National Audit Office submission to the *Inquiry into the Welsh Government's capital funding sources*

NAO Reports

Private Finance Initiative Specific Reports:

1. PFI and PF2, January 2018

There are currently over 700 operational PFI and PF2 deals, with a capital value of around £60 billion. Annual charges for these deals amounted to £10.3 billion in 2016-17. Even if no new deals are entered into, future charges which continue until the 2040s amount to £199 billion. This briefing report looked at the rationale, costs and benefits of the Private Finance Initiative; the use of and impact of PFI, and ability to make savings from operational contracts; and the introduction of PF2.

The NAO found that for PFI to present value for money, the higher costs of the model (for example higher financing, insurance and fees to lenders) need to be offset by the benefits of the model which include certainty over construction costs, operational efficiency and higher asset quality. However, the Treasury has not collected any data on whether these benefits have materialised in practice. The NAO also found that the new PF2 model did not address many of the failings of the previous model, such as the accounting and budgeting incentives which encourage departments to use PFI rather than existing capital budgets.

2. Savings from operational PFI contracts, November 2013

In July 2011, the Government announced plans to deliver £1.5 billion of savings across operational PFI projects in England. As at June 2013, departments had reported £1.6 billion of formally agreed savings to the Treasury, as well a pipeline of further expected savings yet to be formally agreed. Most of these savings are forecast future savings, which will be realised over the remaining years of the contract, rather than immediately. This report examined the reliability of these reported savings.

The NAO found sufficient evidence for £1.2 billion of the forecast signed savings, partial evidence for £0.05 billion of the forecast signed savings and insufficient evidence for £0.09 billion of savings. Furthermore, of the 684 operational PFI contracts, 566 have not yet reported any savings to the Treasury.

3. Review of the VFM assessment process for PFI, October 2013

The Treasury Committee asked the NAO to undertake an analysis of the value-for-money (VFM) assessment process and model for PFI. The VFM assessment processes involves a quantitative assessment, supported by a standardised spreadsheet-based model, and a qualitative assessment – a set of questions around the viability, desirability and achievability of the project. The purpose of the VFM assessment is to determine whether financing public investment projects using PFI provides better VFM than conventional government borrowing.

The NAO found that the VFM assessment model favoured the use of PFI. This is because the model did not reflect the cost of government borrowing, meaning the costs of PFI are compared against a department's existing budget allocation. Since PFI costs are spread out over time, compared to the upfront costs of traditional public financing, the present value calculation benefits PFI. In addition, key assumptions in the model, such as optimism bias, were not supported by empirical evidence. The Treasury withdrew the VFM quantitative tool in December 2012 when PF2 was introduced. A replacement model and guidance were never published with departments needing to use the Green Book.

4. Equity investment in privately financed projects, February 2012

Banks or bondholders provide around 90 per cent of the project funding for a PFI project. Investors provide the remainder as either risk capital or equity, which will be lost first if the project runs into difficulty. Investors are rewarded for taking risks, which include the costs of bidding; contractors may fail to perform; or that other project costs the investors bear the risk for will be higher than envisaged. However, the investors limit their risk by passing it to their contractors. Publicly available information on investors' risks and rewards from private finance projects is limited. This report examined whether investors positively contribute to delivering the specified public services, the risks investors bear and whether returns generated are transparent and reasonable.

The NAO found that public sector authorities have not been equipped with the skills and information required to challenge investors' proposed returns rigorously. Analysis by the NAO has shown that investors selling shares early have typically earned annual returns of between 15 per cent and 30 per cent.

5. [Procurement of the M25 private finance contract](), November 2010

This report examined the Highways Agency's PFI contract to widen the M25 as a way of reducing congestion.[1] In May 2009, the Agency signed a 30-year PFI contract with Connect Plus which required the widening of two sections of the M25 (around 40 miles), and a refurbishment to the Hatfield Tunnel.

The NAO concluded that the contract could have been materially better value for money. An 18-month delay in preparing and finalizing the contract meant it was let in May 2009—the height of the credit crisis. This increased the cost of the deal by £660 million to £3.4 billion. The NAO estimated that £100 million of savings could be generated through refinancing the PFI project debt.

6. Private Finance Projects, October 2009

This report was prepared for the Lords Economic Affairs Committee to help with its inquiry into the use of private finance in the delivery of public services. It is a summary of some of the key findings on PFI projects from 72 NAO reports across 12 years. The report covers the background of PFI, how it works in practise, the incentives to use it, how VFM is assessed and how projects are managed.

The key messages include: private finance can deliver benefits but is not suitable at any price nor in every circumstance, institutional incentives have encouraged the use of private finance, departmental justifications for using private finance are often unclear and the delivery of real risk transfer depends on a good contract.

7. A Framework for evaluating the implementation of Private Finance Initiative projects, May 2006

This report set out the issues that need to be considered in evaluating whether PFI projects have been well thought through and then implemented effectively. The report presents an evaluation framework covering the lifecycle of projects from initial strategic analysis to the mature operational phase. The Framework is intended for use primarily by evaluators, but it will also be of assistance to those implementing PFI projects on a day to day basis.

Other reports of interest:

8. Improving the A303 between Amesbury and Berwick Down, May 2019

In December 2014 the Department for Transport committed to building a tunnel of at least 3.3 kilometres (2.1 miles) beneath the World Heritage Site at Stonehenge. The project was designed to reduce congestion along the A303 between Amesbury and Berwick Down in Wiltshire. The project, which is still at an early stage, is expected to cost between £1.5 billion to £2.4 billion. This report makes early observations on the progress and risks of constructing a tunnel.

The project was delayed because of decisions on how the project will be funded. At first, the project was to be publicly financed. However, in 2016 HM Treasury instructed the Department for Transport to use private finance, which delayed the planned start of works by 21 months (as the PF2 contract was being prepared). In October 2018, the Chancellor of the Exchequer cancelled future PF2 deals, including for the A303 project. There is now uncertainty over

[1] The Highways Agency was replaced by Highways England in 2015.

how this project will be funded—HM Treasury will make its decision on whether to provide additional funding for the A303 alongside all other capital projects as part of the Spending Review 2019.

9. Hinkley Point C, June 2017

The Department for Business, Energy & Industrial Strategy announced on 29 September 2016 that it had reached a deal to support construction of the Hinkley Point C (HPC) nuclear power station. HPC will be the first new nuclear power station built in the UK since 1995 and will generate around 7% of Great Britain's electricity requirement from the mid-2020s. In recent years, it has not been commercially viable for private developers to build new generating capacity in the UK, including nuclear power stations, without government support. To support HPC, the government provided a 'contract for difference' (CfD) which is a guaranteed price—if the market price is lower, a top-up payment is provided, which is ultimately paid for by electricity bill-payers.

The NAO found that there is a risk that the government will need to provide further financial support to HPC and it will not be known for decades whether Hinkley Point C will be value for money.

10. Review of the Thames Tideway Tunnel, March 2017

Thames Tideway Tunnel is a £4.2 billion project to construct a 25 km sewer tunnel running from West to East London to reduce sewage overflows into the Thames. This report looked at the decision to proceed with the tunnel, programme performance and cost estimates.

The NAO found that it is still unclear how much Thames Water customers will pay for the construction of the tunnel. Tunnel costs added £13 a year to the average household bill for Thames Water customers in 2016-17. The company forecasts the bill impact will peak at between £20 and £25 by the early 2020's. The government also provided a contingent support package which seeks to mitigate some risks, transferring liability to the taxpayer if those risks materialise. The government considers that a call on the support package is highly unlikely, although it estimates that the impact could be very large (£6.6 billion in its 'reasonable worst case' scenario) if several risks materialise.

11. The choice of finance for capital investment, March 2015

This briefing paper considers how government decides how to finance capital investment projects. It describes several factors affecting central government capital investment decisions, including budgeting, project appraisal, procurement, finance and accounting treatment. Based on these factors the NAO made a number of observations about the relative flexibility, transparency and other attributes of different financing choices, including cost. The report looks at capital investment using PFI, the project specific risks and the future implications of using this method of financing.

The NAO found that if departments have insufficient budget to fund the construction of an asset, private finance may sometimes be the only option for investment, even though the cost of servicing private finance debt is approximately double that of government debt. The report also noted that despite a long period of low interest rates and the recovery in financial markets, the refinancing of PFI deals to reduce borrowing costs is relatively uncommon.

12. UK Guarantees scheme for infrastructure, January 2015

This report looked at the UK Guarantee Scheme, which was launched in 2012 to address adverse credit conditions and the lack of private finance, in order to prevent delays in investment in UK infrastructure projects that may have stalled. Since then market conditions have improved. Under the Scheme, the Treasury guarantees that lenders to infrastructure projects will be repaid in full and on time, irrespective of project performance. The Scheme transfers project risk to government and ultimately the taxpayer, in return for a fee.

The NAO found that the Treasury does not apply its eligibility criteria strictly, since it has not put in place objective tests to check whether projects genuinely need a guarantee. Furthermore, the Treasury also does not consider the overall value for money of the projects, but instead uses a narrow test that the guarantee fee must represent a market price for the risk.

13. Infrastructure investment: the impact on consumer bills, November 2013

HM Treasury has identified £310 billion of planned investment in UK infrastructure that is needed to replace ageing assets, help meet policy commitments, and meet our growing population's needs, over the next decade and beyond. New infrastructure has increasingly been privately financed and paid for by consumers through their bills. HM

Treasury expects at least two-thirds of the £310 billion of expected infrastructure to be wholly financed, owned and operated by private companies. This report considers the costs of investment in infrastructure which will be financed privately and repaid through consumer bills.

The NAO found that the government and regulators do not know by how much overall expected new investment by the private sector in infrastructure will increase household utility bills and whether bills will be affordable. The report raises concerns over the lack of a common approach across sectors to forecasting bills or measuring affordability.