for £600 billion of public money. Right, well let us now have some answers.
Mr Kingman: I am afraid I do not know at what time the Treasury has been aware of this.

Q68 Mr Williams: Do you mean this came as a surprise to you when the National Audit Office mentioned it?
Mr McKechnie: It did not come as a surprise. We knew that some projects were under-resourced; we have known that for some time.

Q69 Mr Williams: So what did you do about it?
Mr McKechnie: We have done things such as set up the operational taskforce and we have encouraged projects to hire more staff. It is not just about numbers, it is also about getting the right skills and that has to do with the training programmes that have been run by the operational taskforce and indeed the NAO itself has run training programmes.

Q70 Mr Williams: In dealing with setting up a PFI contract, the costs that you incur in relation to the supplier are only part of the costs, are they not? There is the cost that you need to do just what is not being done, to monitor it. Is that cost allowed for anywhere, is financial provision made for adequate supervision?
Mr Kingman: The Treasury is not resourced to monitor every PFI project and we do not seek to monitor every PFI project.

Q71 Mr Williams: No, but you tell someone else to.
Mr Kingman: Departments certainly do and their auditors do and the NAO do and that would be true of a publicly procured project just as much as a PFI one.

Q72 Mr Williams: But it is therefore part of the cost of the PFI contract is it not to have it properly monitored.
Mr McKechnie: Yes.
Mr Kingman: Yes; absolutely.
Mr Williams: Do we know what that aspect is costing us?

Q73 Chairman: Well, what is the answer?
Mr McKechnie: We will need to write you a note on that. [1]

Q74 Chairman: What is the point of sending us a note? Why are you here?
Mr Kingman: We do not have that cost at our fingertips.

Q75 Mr Williams: It is a concealed cost and it looks as though either it is not being met by you or by whomever made the original arrangements or it is not being used properly by those to whom the resource is made available. Which is it?
Mr Kingman: I would strongly agree that it is part of the cost of the project and when a procuring authority looks at doing a PFI project, it should take that into account and I have every reason to think they do so.

Q76 Mr Williams: Who ultimately bears the responsibility for ensuring that something as important as this is applied across the 16% of hospitals and 16% of school that are not doing it? Are they being provided with the resources for it?
Mr Kingman: The responsibility lies with the relevant procuring authorities and ultimately with the relevant accounting officer in the department.
Mr Williams: We are not getting very far.
Chairman: No, we are not.

Q77 Mr Burstow: Just a couple of things I wanted to pick up on. The first thing is something you said earlier on in response to one of the questions that M Bacon was asking in relation to the role Mr McKechnie plays within the Department. You made a comment that we need people from the private sector in the Treasury because they know where the bodies are. Could you perhaps tell us which are the bodies you had in mind and then perhaps Mr McKechnie can tell us where they are?
Mr Kingman: I will ask him to do that. As the Committee has rightly pointed out on a number of occasions, PFI is complex and risky because there is the risk that the public sector frankly has the wool pulled over its eyes by sophisticated people from whom we are buying services. We think that part of the Treasury's role is to prevent that happening and that is what I mean by saying we need to have people who know how it all really works.

Q78 Mr Burstow: Is that one of the reasons that all of these extra charges that the Report has uncovered are being lumped on?

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[1] *Note by witness*: The Committee asked about the financial provision made for monitoring operational PFI projects. The value for money assessment for each PFI project must reflect the cost of ongoing monitoring, as set out in the Treasury's 2006 "Value for Money Assessment Guidance". I am afraid the aggregate cost of monitoring PFI is not recorded by the Treasury nor collected at a departmental level. This is because the ongoing monitoring of PFI projects (or in fact conventionally procured projects) is not recorded separately from the various other ongoing administration costs.

Mr Kingman: On the contrary. I would say that it is a very good example of the kind of thing that we are able to clamp down on because we work out that it is going on and we do something about it.

Q79 Mr Burstow: If they have been clamped down on, why was it they were revealed through the work the NAO has done?
Mr Kingman: Our guidance, which said that we thought these fees were unacceptable, was issued in March 2007, well before the NAO began their work.

Q80 Mr Burstow: But we have established that the guidance does not have much traction in a number of areas. We have established from some of the questioning about these project managers that the guidance is not being followed by all accounting officers and providers in that respect. To go back to that point about monitoring of compliance of the guidance, whilst perhaps accepting that you cannot monitor every single PFI contract that is being let, how do you satisfy yourself that in the generality of PFI contracts there is compliance with the guidance that is being issued?
Mr McKechnie: Let us take specifically the standardisation of PFI contracts, because there are some elements of that which are mandatory. We have a system of those mandatory things and one of them now is that there will be no SPV fees being paid. Those have to go through a system which is run for us jointly with PUK and if a project is unable to satisfy those criteria or does not want to satisfy those criteria, it either does not go ahead or comes to get a derogation. Those derogations are carefully considered as to whether there are appropriate project circumstances.

Q81 Mr Burstow: Presumably that process adds additional time to getting a change through and approved. How much extra time does that process of seeking derogation take?
Mr McKechnie: It depends. Some projects do not seek any derogations at all. Some projects do seek derogations and it may add some time but I hope it does not add too much.

Q82 Mr Burstow: Given that one of the points made in the Report, on page 17, paragraph 2.19, perhaps identifies a skills gap, particularly in respect of public sector managers when it comes to making assessments about the lifecycle, what steps are you taking to address that apparent skills deficit there to ensure that, when it comes to these sorts of processes, a proper assessment is being made of the lifecycle costs?
Mr McKechnie: Again I have to say that this is something that is being addressed in the training. The operational taskforce is doing some of that. The 4ps, which is the Local Government Association entity that looks after PFI projects, is doing some of that. The NAO itself does training programmes, the departmental PFUs assist in this. There is a number of different areas where training is provided to support the guidance which is issued on these subjects.

Q83 Mr Burstow: Over what period of time has that training been? When did it start? Was it before this Report was commissioned, after this Report was commissioned?
Mr McKechnie: It goes back a very long way; I do not know when it started.

Q84 Mr Burstow: Was it before 2006?
Mr McKechnie: Yes.

Q85 Mr Burstow: So given that it is training that has been around for some considerable time, how come the National Audit Office has found that this is still a deficiency? What is being done to react to this finding rather than just relying on what has been done in the past which clearly has not been sufficient?
Mr McKechnie: It is a question of rolling it out more, getting better traction with the training.

Q86 Mr Burstow: In the same way that the guidance gets traction when it comes to ensuring you have the right number of people monitoring contracts?
Mr McKechnie: Again, the training should address these issues. As John said earlier, we cannot enforce it but we can encourage it.

Q87 Mr Burstow: So it may not actually result in any change at all?
Mr McKechnie: I hope it will.
Mr Kingman: It would be wrong to think this guidance just disappears into the ether. We have good reason to believe that people do take notice of our guidance. I cannot tell you, because it is not the case, that there is 100% adherence to it.

Q88 Mr Burstow: But in a way you cannot tell us anything about compliance with the guidance because you have had to rely on the NAO Report to flag up these issues. I have not heard that there is a mechanism in place that actually enables you to know about compliance.
Mr Kingman: There are mechanisms and the SPV fees point we discussed earlier is a very good example of one that we dealt with well before the NAO began their work.

Q89 Keith Hill: I would just like to put a question to the NAO on this thorny issue of the presence or not of full-time management. Is there any correlation between the absence of full-time management and the performance of PFI projects in relation to the cost of change?
Mr Burr: May I just ask the study director?
Mr Robertson: We are not able to do that precise calculation but what we are observing is a wide range of staffing, particularly in larger projects, ten as the Report says, with annual unitary payments of more than £3 million each not being managed on a full-time basis. So while we cannot draw any systematic conclusions, it is our strong feeling that that is a risk to value for money. We cannot put a figure on it but it is undoubtedly a risk to value for money.

Q90 Keith Hill: So you have a feeling that it is a risk?
Mr Robertson: It must be in large projects, in these particular cases paying £3 million a year each, not to have a full-time manager.

Q91 Mr Bacon: I just have a couple more questions. First of all, I asked you Mr Kingman whether Mr McKechnie was indeed not a burden on the public purse, to which you answered, "We have a contract with Deloitte, as you would expect". Am I to take it from that—I do not want to use the word "burden"' because it is tendentious—am I to take it that the contract entails the Treasury paying Deloitte money for Mr McKechnie's services?
Mr Kingman: Yes.

Q92 Mr Bacon: How much?
Mr Kingman: That is a contractual matter between us and Deloitte I am afraid.

Q93 Mr Bacon: It is public money, is it not?
Mr Kingman: It is indeed public money.

Q94 Mr Bacon: Why can you not tell me?
Mr Kingman: It is not a figure I can disclose without discussing it with Deloitte.

Q95 Mr Bacon: Why not? The contract for the Treasury PFI building, for example, involved a lot of consultancy, all kinds of consultancy, and you paid a lot of money, many millions of pounds for it and that was public money. You disclosed that. Why is this any different? My salary is a matter of public record and that of all MPs.
Mr Kingman: It would not be appropriate for me to disclose; I am not in any way embarrassed about the number.

Q96 Mr Bacon: It might represent good value for money but it seems to me it is public money and we ought to be able to know what you are paying Deloitte for the Head of PFI Policy. It seems to me a perfectly reasonable question. Somebody else is nodding behind you.
Mr Kingman: I am very happy to discuss with Deloitte whether it is something they are willing for me to disclose.
Chairman: When you have discussed it, send us a note.[2]

Q97 Mr Bacon: I would like to go back to the net present value, £91 billion going forward, of annual unitary charge payments. How much of that is capital?
Mr Kingman: I am afraid I do not have that figure. I would be happy to send you a note on it.[3]
Mr McKechnie: The total capital value of the PFI programme is £56.9 billion.

Q98 Mr Bacon: So roughly £34 billion is other stuff of one kind or another. Is that right?
Mr McKechnie: You could say that.

Q99 Mr Bacon: So that is £56 billion in net present value terms, is it?
Mr McKechnie: £56 billion is the capital value. It is not a net present value figure, it is a capital value.
Mr Kingman: I am not sure that is on the same basis as the £91 billion.

Q100 Mr Bacon: I want to know what basis it is on because actually the cash payments going forward are £170 billion of cash going out, spread out over N number of years, are they not? What is the £56 billion in relation to that?
Mr McKechnie: For those projects, the capital value, in other words the amount that was spent to build those projects, is £56.9 billion.

Q101 Mr Bacon: Mr Kingman perhaps; you are the one who likes net present value so much. How much of the £91 billion going forward in net present value terms is comprised by things that are not capital?
Mr Kingman: I do not have that number, but I would be very happy to send you a note.

Q102 Mr Bacon: The thing that interests me about this is that plainly there is a difference between adding up all the gas bills and electricity bills in the household going forward for the next 30 years and paying your mortgage. On the other hand, there is a difference between that on the one hand and a legal contractual obligation to pay money in the form of an annual unitary charge on the other. When, once you have paid the money, whether the PFI contractor then goes and spends it on paying bank interest to his bank or whether he spends it on the cleaner is in one sense another matter. You have to, and you have a contractual obligation, pay this money over and the Chancellor has to find it in the budget, as though it were the coupon on a gilt. It is no different in that sense, is it? It is money you have to find so it is not debt in the narrow sense of bank borrowings or a bond, but it is debt that you have to find and pay going forward.
Mr Kingman: Yes, that is correct.

Q103 Mr Bacon: Going back to the question of the additions or the changes to the public sector net borrowing requirement, when do you think there will be more news on that?
Mr Kingman: We have said that it is our intention to move to this new accounting standard for 2008-2009, but what then happens is that auditors will need to study each project in each department under the new standard and that will in fact impact on the accounts that are published in the summer of 2009. How the ONS then interpret that data and how they incorporate that into the public finances and on what basis is a matter for the ONS and I do not know when they will do that.

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[2] *Note by witness*: The Committee asked how much public money was paid to Deloitte under the contract covering Gordon McKechnie's secondment to the Treasury. The Treasury pay Deloitte £150,000 per annum for Gordon McKechnie's full-time services as Head of PFI Policy.

[3] Ev 12

Q104 Mr Bacon: But there will then be subsequent exchanges; once the ONS has opined, there will be subsequent exchanges between you and departments who come to you and say the ONS's ruling means that they could have a problem unless you, the Treasury, amend their budget in the following way. You would be giving them the capital in order to give it back to you, would you not, but presumably you would have to do that?
Mr Kingman: Yes, I would expect there to be exchanges between us and departments about those issues.

Q105 Mr Bacon: But what I have just described about potentially having to allow the department to have more money in order to make a capital charge payment that admittedly would go back to the Treasury is correct, is it not? I have basically got the right end of the stick.
Mr Kingman: What I would certainly say is that if there is a material change that impacts on departments' budgets and on their ability to resource PFI deals, then we will have to ensure that arrangements are in place which make it possible for those deals to be pursued because we have said that we support the pipeline of present deals.

Q106 Mr Bacon: Finally, on this question of the operational taskforce, I think it is very interesting. When did you say it was set up? March 2006? It is fascinating that you only set it up in March 2006, because here you have this very clever complicated thing called PFI that has been set up and evolved over 15 years and really pretty recently in this lifecycle of this thing, you think: "Right, let's set up a taskforce to give people advice on a structured basis". I would have thought, given how complicated it was, given that it relates to local authorities and to central government, given that it relates to everything from prisons to government buildings, to hospitals and schools, that there would very early on have been somebody, because after all the Treasury is full of very bright people, saying let us set up something that captures the information and spreads it around because there is so much learning to get from all of this. The fact that you did not, the fact that you only got round to it in March 2006, suggests that what I was indicating earlier about the fact that actually this is not that interesting, the really boring business of running a contract is really secondary to going out and doing deals. Is that not true?
Mr Kingman: The important point is that the operational taskforce was set up, there was a whole variety of things that were in place before that, not least setting up Partnerships UK itself, which occurred well before that. There had been numerous taskforces to hold departments' hands in various ways. This was, as it were, a successor body to some of those predecessor bodies.
Mr Stewart: Two examples. We have run a helpdesk ever since we started up. What we grew to realise is that a growing proportion of the helpdesk calls were to do with operational matters for example. You love the subject of re-financing: there was a re-financing taskforce which was set up before March 2006, well before March 2006 and that became part of the operational taskforce.

Q107 Nigel Griffiths: If Deloitte had a client who had a £30 million investment in some new building, do you think that they would advise the client to lend on it if they did not have a project manager?
Mr McKechnie: Probably not.
Chairman: That concludes our hearing. This is clearly a very serious issue. In 2006 over £180 million was spent on making changes to existing PFI contracts. This was a point we made on benchmarking last year, Mr Kingman, you will remember. Clearly these projects do need better resources to manage these value for money changes and I hope you feel that, as a result of this hearing, we are going to get more action from the Treasury and Partnerships UK. Thank you very much.

Supplementary memorandum submitted by HM Treasury

Question 97 (Mr Richard Bacon): *Annual unitary charge payments*

Further to earlier exchanges about the whole-life cost of PFI contracts, the Committee wanted to know how much of the total unitary charges were made up of capital payments.

Taking no account of inflation or time preference, the sum total of unitary charge payments over the next 30 years is £180.7 billion based on the latest published data from November 2007. I have previously emphasised to the committee—and will not labour the point here—that this figure is not meaningful as it adds together numbers in money of very different years; expressed in today's terms, using the standard discounting methodology, the aggregate total is £99.9 billion.

This £99.9 billion in present-value unitary charge payments relates to assets with a total capital value of £56.9 billion (under accounting rules set by the independent bodies, £23.9 billion of this capital is considered to be on the public sector's balance sheet). The £99.9 billion also includes payment for the associated services, such as cleaning, catering and maintenance, associated with running these assets.

Letter from John Kingman, Second Permanent Secretary, HM Treasury

I should also like to take this opportunity, since this question came up a number of times at the hearing, to set out some of the issues around what powers the Treasury has and does not have to compel procuring authorities and what alternative support we can provide.

MANDATORY PROCEDURE AND BEST PRACTICE GUIDANCE

Prior to a PFI project being signed, the Treasury stipulates that procurement guidance, including the value for money assessment and the standardised PFI contract must be adhered to, as a condition of being awarded funds, for local authorities and central departments exceeding their delegated limits. These documents are therefore mandatory for PFI projects.

After the PFI credits are allocated or the project approved, and the contract has been signed, the Treasury could not withhold the flow of credit to a project without prompting a contractual default. Therefore we cannot practically enforce constraints on issues such as the staffing levels of a contract management team, which will in any event invariably change over time and must be tailored to the individual circumstances of the project in question. We can and do strongly encourage and guide; but in the end, it is right that Departments and local authorities should be free to make (and defend) their own operational decisions since only they can know all the circumstances of each project. Treasury second-guessing or micro-managing would not be desirable because the Treasury cannot possibly be familiar with all the circumstances and pressures on each project, in the way that the authority responsible for it is. Nor, I am afraid, is the Treasury remotely resourced to undertake the kind of direct policing of Departments' stewardship of individual projects which some members of the Committee seemed to be looking for—for which responsibility, as we would see it, properly and necessarily lies with the relevant Accounting Officer.

What we can and do provide over the whole life of a project is detailed best practice guidance, training and a helpdesk service to provide advice to operational managers. We also support the departmental private finance units which monitor the operational performance of their projects. The best practice guidance includes Operational Taskforce Note 3, which sets out a change protocol for older projects and Operational Taskforce Note 2, which gives advice on a range of operational management issues including the appropriate level of contract management resource. We have seen that this support and guidance has real impact, with many schools, including some quoted in the NAO's Report, already benefiting from change protocols negotiated using these principles. The messages in our guidance are also regularly reinforced through training and conferences.

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